NETGEAR, INC
Form 10-K
March 01, 2007

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

**Form 10-K**

| | |
|---|---|
| þ | **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**<br>**For the fiscal year ended December 31, 2006** |
| o | **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**<br>**For the transition period from to** |

**Commission file number 000-50350**

**NETGEAR, Inc.**
*(Exact name of registrant as specified in its charter)*

| | |
|---|---|
| **Delaware**<br>*(State or other jurisdiction of incorporation or organization)* | **77-0419172**<br>*(I.R.S. Employer Identification No.)* |
| **4500 Great America Parkway, Santa Clara, California**<br>*(Address of principal executive offices)* | **95054**<br>*(Zip Code)* |

**(Registrant s telephone number, including area code)**
**(408) 907-8000**

**Securities registered pursuant to Section 12(b) of the Act:**
**Common Stock, par value $0.001**

**Securities registered pursuant to 12(g) of the Act:**
**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant as of July 2, 2006, was approximately $643,599,531. Such aggregate market value was computed by reference to the closing price of the common stock as reported on the Nasdaq National Market on June 30, 2006 (the last business day of the Registrant s most recently completed fiscal second quarter).

The number of outstanding shares of the registrant s Common Stock, $0.001 par value, was 34,323,928 shares as of February 16, 2007.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for the Registrant s 2007 Annual Meeting of Stockholders are incorporated by reference in Part III of this Form 10-K.

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# PART I

This Form 10-K, including Management s Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 below, includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements other than statements of historical facts contained in this Form 10-K, including statements regarding our future financial position, business strategy and plans and objectives of management for future operations, are forward-looking statements. The words believe, may, will, estimate, continue, anticipate, intend, should, plan, expect and similar e relate to us, are intended to identify forward-looking statements. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. These forward-looking statements are subject to a number of risks, uncertainties and assumptions described in Risk Factors in Part I, Item 1A below, and elsewhere in this Form 10-K, including, among other things: the future growth of the small business and home markets; speed of adoption of wireless networking worldwide; our business strategies and development plans; our successful introduction of new products and technologies; future operating expenses and financing requirements; and competition and competitive factors in the small business and home markets. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this Form 10-K may not occur and actual results could differ materially from those anticipated or implied in the forward-looking statements. All forward-looking statements in this Form 10-K are based on information available to us as of the date hereof and we assume no obligation to update any such forward-looking statements. The following discussion should be read in conjunction with our consolidated financial statements and the accompanying notes contained in this Form 10-K.

## Item 1. *Business*

### General

We design, develop and market networking products for home users and for small business, which we define as a business with fewer than 250 employees. We are focused on satisfying the ease-of-use, quality, reliability, performance and affordability requirements of these users. Our product offerings enable users to connect and communicate across local area networks and the World Wide Web and share Internet access, peripherals, files, digital multimedia content and applications among multiple personal computers, or PCs, and other Internet-enabled devices. We sell our products primarily through a global sales channel network, which includes traditional retailers, online retailers, direct market resellers, or DMRs, value added resellers, or VARs, and broadband service providers. A discussion of factors potentially affecting our operations is set forth in Risk Factors, under Part I, Item 1A of this Form 10-K.

We were incorporated in Delaware on January 8, 1996. Our principal executive offices are located at 4500 Great America Parkway, Santa Clara, California 95054, and our telephone number at that location is (408) 907-8000. We file reports, proxy statements and other information with the Securities and Exchange Commission, or SEC, in accordance with the Securities Exchange Act of 1934, as amended, or the Exchange Act. You may read and copy our reports, proxy statements and other information filed by us at the public reference room of the SEC located at 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information about the public reference rooms. Our filings are also available to the public over the Internet at the SEC s website at *http://www.sec.gov*, and, as soon as practicable after such reports are filed with the SEC, free of charge through a hyperlink on our Internet website at *http://www.netgear.com.* Information contained on the website is not a part of this Form 10-K.

**Markets**

Our objective is to be the leading provider of innovative networking products to the small business and home markets. A number of factors are driving today s increasing demand for networking products within small businesses and homes. As the number of computing devices, such as PCs, has increased in recent years, networks are being deployed in order to share information and resources among users and devices. This information and resource sharing occurs internally, through a local area network, or LAN, or externally, via the Internet. To take

advantage of complex applications, advanced communication capabilities and rich multimedia content, users are upgrading their Internet connections by deploying high-speed broadband access technologies. Users also seek the convenience and flexibility of operating their PCs, laptops and related computing devices in a more mobile, or wireless, manner. Finally, as the usage of networks, including the Internet, has increased, users have become much more focused on the security of their connections and the protection of the data within their networks.

Small business and home users demand a complete set of wired and wireless networking and broadband solutions that are tailored to their specific needs and budgets and also incorporate the latest networking technologies. These users require the continual introduction of new and refined products. Small business and home users often lack extensive IT resources and technical knowledge and therefore demand plug-and-play or easy-to-install and use solutions. These users seek reliable products that require little or no maintenance, and are supported by effective technical support and customer service. We believe that these users also prefer the convenience of obtaining a networking solution from a single company with whom they are familiar; as these users expand their networks, they tend to be loyal purchasers of that brand. In addition, purchasing decisions of users in the small business and home markets are also driven by the affordability of networking products. To provide reliable, easy-to-use products at an attractive price, we believe a successful supplier must have a company-wide focus on the unique requirements of these markets and the operational discipline and cost-efficient company infrastructure and processes that allow for efficient product development, manufacturing and distribution.

## Sales Channels

We sell our products through multiple sales channels worldwide, including traditional retailers, online retailers, wholesale distributors, DMRs, VARs, and broadband service providers.

*Retailers.* Our retail channel primarily supplies products that are sold into the home market. We sell directly to, or enter into consignment arrangements with, a number of our traditional retailers. The remaining traditional retailers, as well as our online retailers, are fulfilled through wholesale distributors, the largest of which are Ingram Micro, Inc. and Tech Data Corporation. We work directly with our retail channels on market development activities, such as co-advertising, in-store promotions and demonstrations, instant rebate programs, event sponsorship and sales associate training, as well as establishing store within a store websites and banner advertising.

*DMRs and VARs.* We primarily sell into the small business market through an extensive network of DMRs and VARs. Our DMRs include companies such as CDW and Insight. VARs include our network of registered Powershift Partners, or resellers who achieve prescribed quarterly sales goals and as a result may receive sales incentives, marketing support and other program benefits from us. Our products are also resold by a large number of smaller VARs whose sales are not large enough to qualify them for our Powershift Partner program. Our DMRs and VARs generally purchase our products through our wholesale distributors, primarily Ingram Micro, Inc. and Tech Data Corporation.

*Broadband Service Providers.* We also supply our products directly to broadband service providers in the United States and internationally, who distribute our products to their small business and home subscribers.

We derive the majority of our net revenue from international sales. International sales as a percentage of net revenue grew from 56% in 2005 to 62% in 2006. Sales in Europe, Middle-East and Africa, or EMEA, grew from $200.0 million in 2005 to $298.2 million in 2006, representing an increase of approximately 49% during that period. We continue to penetrate new markets such as Brazil, Eastern Europe, India, and the Middle-East. The table below sets forth our net revenue by major geographic region.

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2004 | Percentage Change | 2005 | Percentage Change | 2006 |
| | (In thousands, except percentage data) | | | | |
| United States | $ 186,836 | 7% | $ 199,208 | 11% | $ 220,440 |
| EMEA | 159,615 | 25% | 199,951 | 49% | 298,234 |
| Asia Pacific and rest of world | 36,688 | 38% | 50,451 | 9% | 54,896 |
| Total | $ 383,139 | 17% | $ 449,610 | 28% | $ 573,570 |

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Revenues from significant customers as a percentage of our total revenues for the years ended December 31, 2004, 2005 and 2006 were as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2004 | 2005 | 2006 |
| Ingram Micro, Inc. | 27% | 25% | 19% |
| Tech Data Corporation | 18% | 17% | 16% |

**Product Offerings**

Our product line consists of wired and wireless devices that enable Ethernet networking, broadband access, and network connectivity. These products are available in multiple configurations to address the needs of our customers in each geographic region in which our products are sold.

*Ethernet networking.* Ethernet is the most commonly used wired network protocol for connecting devices in today s home and small-office networks. Products that enable Ethernet networking include:

switches, which are multiple port devices used to network PCs and peripherals;

network interface cards, adapters and bridges, that enable PCs and other equipment to be connected to a network;

peripheral servers, such as print servers that manage printing on a network, and disk servers which manage shared disks on the network; and

VPN firewalls, which provide secure remote network access and anti-virus and anti-spam capabilities.

*Broadband Access.* Broadband is a transmission medium capable of moving more information and at a higher speed over public networks than traditional narrowband frequencies. Products that enable broadband access include:

routers, which are used to connect two networks together, such as the home or office network and the Internet;

gateways, or routers with an integrated modem, for Internet access;

IP telephony products, used for transmitting voice communications over a network; and

wireless gateways, or gateways that include an integrated wireless access point.

*Network Connectivity.* Products that enable network connectivity and resource sharing include:

wireless access points, which provide a wireless link between a wired network and wireless devices;

wireless network interface cards and adapters, which enable devices to be connected to the network wirelessly;

media adapters, which connect PCs, stereos, TVs and other equipment to a network;

wi-fi phones, which enable users to make voice calls over the Internet;

- network attached storage, which enables file sharing and remote storage over a local area network; and

- powerline adapters and bridges, which enable devices to be connected to the network over existing electrical wiring.

We design our products to meet the specific needs of both the small business and home markets, tailoring various elements of the product design, including component specification, physical characteristics such as casing, design and coloration, and specific user interface features to meet the needs of these markets. We also leverage many of our technological developments, high volume manufacturing, technical support and engineering infrastructure across our markets to maximize business efficiencies.

Our products that target the small business market are designed with an industrial appearance, including metal cases, and for some product categories, the ability to mount the product within standard data networking racks. These products typically include higher port counts, higher data transfer rates and other performance characteristics designed to meet the needs of a small business user. For example, we offer data transfer rates up to ten Gigabit per second for our business products to meet the higher capacity requirements of business users. Some of these products are also designed to support transmission modes such as fiber optic cabling, which is common in more sophisticated business environments. Security requirements within our products for small business broadband access include firewall and virtual private network capabilities that allow for secure interactions between remote offices and business headquarter locations. Our connectivity product offerings for the small business market include enhanced security and remote configurability often required in a business setting.

Our products for the home user are designed with pleasing visual and physical aesthetics that are more desirable in a home environment. For example, our RangeMax series of routers have distinctive blue antenna-indicator LEDs in a circular dome atop a sleek white plastic casing. Our connectivity offerings for use in the home are generally at a lower price than higher security and configurability wireless offerings for the small business market. Our products for facilitating broadband access in the home are available with features such as parental control capabilities and firewall security, to allow for safer, more controlled Internet usage in families with children. Our broadband products designed for the home market also contain advanced installation software that guides a less sophisticated data networking user through the installation process with their broadband service provider, using a graphical user interface and simple point and click operations. Our connectivity product offerings for the home include powerline data transmission modes which allow home users to take advantage of their existing electrical wiring infrastructure for transmitting data among network components.

**Competition**

The small business and home networking markets are intensely competitive and subject to rapid technological change. We expect competition to continue to intensify. Our principal competitors include:

- within the small business networking market, companies such as 3Com, Allied Telesyn, the Linksys division of Cisco Systems, Dell Computer, D-Link, Hewlett-Packard, Nortel Networks, and SonicWall, Inc.; and

- within the home networking market, companies such as Belkin Corporation, D-Link, and the Linksys division of Cisco Systems.

Other current competitors include numerous local vendors such as Siemens Corporation and AVM in Europe, Corega International SA and Melco, Inc./Buffalo Technology in Japan and TP-Link in China, and broadband equipment suppliers such as ARRIS Group, Inc., Motorola, Inc., Sagem Corporation, Scientific Atlanta, a Cisco company, Terayon Communications Systems, Inc., Thomson Corporation and 2Wire, Inc. Our potential competitors include consumer electronics vendors and telecommunications equipment vendors who could integrate networking capabilities into their line of products, and our channel customers who may decide to offer self-branded networking products. We also face competition from service providers who may bundle a free networking device with their broadband service offering, which would reduce our sales if we are not the supplier of choice to those service providers.

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources. As a result, they may have more advanced technology, larger distribution channels, stronger brand names, better customer service and access to more customers than we do. For example, Dell Computer has significant brand name recognition and has an advertising

presence substantially greater than ours. Similarly, Cisco Systems is well recognized as a leader in providing networking solutions to businesses and has substantially greater financial resources than we do. Several of our competitors, such as the Linksys division of Cisco Systems and D-Link, offer a range of products that directly compete with most of our product offerings. Several of our other competitors primarily compete in a more limited manner. For example, Hewlett-Packard sells networking products primarily targeted at larger businesses or enterprises. However, the competitive environment in which we operate changes rapidly. Other large companies with significant resources could become direct competitors, either through acquiring a competitor or through internal efforts.

We believe that the principal competitive factors in the small business and home markets for networking products include product breadth, size and scope of the sales channel, brand name, timeliness of new product introductions, product performance, features, functionality and reliability, price, ease-of-installation, maintenance and use, and customer service and support.

To remain competitive, we believe we must invest significant resources in developing new products, enhancing our current products, expanding our sales channels and maintaining customer satisfaction worldwide.

**Research and Development**

As of December 31, 2006, we had 62 employees engaged in research and development. We believe that our success depends on our ability to develop products that meet the changing user needs and to anticipate and proactively respond to evolving technology in a timely and cost-effective manner. Accordingly, we have made investments in our research and development department in order to effectively evaluate new technologies and develop and test new products. Our research and development employees work closely with our technology and manufacturing partners to bring our products to market in a timely, high quality and cost-efficient manner.

We identify and qualify new technologies, and we work closely with our various technology suppliers and manufacturing partners to develop products using one of the two manufacturing methodologies described below.

*ODM.* Under the original design manufacturer, or ODM, methodology, which we use for most of our product development activities, we define the product concept and specification and perform the technology selection. We then coordinate with our technology suppliers while they develop the chipsets, software and detailed circuit designs. Once prototypes are completed, we work with our partners to complete the debugging and systems integration and testing. Our ODMs are responsible for conducting all of the regulatory agency approval processes required for each product. After completion of the final tests, agency approvals and product documentation, the product is released for production.

*OEM.* Under the original equipment manufacturer, or OEM, methodology, which we use for a limited number of products, we define the product specification and then purchase the product from OEM suppliers that have existing products fitting our design requirements. Once a technology supplier s product is selected, we work with the OEM supplier to complete the cosmetic changes to fit into our mechanical and packaging design, as well as our documentation and graphical user interface, or GUI, standard. The OEM supplier completes regulatory approvals on our behalf. When all design verification and regulatory testing is completed, the product is released for production.

Our internal research and development efforts focus on improving the reliability, functionality, cost and performance of our partner s designs. In addition, we define the industrial design, GUI, documentation and installation process of our products. In August 2006, we acquired SkipJam Corp. ( SkipJam ), a developer of networkable media devices for integrating television into the home network and to the Internet for entertainment content streaming. Our total research and development expenses were $18.4 million in 2006, $12.8 million in 2005 and $10.3 million in 2004.

**Manufacturing**

Our primary manufacturers are ASUSTek Computer, Inc., Cameo Communications Inc., Delta Networks Incorporated, Gemtek Technology Co., Hon Hai Precision Industry Co., Ltd. (more commonly known as Foxconn Corporation), and SerComm Corporation, all of which are headquartered in Taiwan. The actual manufacturing of our products occurs primarily in mainland China, and is supplemented with manufacturing in Taiwan on a select basis. We distribute our manufacturing among these key suppliers to avoid excessive concentration with a single supplier. In

addition to their responsibility for the manufacturing of our products, our manufacturers purchase all necessary parts and materials to produce complete, finished goods. To maintain quality standards for our suppliers, we have established our own product testing and quality organization based in Hong Kong and mainland China. They are responsible for auditing and inspecting product quality on the premises of our ODMs and OEMs.

We currently outsource warehousing and distribution logistics to four third-party providers who are responsible for warehousing, distribution logistics and order fulfillment. In addition, these parties are also responsible for

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some re-packaging of our products including bundling components to form kits, inserting appropriate documentation and adding power adapters. APL Logistics Americas, Ltd. in City of Industry, California serves the Americas region, Kerry Logistics Ltd. in Hong Kong serves the Asia Pacific region, and Furness Logistics BV and ModusLink BV in the Netherlands serve the EMEA region.

**Sales and Marketing**

As of December 31, 2006, we had 187 employees engaged in sales and marketing. We work directly with our customers on market development activities, such as co-advertising, in-store promotions and demonstrations, instant rebate programs, event sponsorship and sales associate training. We also participate in major industry trade shows and marketing events. Our marketing department is comprised of our product marketing and corporate marketing groups.

Our product marketing group focuses on product strategy, product development roadmaps, the new product introduction process, product lifecycle management, demand assessment and competitive analysis. The group works closely with our sales and research and development groups to align our product development roadmap to meet customer technology demands from a strategic perspective. The group also ensures that product development activities, product launches, channel marketing program activities, and ongoing demand and supply planning occur in a well-managed, timely basis in coordination with our development, manufacturing, and sales groups, as well as our ODM, OEM and sales channel partners.

Our corporate marketing group is responsible for defining and building our corporate brand. The group focuses on defining our mission, brand promise and marketing messages on a worldwide basis. This group also defines the marketing approaches in the areas of advertising, public relations, events, channel programs and our web delivery mechanisms. These marketing messages and approaches are customized for both the small business and home markets through a variety of delivery mechanisms designed to effectively reach end-users in a cost-efficient manner.

We conduct much of our international sales and marketing operations through NETGEAR International, Inc. and NETGEAR International Ltd., our wholly-owned subsidiaries which have formed sales and marketing subsidiaries and branch offices worldwide.

**Technical Support**

We provide technical support to our customers through a combination of limited number of permanent employees and extensive use of subcontracted, out-sourcing resources. Although we design our products to require minimal technical support, if a customer requires assistance, we generally provide free, high-quality technical advice worldwide over the phone and Internet for a specified period of time, generally less than one year. We currently subcontract first level and the majority of second level technical support for our products and as of December 31, 2006, we were utilizing approximately 720 part-time and full-time individuals to answer customers technical questions. First level technical support represents the first team member a customer will reach with questions; and, typically, these individuals are able to answer routine technical questions. If they are unable to resolve the issue, the first level support member will forward the customer to our more highly trained second level support group. The most difficult or unique questions are forwarded to NETGEAR employees. This 20 person in-house staff provides the most sophisticated support when customer issues require escalation.

In addition to providing third level technical support, these internal NETGEAR employees design our technical support database and are responsible for training and managing our outsourced sub-contractors. We utilize the information gained from customers by our technical support organization to enhance our current and future products by providing bug fixes, simplifying the installation process and planning future product needs.

In North America, the United Kingdom, South East Asia and Australia, the first and second level technical support in English is provided 24 hours a day, 7 days a week, 365 days a year. Local language support is also available during local business hours in Austria, Switzerland, China, France, Germany, Italy, Japan, Korea, Spain, Thailand, Brazil, Hungary, Russia, the Nordic countries, Belgium and the Netherlands.

**Intellectual Property**

We believe that our continued success will depend primarily on the technical expertise, speed of technology implementation, creative skills and management abilities of our officers and key employees, plus ownership of a limited but important set of copyrights, trademarks, trade secrets and patents. We primarily rely on a combination of copyright, trademark and trade secret and patent laws, nondisclosure agreements with employees, consultants and suppliers and other contractual provisions to establish, maintain and protect our proprietary rights. We hold two issued patents that expire between years 2023 and 2025 and currently have a number of pending United States patent applications related to technology and products offered by us. In addition, we rely on third-party licensors for patented hardware and software license rights in technology that are incorporated into and are necessary for the operation and functionality of our products. We typically retain limited exclusivity over intellectual property we jointly develop with our OEMs and ODMs. Our success will depend in part on our continued ability to have access to these technologies.

We have trade secret rights for our products, consisting mainly of product design, technical product documentation and software. We also own, or have applied for registration of trademarks, in connection with our products, including NETGEAR, the NETGEAR logo, the NETGEAR Digital Entertainer logo, the Gear Guy logo, Connect with Innovation, Everybody s connecting, IntelliFi, ProSafe, RangeMax and Smart Wizard, in the United States and internationally. We have registered several Internet domain names that we use for electronic interaction with our customers including dissemination of product information, marketing programs, product registration, sales activities, and other commercial uses.

**Employees**

As of December 31, 2006, we had 388 full-time employees, with 207 in sales, marketing and technical support, 62 in research and development, 53 in operations, and 66 in finance, information systems and administration. We also utilize a number of temporary staff, including 15 full-time contractors, to supplement our workforce. We have never had a work stoppage among our employees and no personnel are represented under collective bargaining agreements. We consider our relations with our employees to be good.

**Website Posting of SEC Filings**

Our website provides a link to our SEC filings, which are available on the same day such filings are made. The specific location on the website where these reports can be found is http://www.investor.netgear.com/edgar.cfm. Our website also provides a link to Section 16 filings which are available on the same day as such filings are made.

**Executive Officers of the Registrant**

The following table sets forth the names, ages and positions of our executive officers (who are subject to Section 16 of the Securities Exchange Act of 1934) as of March 1, 2007.

| Name | Age | Position |
|---|---|---|
| Patrick C.S. Lo | 50 | Chairman and Chief Executive Officer |
| Mark G. Merrill | 52 | Chief Technology Officer |
| Michael F. Falcon | 50 | Senior Vice President of Operations |
| Christine M. Gorjanc | 50 | Chief Accounting Officer |
| Albert Y. Liu | 34 | Vice President, Legal and Corporate Development |

| | | |
|---|---|---|
| Charles T. Olson | 51 | Senior Vice President of Engineering |
| David Soares | 40 | Senior Vice President of Worldwide Sales and Support |
| Michael A. Werdann | 38 | Vice President of Americas Sales |
| Deborah A. Williams | 49 | Senior Vice President, Marketing and Chief Marketing Officer |

*Patrick C.S. Lo* has served as our Chairman and Chief Executive Officer since March 2002. From September 1999 to March 2002, he served as our President, and since our inception in 1996 to September 1999, he served as Vice President and General Manager. Mr. Lo joined Bay Networks, a networking company, in August 1995 to launch a division targeting the small business and home markets and established the NETGEAR division in January 1996. From 1983 until 1995, Mr. Lo worked at Hewlett-Packard Company, a computer and test equipment company, where he served in various management positions in software sales, technical support, network product management, sales support and marketing in the United States and Asia, including as the Asia/Pacific marketing director for Unix servers. Mr. Lo received a B.S. degree in Electrical Engineering from Brown University.

*Mark G. Merrill* has served as our Chief Technology Officer since January 2003. From September 1999 to January 2003, he served as Vice President of Engineering and served as Director of Engineering from September 1995 to September 1999. From 1987 to 1995, Mr. Merrill worked at SynOptics Communications, a local area networking company, which later merged with Wellfleet to become Bay Networks, where his responsibilities included system design and analog implementations for SynOptic s first 10BASE-T products. Mr. Merrill received both a B.S. degree and an M.S. degree in Electrical Engineering from Stanford University.

*Michael F. Falcon* has served as our Senior Vice President of Operations since March 2006 and Vice President of Operations since November 2002. From September 1999 to November 2002, Mr. Falcon worked at Quantum Corporation, a data technology company, where he served as Vice President of Operations and Supply Chain Management. From April 1999 to September 1999, Mr. Falcon was at Meridian Data, a storage company acquired by Quantum Corporation, where he served as Vice President of Operations. From February 1989 to April 1999, Mr. Falcon was at Silicon Valley Group, a semiconductor equipment manufacturer, where he served as Director of Operations, Strategic Planning and Supply Chain Management. Prior to that, he served in management positions at SCI Systems, an electronics manufacturer, Xerox Imaging Systems, a provider of scanning and text recognition solutions, and Plantronics, Inc., a provider of lightweight communication headsets. Mr. Falcon received a B.A. degree in Economics from the University of California, Santa Cruz and has completed coursework in the M.B.A. program at Santa Clara University.

*Christine M. Gorjanc* has served as our Chief Accounting Officer since December 2006 and our Vice President, Finance since November 2005. From September 1996 through November 2005, Ms. Gorjanc served as Vice President, Controller, Treasurer and Assistant Secretary for Aspect Communications Corporation, a provider of workforce and customer management solutions. From October 1988 through September 1996, she served as the Manager of Tax for Tandem Computers, Inc., a provider of fault-tolerant computer systems. Prior to that, she served in management positions at Xidex Corporation, a manufacturer of storage devices, and spent eight years in public accounting with a number of accounting firms. Ms. Gorjanc holds a B.A. in Accounting (with honors) from the University of Texas at El Paso, a M.S. in Taxation from Golden Gate University, and is a Certified Public Accountant.

*Albert Y. Liu* has served as our Vice President, Legal and Corporate Development and Corporate Secretary since March 2006 and our General Counsel and Secretary since October 2004. From March 2004 to October 2004, Mr. Liu consulted as Acting General Counsel and Secretary for Yipes Enterprise Services, Inc., an emerging telecom services company. From May 2000 to June 2004, Mr. Liu worked at Turnstone Systems, Inc., a telecommunications equipment provider, where he served as General Counsel and Secretary, as Director of Human Resources since September 2001 and as a member of the board of directors since November 2003. Prior to that, Mr. Liu practiced corporate and securities law at Sullivan & Cromwell, a leading U.S. law firm, from October 1997 to May 2000. Mr. Liu holds a J.D. from the University of California, Hastings College of the Law, and an A.B. in Political Science and a B.S. in Computer Science from Stanford University.

*Charles T. Olson* has served as our Senior Vice President of Engineering since March 2006 and our Vice President of Engineering since January 2003. From July 1978 to January 2003, Mr. Olson worked at Hewlett-Packard Company, a

computer and test equipment company, where he served as Director of Research and Development for ProCurve networking from 1998 to 2003, as Research and Development Manager for the Enterprise Netserver division from 1997 to 1998, and, prior to that, in various other engineering management roles in Hewlett-Packard s Unix server and personal computer product divisions. Mr. Olson received a B.S. degree in Electrical Engineering from the University of California, Davis and an M.B.A. from Santa Clara University.

*David Soares* has served as our Senior Vice President of Worldwide Sales and Support since August 2004. Mr. Soares joined us in January 1998, and served as Vice President of EMEA sales from December 2003 to July 2004, EMEA Managing Director from April 2000 to November 2003, United Kingdom and Nordic Regional Manager from February 1999 to March 2000 and United Kingdom Country Manager from January 1998 to January 1999. Prior to joining us, Mr. Soares was at Hayes Microcomputer Products, a manufacturer of dial-up modems. Mr. Soares attended Ridley College, Ontario Canada.

*Michael A. Werdann* has served as our Vice President of Americas Sales since December 2003. Since joining us in 1998, Mr. Werdann has served as our United States Director of Sales, E-Commerce and DMR from December 2002 to 2003 and as our Eastern regional sales director from October 1998 to December 2002. Prior to joining us, Mr. Werdann worked for three years at Iomega Corporation, a computer hardware company, as a sales director for the value added reseller sector. Mr. Werdann holds a B.S. Degree in Communications from Seton Hall University.

*Deborah A. Williams* has served as our Senior Vice President, Marketing and Chief Marketing Officer since September 2006. From 1984 through 2005, Ms. Williams worked at Hewlett-Packard Company, a computer and test equipment company, where she held various executive-level marketing positions, most recently as Vice President of Marketing for the Business Imaging and Printing Global Business Unit. Ms. Williams previously served as Vice President of Marketing of the LaserJet Supplies Division, Vice President of Category Operations and Marketing of the Supplies Global Business Unit, Director of Marketing of the DeskJet Printers Division, Director of Consumer Marketing of the European Peripherals Group, and Director of Support of the European Computer Products Sales Unit. Ms. Williams holds a B.A. in Industrial Distribution from Clarkson University, and an M.B.A. from the J.L. Kellogg Graduate School of Management.

## Item 1A. *Risk Factors*

*Investing in our common stock involves a high degree of risk. The risks described below are not exhaustive of the risks that might affect our business. Other risks, including those we currently deem immaterial, may also impact our business. Any of the following risks could materially adversely affect our business operations, results of operations and financial condition and could result in a significant decline in our stock price.*

***We expect our operating results to fluctuate on a quarterly and annual basis, which could cause our stock price to fluctuate or decline.***

Our operating results are difficult to predict and may fluctuate substantially from quarter-to-quarter or year-to-year for a variety of reasons, many of which are beyond our control. If our actual revenue were to fall below our estimates or the expectations of public market analysts or investors, our quarterly and annual results would be negatively impacted and the price of our stock could decline. Other factors that could affect our quarterly and annual operating results include those listed in this risk factors section of this Form 10-K and others such as:

- changes in the pricing policies of or the introduction of new products by us or our competitors;
- changes in the terms of our contracts with customers or suppliers that cause us to incur additional expenses or assume additional liabilities;
- slow or negative growth in the networking product, personal computer, Internet infrastructure, home electronics and related technology markets, as well as decreased demand for Internet access;

changes in or consolidation of our sales channels and wholesale distributor relationships or failure to manage our sales channel inventory and warehousing requirements;

delay or failure to fulfill orders for our products on a timely basis;

our inability to accurately forecast product demand;

unfavorable level of inventory and turns;

unanticipated shift in overall product mix from higher to lower margin products which would adversely impact our margins;

- delays in the introduction of new products by us or market acceptance of these products;
- an increase in price protection claims, redemptions of marketing rebates, product warranty returns or allowance for doubtful accounts;
- operational disruptions, such as transportation delays or failure of our order processing system, particularly if they occur at the end of a fiscal quarter;
- seasonal patterns of higher sales during the second half of our fiscal year, particularly retail-related sales in our fourth quarter;
- delay or failure of our service provider customers to purchase at the volumes that we forecast;
- foreign currency exchange rate fluctuations in the jurisdictions where we transact sales in local currency;
- bad debt exposure as we expand into new international markets; and
- changes in accounting rules, such as recording expenses for employee stock option grants.

As a result, period-to-period comparisons of our operating results may not be meaningful, and you should not rely on them as an indication of our future performance. In addition, our future operating results may fall below the expectations of public market analysts or investors. In this event, our stock price could decline significantly.

***Some of our competitors have substantially greater resources than we do, and to be competitive we may be required to lower our prices or increase our advertising expenditures or other expenses, which could result in reduced margins and loss of market share.***

We compete in a rapidly evolving and highly competitive market, and we expect competition to intensify. Our principal competitors in the small business market include 3Com Corporation, Allied Telesyn International, Dell Computer Corporation, D-Link Systems, Inc., Hewlett-Packard Company, the Linksys division of Cisco Systems and Nortel Networks. Our principal competitors in the home market include Belkin Corporation, D-Link and the Linksys division of Cisco Systems. Our principal competitors in the broadband service provider market include AARIS Group, Inc., Motorola, Inc., Sagem Corporation, Scientific Atlanta, a Cisco company, Terayon Communications Systems, Inc., Thomson Corporation and 2Wire, Inc. Other current and potential competitors include numerous local vendors such as Siemens Corporation and AVM in Europe, Corega International SA, Melco, Inc./Buffalo Technology in Japan and TP-Link in China. Our potential competitors also include consumer electronics vendors who could integrate networking capabilities into their line of products, and our channel customers who may decide to offer self-branded networking products. We also face competition from service providers who may bundle a free networking device with their broadband service offering, which would reduce our sales if we are not the supplier of choice to those service providers.

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources. These competitors may, among other things, undertake more extensive marketing campaigns, adopt more aggressive pricing policies, obtain more favorable pricing from suppliers and manufacturers, and exert more influence on the sales channel than we can. We anticipate that current and potential competitors will also intensify their efforts to penetrate our target markets. These competitors may have more advanced technology, more extensive distribution channels, stronger brand names, greater access to shelf space in retail locations, bigger promotional budgets and larger customer bases than we do. These

companies could devote more capital resources to develop, manufacture and market competing products than we could. If any of these companies are successful in competing against us, our sales could decline, our margins could be negatively impacted, and we could lose market share, any of which could seriously harm our business and results of operations.

***If we do not effectively manage our sales channel inventory and product mix, we may incur costs associated with excess inventory, or lose sales from having too few products.***

If we are unable to properly monitor, control and manage our sales channel inventory and maintain an appropriate level and mix of products with our wholesale distributors and within our sales channel, we may incur

increased and unexpected costs associated with this inventory. We generally allow wholesale distributors and traditional retailers to return a limited amount of our products in exchange for other products. Under our price protection policy, if we reduce the list price of a product, we are often required to issue a credit in an amount equal to the reduction for each of the products held in inventory by our wholesale distributors and retailers. If our wholesale distributors and retailers are unable to sell their inventory in a timely manner, we might lower the price of the products, or these parties may exchange the products for newer products. Also, during the transition from an existing product to a new replacement product, we must accurately predict the demand for the existing and the new product.

If we improperly forecast demand for our products we could end up with too many products and be unable to sell the excess inventory in a timely manner, if at all, or, alternatively we could end up with too few products and not be able to satisfy demand. This problem is exacerbated because we attempt to closely match inventory levels with product demand leaving limited margin for error. If these events occur, we could incur increased expenses associated with writing off excessive or obsolete inventory or lose sales or have to ship products by air freight to meet immediate demand incurring incremental freight costs above the costs of transporting product via boat, a preferred method, and suffering a corresponding decline in gross margins.

***We are currently involved in various litigation matters and may in the future become involved in additional litigation, including litigation regarding intellectual property rights, which could be costly and subject us to significant liability.***

The networking industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding infringement of patents, trade secrets and other intellectual property rights. In particular, leading companies in the data communications markets, some of which are competitors, have extensive patent portfolios with respect to networking technology. From time to time, third parties, including these leading companies, have asserted and may continue to assert exclusive patent, copyright, trademark and other intellectual property rights against us demanding license or royalty payments or seeking payment for damages, injunctive relief and other available legal remedies through litigation. These include third parties who claim to own patents or other intellectual property that cover industry standards that our products comply with. If we are unable to resolve these matters or obtain licenses on acceptable or commercially reasonable terms, we could be sued or we may be forced to initiate litigation to protect our rights. The cost of any necessary licenses could significantly harm our business, operating results and financial condition. Also, at any time, any of these companies, or any other third-party could initiate litigation against us, or we may be forced to initiate litigation against them, which could divert management attention, be costly to defend or prosecute, prevent us from using or selling the challenged technology, require us to design around the challenged technology and cause the price of our stock to decline. In addition, third parties, some of whom are potential competitors, have initiated and may continue to initiate litigation against our manufacturers, suppliers or members of our sales channel, alleging infringement of their proprietary rights with respect to existing or future products. In the event successful claims of infringement are brought by third parties, and we are unable to obtain licenses or independently develop alternative technology on a timely basis, we may be subject to indemnification obligations, be unable to offer competitive products, or be subject to increased expenses. Finally, consumer class-action lawsuits related to the marketing and performance of our home networking products have been asserted and may in the future be asserted against us. If we do not resolve these claims on a favorable basis, our business, operating results and financial condition could be significantly harmed.

***The average selling prices of our products typically decrease rapidly over the sales cycle of the product, which may negatively affect our gross margins.***

Our products typically experience price erosion, a fairly rapid reduction in the average selling prices over their respective sales cycles. In order to sell products that have a falling average selling price and maintain margins at the same time, we need to continually reduce product and manufacturing costs. To manage manufacturing costs, we must

collaborate with our third-party manufacturers to engineer the most cost-effective design for our products. In addition, we must carefully manage the price paid for components used in our products. We must also successfully manage our freight and inventory costs to reduce overall product costs. We also need to continually introduce new products with higher sales prices and gross margins in order to maintain our overall gross margins. If we are unable

to manage the cost of older products or successfully introduce new products with higher gross margins, our net revenue and overall gross margin would likely decline.

***Our future success is dependent on the growth in personal computers sales and the acceptance of networking products in the small business and home markets into which we sell substantially all of our products. If the acceptance of networking products in these markets does not continue to grow, we will be unable to increase or sustain our net revenue, and our business will be severely harmed.***

We believe that growth in the small business market will depend, in significant part, on the growth of the number of personal computers purchased by these end-users and the demand for sharing data intensive applications, such as large graphic files. We believe that acceptance of networking products in the home will depend upon the availability of affordable broadband Internet access and increased demand for wireless products. Unless these markets continue to grow, our business will be unable to expand, which could cause the value of our stock to decline. Moreover, if networking functions are integrated more directly into personal computers and other Internet-enabled devices, such as electronic gaming platforms or personal video recorders, and these devices do not rely upon external network-enabling devices, sales of our products could suffer. In addition, if the small business or home markets experience a recession or other cyclical effects that diminish or delay networking expenditures, our business growth and profits would be severely limited, and our business could be more severely harmed than those companies that primarily sell to large business customers.

***If we fail to continue to introduce new products that achieve broad market acceptance on a timely basis, we will not be able to compete effectively and we will be unable to increase or maintain net revenue and gross margins.***

We operate in a highly competitive, quickly changing environment, and our future success depends on our ability to develop and introduce new products that achieve broad market acceptance in the small business and home markets. Our future success will depend in large part upon our ability to identify demand trends in the small business and home markets and quickly develop, manufacture and sell products that satisfy these demands in a cost effective manner. Successfully predicting demand trends is difficult, and it is very difficult to predict the effect introducing a new product will have on existing product sales. We will also need to respond effectively to new product announcements by our competitors by quickly introducing competitive products.

We have experienced delays in releasing new products in the past, which resulted in lower quarterly net revenue than expected. In addition, we have experienced, and may in the future experience, product introductions that fall short of our projected rates of market adoption. Any future delays in product development and introduction or product introductions that do not meet broad market acceptance could result in:

- loss of or delay in revenue and loss of market share;
- negative publicity and damage to our reputation and brand;
- a decline in the average selling price of our products;
- adverse reactions in our sales channel, such as reduced shelf space, reduced online product visibility, or loss of sales channel; and
- increased levels of product returns.

***We depend substantially on our sales channel, and our failure to maintain and expand our sales channel would result in lower sales and reduced net revenue.***

To maintain and grow our market share, net revenue and brand, we must maintain and expand our sales channel. We sell our products through our sales channel, which consists of traditional retailers, on-line retailers, DMRs, VARs, and broadband service providers. Some of these entities purchase our products through our wholesale distributors. We generally have no minimum purchase commitments or long-term contracts with any of these third parties.

Traditional retailers have limited shelf space and promotional budgets, and competition is intense for these resources. If the networking sector does not experience sufficient growth, retailers may choose to allocate more shelf space to other consumer product sectors. A competitor with more extensive product lines and stronger brand identity, such as Cisco Systems, may have greater bargaining power with these retailers. Any reduction in available shelf space or increased competition for such shelf space would require us to increase our marketing expenditures simply to maintain current levels of retail shelf space, which would harm our operating margin. The recent trend in the consolidation of online retailers and DMR channels has resulted in intensified competition for preferred product placement, such as product placement on an online retailer s Internet home page. Expanding our presence in the VAR channel may be difficult and expensive. We compete with established companies that have longer operating histories and longstanding relationships with VARs that we would find highly desirable as sales channel partners. If we were unable to maintain and expand our sales channel, our growth would be limited and our business would be harmed.

We must also continuously monitor and evaluate emerging sales channels. If we fail to establish a presence in an important developing sales channel, our business could be harmed.

***If we fail to successfully overcome the challenges associated with profitably growing our broadband service provider sales channel, our net revenue and gross profit will be negatively impacted.***

We face a number of challenges associated with penetrating the broadband service provider channel that differ from what we have traditionally faced with the other channels. These challenges include a longer sales cycle, more stringent product testing and validation requirements, a higher level of customer service and support demands, competition from established suppliers, pricing pressure resulting in lower gross margins, and our general inexperience in selling to service providers. Orders from service providers generally tend to be large but sporadic, which causes our revenues from them to fluctuate wildly and challenges our ability to accurately forecast demand from them. Even if we are selected as a supplier, typically a service provider will also designate a second source supplier, which over time will reduce the aggregate orders that we receive from that service provider. In addition, service providers may choose to prioritize the implementation of other technologies or the roll out of other services than home networking. Any slowdown in the general economy, over capacity, consolidation among service providers, regulatory developments and constraint on capital expenditures could result in reduced demand from service providers and therefore adversely affect our sales to them. If we do not successfully overcome these challenges, we will not be able to profitably grow our service provider sales channel and our growth will be slowed.

***If our products contain defects or errors, we could incur significant unexpected expenses, experience product returns and lost sales, experience product recalls, suffer damage to our brand and reputation, and be subject to product liability or other claims.***

Our products are complex and may contain defects, errors or failures, particularly when first introduced or when new versions are released. The industry standards upon which many of our products are based are also complex, experience change over time and may be interpreted in different manners. Some errors and defects may be discovered only after a product has been installed and used by the end-user. If our products contain defects or errors, or are found to be noncompliant with industry standards, we could experience decreased sales and increased product returns, loss of customers and market share, and increased service, warranty and insurance costs. In addition, our reputation and brand could be damaged, and we could face legal claims regarding our products. A successful product liability or other claim could result in negative publicity and harm our reputation, result in unexpected expenses and adversely impact our operating results.

***We obtain several key components from limited or sole sources, and if these sources fail to satisfy our supply requirements, we may lose sales and experience increased component costs.***

Any shortage or delay in the supply of key product components would harm our ability to meet scheduled product deliveries. Many of the semiconductors used in our products are specifically designed for use in our products and are obtained from sole source suppliers on a purchase order basis. In addition, some components that are used in all our products are obtained from limited sources. These components include connector jacks, plastic casings and physical layer transceivers. We also obtain switching fabric semiconductors, which are used in our

Ethernet switches and Internet gateway products, and wireless local area network chipsets, which are used in all of our wireless products, from a limited number of suppliers. Semiconductor suppliers have experienced and continue to experience component shortages themselves, such as with substrates used in manufacturing chipsets, which in turn adversely impact our ability to procure semiconductors from them. Our contract manufacturers purchase these components on our behalf on a purchase order basis, and we do not have any contractual commitments or guaranteed supply arrangements with our suppliers. If demand for a specific component increases, we may not be able to obtain an adequate number of that component in a timely manner. In addition, if our suppliers experience financial or other difficulties or if worldwide demand for the components they provide increases significantly, the availability of these components could be limited. It could be difficult, costly and time consuming to obtain alternative sources for these components, or to change product designs to make use of alternative components. In addition, difficulties in transitioning from an existing supplier to a new supplier could create delays in component availability that would have a significant impact on our ability to fulfill orders for our products. If we are unable to obtain a sufficient supply of components, or if we experience any interruption in the supply of components, our product shipments could be reduced or delayed. This would affect our ability to meet scheduled product deliveries, damage our brand and reputation in the market, and cause us to lose market share.

***We are exposed to adverse currency exchange rate fluctuations in jurisdictions where we transact in local currency, which could harm our financial results and cash flows.***

Although a significant portion of our international sales are currently invoiced in United States dollars, we have implemented and continue to implement for certain countries both invoicing and payment in foreign currencies. Recently, we have experienced currency exchange gains, however our exposure to adverse foreign currency rate fluctuations will likely increase. We currently do not engage in any currency hedging transactions. Moreover, the costs of doing business abroad may increase as a result of adverse exchange rate fluctuations. For example, if the United States dollar declined in value relative to a local currency, we could be required to pay more in U.S. dollar terms for our expenditures in that market, including salaries, commissions, local operations and marketing expenses, each of which is paid in local currency. In addition, we may lose customers if exchange rate fluctuations, currency devaluations or economic crises increase the local currency prices of our products or reduce our customers ability to purchase products.

***Rising oil prices, unfavorable economic conditions, particularly in Western Europe, and turmoil in the international geopolitical environment may adversely affect our operating results.***

We derive a significant percentage of our revenues from international sales, and a deterioration in global economic and market conditions, particularly in Western Europe, may result in reduced product demand, increased price competition and higher excess inventory levels. Turmoil in the global geopolitical environment, including the ongoing tensions in Iraq and the Middle-East, have pressured and continue to pressure global economies. In addition, rising oil prices may result in a reduction in consumer spending and an increase in freight costs to us. If the global economic climate does not improve, our business and operating results will be harmed.

***If disruptions in our transportation network occur or our shipping costs substantially increase, we may be unable to sell or timely deliver our products and our operating expenses could increase.***

We are highly dependent upon the transportation systems we use to ship our products, including surface and air freight. Our attempts to closely match our inventory levels to our product demand intensify the need for our transportation systems to function effectively and without delay. On a quarterly basis, our shipping volume also tends to steadily increase as the quarter progresses, which means that any disruption in our transportation network in the latter half of a quarter will have a more material effect on our business than at the beginning of a quarter.

The transportation network is subject to disruption or congestion from a variety of causes, including labor disputes or port strikes, acts of war or terrorism, natural disasters and congestion resulting from higher shipping volumes. Labor disputes among freight carriers and at ports of entry are common, especially in Europe, and we expect labor unrest and its effects on shipping our products to be a continuing challenge for us. Since September 11, 2001, the rate of inspection of international freight by governmental entities has substantially increased, and has become increasingly unpredictable. If our delivery times increase unexpectedly for these or any other reasons, our

ability to deliver products on time would be materially adversely affected and result in delayed or lost revenue. In addition, if the increases in fuel prices were to continue, our transportation costs would likely further increase. Moreover, the cost of shipping our products by air freight is greater than other methods. From time to time in the past, we have shipped products using air freight to meet unexpected spikes in demand or to bring new product introductions to market quickly. If we rely more heavily upon air freight to deliver our products, our overall shipping costs will increase. A prolonged transportation disruption or a significant increase in the cost of freight could severely disrupt our business and harm our operating results.

***We rely on a limited number of wholesale distributors for most of our sales, and if they refuse to pay our requested prices or reduce their level of purchases, our net revenue could decline.***

We sell a substantial portion of our products through wholesale distributors, including Ingram Micro, Inc. and Tech Data Corporation. During the fiscal year ended December 31, 2006, sales to Ingram Micro and its affiliates accounted for 19% of our net revenue and sales to Tech Data and its affiliates accounted for 16% of our net revenue. We expect that a significant portion of our net revenue will continue to come from sales to a small number of wholesale distributors for the foreseeable future. In addition, because our accounts receivable are concentrated with a small group of purchasers, the failure of any of them to pay on a timely basis, or at all, would reduce our cash flow. We generally have no minimum purchase commitments or long-term contracts with any of these distributors. These purchasers could decide at any time to discontinue, decrease or delay their purchases of our products. In addition, the prices that they pay for our products are subject to negotiation and could change at any time. If any of our major wholesale distributors reduce their level of purchases or refuse to pay the prices that we set for our products, our net revenue and operating results could be harmed. If our wholesale distributors increase the size of their product orders without sufficient lead-time for us to process the order, our ability to fulfill product demands would be compromised.

***If the redemption rate for our end-user promotional programs is higher than we estimate, then our net revenue and gross margin will be negatively affected.***

From time to time we offer promotional incentives, including cash rebates, to encourage end-users to purchase certain of our products. Purchasers must follow specific and stringent guidelines to redeem these incentives or rebates. Often qualified purchasers choose not to apply for the incentives or fail to follow the required redemption guidelines, resulting in an incentive redemption rate of less than 100%. Based on historical data, we estimate an incentive redemption rate for our promotional programs. If the actual redemption rate is higher than our estimated rate, then our net revenue and gross margin will be negatively affected.

***We are required to evaluate our internal control under Section 404 of the Sarbanes-Oxley Act of 2002 and any adverse results from such evaluation could impact investor confidence in the reliability of our internal controls over financial reporting.***

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we are required to furnish a report by our management on our internal control over financial reporting. Such report must contain among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management. Such report must also contain a statement that our independent registered public accounting firm has issued an audit report on management s assessment of such internal controls.

We will continue to perform the system and process documentation and evaluation needed to comply with Section 404, which is both costly and challenging. During this process, if our management identifies one or more material weaknesses in our internal control over financial reporting, we will be unable to assert such internal control is

effective. If we are unable to assert that our internal control over financial reporting is effective as of the end of a fiscal year, or if our independent registered public accounting firm is unable to attest that our management s report is fairly stated or they are unable to express an opinion on the effectiveness of our internal control over financial reporting, we could lose investor confidence in the accuracy and completeness of our financial reports, which may have an adverse effect on our stock price.

***We depend on a limited number of third-party contract manufacturers for substantially all of our manufacturing needs. If these contract manufacturers experience any delay, disruption or quality control problems in their operations, we could lose market share and our brand may suffer.***

All of our products are manufactured, assembled, tested and generally packaged by a limited number of original design manufacturers, or ODMs, and original equipment manufacturers, or OEMs. We rely on our contract manufacturers to procure components and, in some cases, subcontract engineering work. Some of our products are manufactured by a single contract manufacturer. We do not have any long-term contracts with any of our third-party contract manufacturers. Some of these third-party contract manufacturers produce products for our competitors. The loss of the services of any of our primary third-party contract manufacturers could cause a significant disruption in operations and delays in product shipments. Qualifying a new contract manufacturer and commencing volume production is expensive and time consuming.

Our reliance on third-party contract manufacturers also exposes us to the following risks over which we have limited control:

- unexpected increases in manufacturing and repair costs;
- inability to control the quality of finished products;
- inability to control delivery schedules; and
- potential lack of adequate capacity to manufacture all or a part of the products we require.

All of our products must satisfy safety and regulatory standards and some of our products must also receive government certifications. Our ODM and OEM contract manufacturers are primarily responsible for obtaining most regulatory approvals for our products. If our ODMs and OEMs fail to obtain timely domestic or foreign regulatory approvals or certificates, we would be unable to sell our products and our sales and profitability could be reduced, our relationships with our sales channel could be harmed, and our reputation and brand would suffer.

***If we are unable to provide our third-party contract manufacturers a timely and accurate forecast of our component and material requirements, we may experience delays in the manufacturing of our products and the costs of our products may increase.***

We provide our third-party contract manufacturers with a rolling forecast of demand, which they use to determine our material and component requirements. Lead times for ordering materials and components vary significantly and depend on various factors, such as the specific supplier, contract terms and demand and supply for a component at a given time. Some of our components have long lead times, such as wireless local area network chipsets, switching fabric chips, physical layer transceivers, connector jacks and metal and plastic enclosures. If our forecasts are not timely provided or are less than our actual requirements, our contract manufacturers may be unable to manufacture products in a timely manner. If our forecasts are too high, our contract manufacturers will be unable to use the components they have purchased on our behalf. The cost of the components used in our products tends to drop rapidly as volumes increase and the technologies mature. Therefore, if our contract manufacturers are unable to promptly use components purchased on our behalf, our cost of producing products may be higher than our competitors due to an over supply of higher-priced components. Moreover, if they are unable to use components ordered at our direction, we will need to reimburse them for any losses they incur.

***We rely upon third parties for technology that is critical to our products, and if we are unable to continue to use this technology and future technology, our ability to develop, sell, maintain and support technologically advanced products would be limited.***

We rely on third parties to obtain non-exclusive patented hardware and software license rights in technologies that are incorporated into and necessary for the operation and functionality of most of our products. In these cases, because the intellectual property we license is available from third parties, barriers to entry may be lower than if we owned exclusive rights to the technology we license and use. On the other hand, if a competitor or potential competitor enters into an exclusive arrangement with any of our key third-party technology providers, or if any of these providers unilaterally decide not to do business with us for any reason, our ability to develop and sell products

containing that technology would be severely limited. If we are shipping products which contain third party technology that we subsequently lose the right to license, then we will not be able to continue to offer or support those products. Our licenses often require royalty payments or other consideration to third parties. Our success will depend in part on our continued ability to have access to these technologies, and we do not know whether these third-party technologies will continue to be licensed to us on commercially acceptable terms or at all. If we are unable to license the necessary technology, we may be forced to acquire or develop alternative technology of lower quality or performance standards. This would limit and delay our ability to offer new or competitive products and increase our costs of production. As a result, our margins, market share, and operating results could be significantly harmed.

We also utilize third party software development companies to develop, customize, maintain and support software that is incorporated into our products. If these companies fail to timely deliver or continuously maintain and support the software that we require of them, we may experience delays in releasing new products or difficulties with supporting existing products and customers.

***If we are unable to secure and protect our intellectual property rights, our ability to compete could be harmed.***

We rely upon third parties for a substantial portion of the intellectual property we use in our products. At the same time, we rely on a combination of copyright, trademark, patent and trade secret laws, nondisclosure agreements with employees, consultants and suppliers and other contractual provisions to establish, maintain and protect our intellectual property rights. Despite efforts to protect our intellectual property, unauthorized third parties may attempt to design around, copy aspects of our product design or obtain and use technology or other intellectual property associated with our products. For example, one of our primary intellectual property assets is the NETGEAR name, trademark and logo. We may be unable to stop third parties from adopting similar names, trademarks and logos, especially in those international markets where our intellectual property rights may be less protected. Furthermore, our competitors may independently develop similar technology or design around our intellectual property. Our inability to secure and protect our intellectual property rights could significantly harm our brand and business, operating results and financial condition.

***Our sales and operations in international markets expose us to operational, financial and regulatory risks.***

International sales comprise a significant amount of our overall net revenue. International sales were 62% of overall net revenue in fiscal 2006. We anticipate that international sales may grow as a percentage of net revenue. We have committed resources to expanding our international operations and sales channels and these efforts may not be successful. International operations are subject to a number of other risks, including:

- political and economic instability, international terrorism and anti-American sentiment, particularly in emerging markets;
- preference for locally branded products, and laws and business practices favoring local competition;
- exchange rate fluctuations;
- increased difficulty in managing inventory;
- delayed revenue recognition;
- less effective protection of intellectual property;

stringent consumer protection and product compliance regulations, including but not limited to the recently enacted Restriction of Hazardous Substances directive and the Waste Electrical and Electronic Equipment, or WEEE directive in Europe, that may vary from country to country and that are costly to comply with; and

difficulties and costs of staffing and managing foreign operations.

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***We intend to expand our operations and infrastructure, which may strain our operations and increase our operating expenses.***

We intend to expand our operations and pursue market opportunities domestically and internationally to grow our sales. We expect that this attempted expansion will strain our existing management information systems, and operational and financial controls. In addition, if we continue to grow, our expenditures will likely be significantly higher than our historical costs. We may not be able to install adequate controls in an efficient and timely manner as our business grows, and our current systems may not be adequate to support our future operations. The difficulties associated with installing and implementing these new systems, procedures and controls may place a significant burden on our management, operational and financial resources. In addition, if we grow internationally, we will have to expand and enhance our communications infrastructure. If we fail to continue to improve our management information systems, procedures and financial controls or encounter unexpected difficulties during expansion, our business could be harmed.

***We are continuing to implement our international reorganization, which is straining our resources and increasing our operating expenses.***

We have been reorganizing our foreign subsidiaries and entities to better manage and optimize our international operations. Our implementation of this project requires substantial efforts by our staff and is resulting in increased staffing requirements and related expenses. Failure to successfully execute the reorganization or other factors outside of our control could negatively impact the timing and extent of any benefit we receive from the reorganization. As part of the reorganization, we have been implementing new information technology systems, including new forecasting and order processing systems. If we fail to successfully and timely integrate these new systems, we will suffer disruptions to our operations. Any unanticipated interruptions in our business operations as a result of implementing these changes could result in loss or delay in revenue causing an adverse effect on our financial results.

***Our stock price may be volatile and your investment in our common stock could suffer a decline in value.***

With the continuing uncertainty about economic conditions in the United States, there has been significant volatility in the market price and trading volume of securities of technology and other companies, which may be unrelated to the financial performance of these companies. These broad market fluctuations may negatively affect the market price of our common stock.

Some specific factors that may have a significant effect on our common stock market price include:

- actual or anticipated fluctuations in our operating results or our competitors operating results;
- actual or anticipated changes in the growth rate of the general networking sector, our growth rates or our competitors growth rates;
- conditions in the financial markets in general or changes in general economic conditions;
- interest rate or currency exchange rate fluctuations;
- our ability to raise additional capital; and
- changes in stock market analyst recommendations regarding our common stock, other comparable companies or our industry generally.

***Natural disasters, mischievous actions or terrorist attacks could delay our ability to receive or ship our products, or otherwise disrupt our business.***

Our corporate headquarters are located in Northern California and one of our warehouses is located in Southern California, regions known for seismic activity. In addition, substantially all of our manufacturing occurs in two geographically concentrated areas in mainland China, where disruptions from natural disasters, health epidemics and political, social and economic instability may affect the region. If our manufacturers or warehousing facilities are disrupted or destroyed, we would be unable to distribute our products on a timely basis, which could

harm our business. Moreover, if our computer information systems or communication systems, or those of our vendors or customers, are subject to disruptive hacker attacks or other disruptions, our business could suffer. We have not established a formal disaster recovery plan. Our back-up operations may be inadequate and our business interruption insurance may not be enough to compensate us for any losses that may occur. A significant business interruption could result in losses or damages and harm our business. For example, much of our order fulfillment process is automated and the order information is stored on our servers. If our computer systems and servers go down even for a short period at the end of a fiscal quarter, our ability to recognize revenue would be delayed until we were again able to process and ship our orders, which could cause our stock price to decline significantly.

***If we lose the services of our Chairman and Chief Executive Officer, Patrick C.S. Lo, or our other key personnel, we may not be able to execute our business strategy effectively.***

Our future success depends in large part upon the continued services of our key technical, sales, marketing and senior management personnel. In particular, the services of Patrick C.S. Lo, our Chairman and Chief Executive Officer, who has led our company since its inception, are very important to our business. In November 2006, Jonathan R. Mather, our former Executive Vice President and Chief Financial Officer, left the company to pursue other opportunities, and we are still in the process of hiring his replacement. We do not maintain any key person life insurance policies. The loss of any of our senior management or other key research, development, sales or marketing personnel, particularly if lost to competitors, could harm our ability to implement our business strategy and respond to the rapidly changing needs of the small business and home markets.

**Item 1B.** ***Unresolved Staff Comments.***

None.

**Item 2.** ***Properties***

Our principal administrative, sales, marketing and research and development facilities occupy approximately 74,000 square feet in an office complex in Santa Clara, California, under a lease that expires in December 2007, with a three-year renewal option. Our international headquarters occupy approximately 10,000 square feet in an office complex in Cork, Ireland, under a lease entered into in February 2006 and expiring in December 2026. Our international sales personnel reside in local sales offices or home offices in Austria, Australia, Brazil, China, Czech Republic, Denmark, France, Germany, India, Italy, Japan, Korea, Norway, Poland, Russia, Singapore, Spain, Sweden, Switzerland, the Netherlands, the United Arab Emirates, and the United Kingdom. We also have operations personnel using a facility in Hong Kong, which is subleased from our third party logistics provider, Kerry Logistics. We also maintain a research and development facility in Taipei, Taiwan. From time to time we consider various alternatives related to our long-term facilities needs. While we believe our existing facilities are adequate to meet our immediate needs, it may be necessary to lease additional space to accommodate future growth.

We use third parties to provide warehousing services to us, consisting of facilities in Southern California, Hong Kong and the Netherlands.

**Item 3.** ***Legal Proceedings***

The information set forth under Note 6 of the Notes to Consolidated Financial Statements, included in Part IV, Item 15 of this report, is incorporated herein by reference. For an additional discussion of certain risks associated with legal proceedings, see the section entitled Risk Factors in Item 1A of this report.

**Item 4.** ***Submission of Matters to a Vote of Security Holders***

No matters were submitted to a vote of the security holders during the quarter ended December 31, 2006.

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## PART II

**Item 5.** ***Market for Registrant s Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Our common stock has been quoted under the symbol NTGR on the Nasdaq National Market from July 31, 2003 to July 1, 2006, and on the Nasdaq Global Select Market since then. Prior to that time, there was no public market for our common stock. The following table sets forth for the indicated periods the high and low sales prices for our common stock on the Nasdaq markets. Such information reflects interdealer prices, without retail markup, markdown or commission, and may not represent actual transactions.

| Fiscal Year Ended December 31, 2005 | High | Low |
|---|---|---|
| First Quarter | $ 19.16 | $ 13.45 |
| Second Quarter | 20.78 | 12.96 |
| Third Quarter | 25.73 | 18.65 |
| Fourth Quarter | 24.30 | 17.52 |

| Fiscal Year Ended December 31, 2006 | High | Low |
|---|---|---|
| First Quarter | $ 19.59 | $ 16.64 |
| Second Quarter | 25.39 | 18.40 |
| Third Quarter | 21.64 | 16.92 |
| Fourth Quarter | 28.15 | 20.01 |

On February 16, 2007, there were 26 stockholders of record.

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**Company Performance**

*Notwithstanding any statement to the contrary in any of our previous or future filings with the Securities and Exchange Commission, the following information relating to the price performance of our common stock shall not be deemed filed with the Commission or soliciting material under the 1934 Act and shall not be incorporated by reference into any such filings.*

The following graph shows a comparison from July 31, 2003 (the date our common stock commenced trading on the Nasdaq National Market) through December 31, 2006 of cumulative total return for our common stock, the Nasdaq Composite Index and the Nasdaq Computer Index. Such returns are based on historical results and are not intended to suggest future performance. Data for the Nasdaq Composite Index and the Nasdaq Computer Index assume reinvestment of dividends. We have never paid dividends on our common stock and have no present plans to do so.

| | July 31, 2003 | December 31, 2003 | December 31, 2004 | December 31, 2005 | December 31, 2006 |
|---|---|---|---|---|---|
| NETGEAR, Inc. | $ 100.00 | $ 90.39 | $ 102.66 | $ 108.82 | $ 148.39 |
| NASDAQ Computer Index | $ 100.00 | $ 116.78 | $ 120.58 | $ 123.89 | $ 131.51 |
| NASDAQ Composite Index | $ 100.00 | $ 115.47 | $ 125.38 | $ 127.11 | $ 139.21 |

**Dividend Policy**

We have never declared or paid cash dividends on our capital stock. We currently intend to retain future earnings, if any, to finance the operation and expansion of our business, and we do not anticipate paying cash dividends in the foreseeable future.

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**Equity Compensation Plan Information**

The following table summarizes the number of outstanding options granted to employees and directors, as well as the number of securities remaining available for future issuance, under our compensation plans as of December 31, 2006.

| Plan Category | (a) Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights | (b) Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights | (c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column(a)) |
|---|---|---|---|
| Equity compensation plans approved by security holders(1) | 4,048,457 | $ 14.37 | 1,911,861 |
| Equity compensation plans not approved by security holder | | | |

(1) These plans include our 2000 Stock Option Plan, 2003 Stock Plan, 2006 Long Term Incentive Plan, 2006 Stand-Alone Stock Option Agreement, and 2003 Employee Stock Purchase Plan.

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**Item 6.** ***Selected Consolidated Financial Data***

The following selected consolidated financial data are qualified in their entirety, and should be read in conjunction with, the consolidated financial statements and related notes thereto, and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Form 10-K.

We derived the selected consolidated statement of operations data for the years ended December 2004, 2005, and 2006 and the selected consolidated balance sheet data as of December 31, 2005 and 2006 from our audited consolidated financial statements appearing elsewhere in this Form 10-K. We derived the selected consolidated statement of operations data for the years ended December 31, 2002 and 2003 and the selected consolidated balance sheet data as of December 31, 2002, 2003 and 2004 from our audited consolidated financial statements, which are not included in this Form 10-K.

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | **2002** | **2003** | **2004** | **2005** | **2006** |
| | (In thousands, except per share data) | | | | |
| **Consolidated Statement of Operations Data:** | | | | | |
| Net revenue | $ 237,331 | $ 299,302 | $ 383,139 | $ 449,610 | $ 573,570 |
| Cost of revenue(2) | 177,116 | 215,460 | 260,318 | 297,911 | 379,911 |
| Gross profit | 60,215 | 83,842 | 122,821 | 151,699 | 193,659 |
| Operating expenses: | | | | | |
| Research and development(2) | 7,665 | 8,674 | 10,316 | 12,837 | 18,443 |
| Sales and marketing(2) | 32,968 | 49,678 | 62,247 | 71,345 | 91,881 |
| General and administrative(2) | 8,970 | 9,453 | 14,905 | 14,559 | 20,905 |
| In-process research and development | | | | | 2,900 |
| Litigation reserves | | | | 802 | |
| Total operating expenses | 49,603 | 67,805 | 87,468 | 99,543 | 134,129 |
| Income from operations | 10,612 | 16,037 | 35,353 | 52,156 | 59,530 |
| Interest income | 119 | 364 | 1,593 | 4,104 | 6,974 |
| Interest expense | (1,240) | (901) | | | |
| Extinguishment of debt | | (5,868) | | | |
| Other income (expense) | (19) | (59) | (560) | (1,770) | 2,495 |
| Income before taxes | 9,472 | 9,573 | 36,386 | 54,490 | 68,999 |
| Provision for (benefit from) income taxes | 1,333 | (3,524) | 12,921 | 20,867 | 27,867 |
| Net income | 8,139 | 13,097 | 23,465 | 33,623 | 41,132 |
| Deemed dividend on preferred stock | (17,881) | | | | |
| | $ (9,742) | $ 13,097 | $ 23,465 | $ 33,623 | $ 41,132 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Net income (loss) attributable to common stockholders | | | | | | | | | | |
| Net income (loss) per share attributable to common stockholders: | | | | | | | | | | |
| Basic(1) | $ | (0.46) | $ | 0.55 | $ | 0.77 | $ | 1.04 | $ | 1.23 |
| Diluted(1) | $ | (0.46) | $ | 0.49 | $ | 0.72 | $ | 0.99 | $ | 1.19 |

(1) Information regarding calculation of per share data is described in Note 4 of the Notes to Consolidated Financial Statements.

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(2) Stock-based compensation expense was allocated as follows:

| | | | | | |
|---|---|---|---|---|---|
| Cost of revenue | $ 144 | $ 128 | $ 163 | $ 147 | $ 430 |
| Research and development | 306 | 454 | 400 | 293 | 1,119 |
| Sales and marketing | 346 | 715 | 733 | 375 | 1,405 |
| General and administrative | 867 | 476 | 391 | 249 | 1,551 |

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), Share-Based Payment ( SFAS 123R ).

| | | | **December 31,** | | |
|---|---|---|---|---|---|
| | **2002** | **2003** | **2004** | **2005** | **2006** |
| | | | **(In thousands)** | | |
| **Consolidated Balance Sheet Data:** | | | | | |
| Cash, cash equivalents and short-term investments | $ 19,880 | $ 73,605 | $ 141,715 | $ 173,656 | $ 197,465 |
| Working capital | 13,753 | 130,755 | 180,696 | 230,416 | 280,877 |
| Total assets | 93,851 | 205,146 | 300,238 | 356,297 | 437,904 |
| Total current liabilities | 76,396 | 70,207 | 115,044 | 120,293 | 143,482 |
| Redeemable convertible preferred stock | 48,052 | | | | |
| Total stockholders equity (deficit) | (30,597) | 134,939 | 185,194 | 236,004 | 294,422 |

**Item 7. *Management s Discussion and Analysis of Financial Condition and Results of Operations***

*You should read the following discussion of our financial condition and results of operations together with the audited consolidated financial statements and notes to the financial statements included elsewhere in this Form 10-K. This discussion contains forward-looking statements that involve risks and uncertainties. The forward-looking statements are not historical facts, but rather are based on current expectations, estimates, assumptions and projections about our industry, business and future financial results. Our actual results could differ materially from the results contemplated by these forward-looking statements due to a number of factors, including those discussed under Risk Factors in Part I, Item 1A above.*

**Business Overview**

We design, develop and market innovative networking products that address the specific needs of small business and home users. We define small business as a business with fewer than 250 employees. We are focused on satisfying the ease-of-use, reliability, performance and affordability requirements of these users. Our product offerings enable users to share Internet access, peripherals, files, digital multimedia content and applications among multiple personal computers, or PCs, and other Internet-enabled devices.

Our product line consists of wired and wireless devices that enable Ethernet networking, broadband access, and network connectivity. These products are available in multiple configurations to address the needs of our end-users in each geographic region in which our products are sold.

We sell our networking products through multiple sales channels worldwide, including traditional retailers, online retailers, wholesale distributors, DMRs, VARs, and broadband service providers. Our retail channel includes traditional retail locations domestically and internationally, such as Best Buy, Circuit City, CompUSA, Costco, Fry s Electronics, Radio Shack, Staples, Argos (U.K.), Dixons (U.K.), PC World (U.K.), MediaMarkt (Germany, Austria), and FNAC (France). Online retailers include Amazon.com, Newegg.com and Buy.com. Our DMRs include Dell, CDW Corporation, Insight Corporation and PC Connection in domestic markets and Misco throughout Europe. In addition, we also sell our products through broadband service providers, such as multiple system operators in domestic markets and cable and DSL operators internationally. Some of these retailers and resellers purchase directly from us while most are fulfilled through wholesale distributors around the world. A substantial portion of our net revenue to date has been derived from a limited number of wholesale distributors, the

largest of which are Ingram Micro Inc. and Tech Data Corporation. We expect that these wholesale distributors will continue to contribute a significant percentage of our net revenue for the foreseeable future.

We have well developed channels in the United States and Europe, Middle-East and Africa, or EMEA, and are building a strong presence in the Asia Pacific region. We derive the majority of our net revenue from international sales. International sales as a percentage of net revenue grew from 56% in 2005 to 62% in 2006. Sales in EMEA grew from $200.0 million in 2005 to $298.2 million in 2006, representing an increase of approximately 49% during that period. We continue to penetrate new markets such as Brazil, Eastern Europe, India, and the Middle-East.

Our net revenue grew 27.6% during the year ended December 31, 2006, primarily attributable to higher sales of DSL gateway and powerline products to new and existing service provider customers, especially in Europe, as well as continued strength in our RangeMax wireless router product line.

The small business and home networking markets are intensely competitive and subject to rapid technological change. We expect our competition to continue to intensify. We believe that the principal competitive factors in the small business and home markets for networking products include product breadth, size and scope of the sales channel, brand name, timeliness of new product introductions, product performance, features, functionality and reliability, ease-of-installation, maintenance and use, and customer service and support. To remain competitive, we believe we must invest significant resources in developing new products, enhancing our current products, expanding our channels and maintaining customer satisfaction worldwide.

Our gross margin improved to 33.8% for the year ended December 31, 2006 from 33.7% for the year ended December 31, 2005. Our gross margin improvement was primarily due to decreased marketing costs and improved vendor rebates, offset by increased sales of products carrying lower gross margins to service providers. Operating expenses for the year ended December 31, 2006 were $134.1 million or 23.4% of net revenue and $99.5 million or 22.1% of net revenue for the year ended December 31, 2005.

Net income increased $7.5 million, to $41.1 million for the year ended December 31, 2006 from $33.6 million for the year ended December 31, 2005. This increase was due to an increase in gross profit of $42.0 million and an increase in interest and other income of $7.1 million, offset by an increase in operating expenses of $34.6 million and an increase in provision for income taxes of $7.0 million.

**Critical Accounting Policies and Estimates**

Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make assumptions, judgments and estimates that can have a significant impact on the reported amounts of assets, liabilities, revenues and expenses. We base our estimates on historical experience and on various other assumptions believed to be applicable and reasonable under the circumstances. Actual results could differ significantly from these estimates. These estimates may change as new events occur, as additional information is obtained and as our operating environment changes. On a regular basis we evaluate our assumptions, judgments and estimates and make changes accordingly. We also discuss our critical accounting estimates with the Audit Committee of the Board of Directors. Note 1 of the Notes to Consolidated Financial Statements describes the significant accounting policies used in the preparation of the consolidated financial statements. We have listed below our critical accounting policies which we believe to have the greatest potential impact on our consolidated financial statements. Historically, our assumptions, judgments and estimates relative to our critical accounting policies have not differed materially from actual results.

***Revenue Recognition***

Revenue from product sales is recognized at the time the product is shipped provided that persuasive evidence of an arrangement exists, title and risk of loss has transferred to the customer, the selling price is fixed or determinable and collection of the related receivable is reasonably assured. Currently, for some of our customers, title passes to the customer upon delivery to the port or country of destination, upon their receipt of the product, or upon the customer s resale of the product. At the end of each fiscal quarter, we estimate and defer revenue related to product where title has not transferred. The revenue continues to be deferred until such time that title passes to the

customer. The amount and timing of our revenue for any period could be materially different if our management made different judgments and estimates.

***Allowances for Product Warranties, Returns due to Stock Rotation, Price Protection, Sales Incentives and Doubtful Accounts***

Our standard warranty obligation to our direct customers generally provides for a right of return of any product for a full refund in the event that such product is not merchantable or is found to be damaged or defective. At the time revenue is recognized, an estimate of future warranty returns is recorded to reduce revenue in the amount of the expected credit or refund to be provided to the our direct customers. At the time we record the reduction to revenue related to warranty returns, we include within cost of revenue a write-down to reduce the carrying value of such products to net realizable value. Our standard warranty obligation to end-users provides for repair or replacement of a defective product for one or more years. Factors that affect the warranty obligation include product failure rates, material usage, and service delivery costs incurred in correcting product failures. The estimated cost associated with fulfilling the warranty obligation to end-users is recorded in cost of revenue. Because our products are manufactured by contract manufacturers, in certain cases we have recourse to the contract manufacturer for replacement or credit for the defective products. We give consideration to amounts recoverable from our contract manufacturers in determining our warranty liability. Our estimated allowances for product warranties can vary from actual results and we may have to record additional revenue reductions or charges to cost of revenue which could materially impact our financial position and results of operations.

In addition to warranty-related returns, certain distributors and retailers generally have the right to return product for stock rotation purposes. Every quarter, stock rotation rights are generally limited to 10% of invoiced sales to the distributor or retailer in the prior quarter. Upon shipment of the product, we reduce revenue for an estimate of potential future stock rotation returns related to the current period product revenue. We analyze historical returns, channel inventory levels, current economic trends and changes in customer demand for our products when evaluating the adequacy of the allowance for sales returns, namely stock rotation returns. Our estimated allowances for returns due to stock rotation can vary from actual results and we may have to record additional revenue reductions which could materially impact our financial position and results of operations.

Sales incentives provided to customers are accounted for in accordance with Emerging Issues Task Force ( EITF ) Issue No. 01-9, Accounting for Consideration Given by a Vendor to a Customer or Reseller of the Vendor s Products . Under these guidelines, we accrue for sales incentives as a marketing expense if we receive an identifiable benefit in exchange and can reasonably estimate the fair value of the identifiable benefit received; otherwise, it is recorded as a reduction of revenues. Our estimated provisions for sales incentives can vary from actual results and we may have to record additional expenses or additional revenue reductions dependent on the classification of the sales incentive.

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We regularly perform credit evaluations of our customers financial condition and consider factors such as historical experience, credit quality, age of the accounts receivable balances, and geographic or country-specific risks and economic conditions that may affect a customer s ability to pay. The allowance for doubtful accounts is reviewed monthly and adjusted if necessary based on our assessments of our customers ability to pay. If the financial condition of our customers should deteriorate or if actual defaults are higher than our historical experience, additional allowances may be required, which could have an adverse impact on operating expenses.

***Valuation of Inventory***

We value our inventory at the lower of cost or market, cost being determined using the first-in, first-out method. We continually assess the value of our inventory and will periodically write down its value for estimated excess and

obsolete inventory based upon assumptions about future demand and market conditions. On a quarterly basis, we review inventory quantities on hand and on order under non-cancelable purchase commitments, including consignment inventory, in comparison to our estimated forecast of product demand for the next nine months to determine what inventory, if any, are not saleable. Our analysis is based on the demand forecast but takes into

account market conditions, product development plans, product life expectancy and other factors. Based on this analysis, we write down the affected inventory value for estimated excess and obsolescence charges. At the point of loss recognition, a new, lower cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis. As demonstrated during prior years, demand for our products can fluctuate significantly. If actual demand is lower than our forecasted demand and we fail to reduce our manufacturing accordingly, we could be required to write down additional inventory, which would have a negative effect on our gross margin.

***Income Taxes***

We account for income taxes under an asset and liability approach. Under this method, income tax expense is recognized for the amount of taxes payable or refundable for the current year. In addition, deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences resulting from different treatments for tax versus accounting of certain items, such as accruals and allowances not currently deductible for tax purposes. These differences result in deferred tax assets and liabilities, which are included within the consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not more likely than not, we must establish a valuation allowance. As of December 31, 2006, we believe that all of our deferred tax assets are recoverable; however, if there were a change in our ability to recover our deferred tax assets, we would be required to take a charge in the period in which we determined that recovery was not more likely than not.

Our effective tax rate differs from the statutory rate due to tax credits, state taxes, stock compensation and other factors. Our future effective tax rate could be impacted by a shift in the mix of domestic and foreign income, tax treaties with foreign jurisdictions; changes in tax laws in the United States or internationally; a change which would result in a valuation allowance being required to be recorded; or a federal, state or foreign jurisdiction s view of tax returns which differs materially from what we originally provided. We assess the probability of adverse outcomes from tax examinations regularly to determine the adequacy of our income tax liability. If we ultimately determine that payment of these amounts is unnecessary, we reverse the liability and recognize a tax benefit during the period in which we determine that the liability is no longer necessary. We record an additional charge in our provision for taxes in the period in which we determine that the recorded tax liability is less than we expect the ultimate assessment to be.

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**Results of Operations**

The following table sets forth the consolidated statements of operations and the percentage change from the preceding year for the periods indicated:

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2004 | Percentage Change | 2005 | Percentage Change | 2006 |
| | (In thousands, except percentage data) | | | | |
| Net revenue | $ 383,139 | 17.3% | $ 449,610 | 27.6% | $ 573,570 |
| Cost of revenue | 260,318 | 14.4 | 297,911 | 27.5 | 379,911 |
| Gross profit | 122,821 | 23.5 | 151,699 | 27.7 | 193,659 |
| Operating expenses: | | | | | |
| Research and development | 10,316 | 24.4 | 12,837 | 43.7 | 18,443 |
| Sales and marketing | 62,247 | 14.6 | 71,345 | 28.8 | 91,881 |
| General and administrative | 14,905 | (2.3) | 14,559 | 43.6 | 20,905 |
| In-process research and development | | ** | | ** | 2,900 |
| Litigation reserves | | ** | 802 | (100.0) | |
| Total operating expenses | 87,468 | 13.8 | 99,543 | 34.7 | 134,129 |
| Income from operations | 35,353 | 47.5 | 52,156 | 14.1 | 59,530 |
| Interest income | 1,593 | 157.6 | 4,104 | 69.9 | 6,974 |
| Other income (expense), net | (560) | 216.1 | (1,770) | ** | 2,495 |
| Income before income taxes | 36,386 | 49.8 | 54,490 | 26.6 | 68,999 |
| Provision for income taxes | 12,921 | 61.5 | 20,867 | 33.5 | 27,867 |
| Net income | $ 23,465 | 43.3% | $ 33,623 | 22.3% | $ 41,132 |

** Percentage change not meaningful as prior year basis is zero or a negative amount.

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The following table sets forth the consolidated statements of operations, expressed as a percentage of net revenue, for the periods presented:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2004 | 2005 | 2006 |
| Net revenue | 100% | 100% | 100% |
| Cost of revenue | 67.9 | 66.3 | 66.2 |
| Gross margin | 32.1 | 33.7 | 33.8 |
| Operating expenses: | | | |
| Research and development | 2.7 | 2.8 | 3.2 |
| Sales and marketing | 16.3 | 15.9 | 16.0 |
| General and administrative | 3.9 | 3.2 | 3.7 |
| In-process research and development | 0.0 | 0.0 | 0.5 |
| Litigation reserves | 0.0 | 0.2 | 0.0 |
| Total operating expenses | 22.9 | 22.1 | 23.4 |
| Income from operations | 9.2 | 11.6 | 10.4 |
| Interest income | 0.4 | 0.9 | 1.2 |
| Other income (expense), net | (0.1) | (0.4) | 0.4 |
| Income before income taxes | 9.5 | 12.1 | 12.0 |
| Provision for income taxes | 3.4 | 4.6 | 4.8 |
| Net income | 6.1% | 7.5% | 7.2% |

**Net Revenue**

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2004 | Percentage Change | 2005 | Percentage Change | 2006 |
| | (In thousands, except percentage data) | | | | |
| Net revenue | $ 383,139 | 17.3% | $ 449,610 | 27.6% | $ 573,570 |

Our net revenue consists of gross product shipments, less allowances for estimated returns for stock rotation and warranty, price protection and sales incentives deemed to be a reduction of net revenue per EITF Issue No. 01-9 and net changes in deferred revenue. Sales incentives include advertising, cooperative marketing programs, end-caps, instant rebates and mail-in rebates.

***2006 Net Revenue Compared to 2005 Net Revenue***

Net revenue increased $124.0 million, or 27.6%, to $573.6 million for the year ended December 31, 2006, from $449.6 million for the year ended December 31, 2005. We continued to experience our seasonal pattern of higher net revenues in the second half of the year. The increase in revenue was especially attributable to higher sales of DSL gateway and powerline products to new and existing service provider customers, especially in Europe. The majority of these incremental sales specifically included our wireless gateway customized for major service provider British Sky Broadcasting in the United Kingdom, with shipments of wireless gateways and powerline products to other service providers further improving revenue.

Sales were further enhanced by the first full year of RangeMax wireless router sales to the home market. We introduced our RangeMax family of products, which included performance-enhancing Multiple-In Multiple-Out (MIMO) technology, during 2005, and the market has continued to embrace this key product line throughout the year. We expect the RangeMax family to remain strong in the coming year, and anticipate continuing our recent trend of increased sales of customized wireless gateways to service providers, both domestically and abroad. We

also anticipate new products such as our wireless-N routers, Skype wi-fi phones, and Gigabit smart switches to drive revenue in the near future.

Sales incentives that are classified as contra-revenue grew at a slower rate than overall gross sales, which further contributed to the increased net revenue. This is primarily due to increased sales to the service provider markets, which typically require less marketing spending. This favorable net revenue impact was partially offset by an increase in sales returns compared to historical return rates.

For the year ended December 31, 2006 revenue generated in the United States, EMEA and Asia Pacific and rest of world was 38.4%, 52.0% and 9.6%, respectively. The comparable net revenue for the year ended December 31, 2005 was 44.3%, 44.5% and 11.2%, respectively. The increase in net revenue over the prior year for each region was 10.7%, 49.2% and 8.8%, respectively.

***2005 Net Revenue Compared to 2004 Net Revenue***

Net revenue increased $66.5 million, or 17.3%, to $449.6 million for the year ended December 31, 2005, from $383.1 million for the year ended December 31, 2004. We continued to experience our seasonal pattern of higher net revenues in the second half of the year. The increase in revenue was especially attributable to higher sales of wireless LAN products to the home market, especially the new RangeMax family of products and continued strength in G and Super-G products, as well as increased gross shipments of our broadband gateways. These revenue increases were partially offset by increases in allowances for sales incentives associated with increased retail product sales.

We were able to slow down the pace of erosion in our average selling prices on our relatively older products in 2005 in part due to our new minimum advertised price policy with our U.S. retailers, as well as a general slowdown in competitive pricing pressures.

End-user customer rebates and other sales incentives which are classified as reductions in net revenue increased in 2005, especially in the latter half of 2005 when we took advantage of significant strategic joint promotion opportunities with our biggest retail partners both in the U.S. and in Europe. For example, we co-marketed our new RangeMax family of products with U.S. national retailers using a unified advertising campaign involving ad circulars and new end-cap displays. These increases in spending combined with higher use of end-user customer rebates impacted our revenue growth.

For the year ended December 31, 2005 revenue generated in the United States, EMEA and Asia Pacific and rest of world was 44.3%, 44.5% and 11.2%, respectively. The comparable net revenue for the year ended December 31, 2004 was 48.8%, 41.6% and 9.6%, respectively. The increase in net revenue over the prior year for each region was 6.6%, 25.3% and 37.5%, respectively.

**Cost of Revenue and Gross Margin**

| | **Year Ended December 31,** | | | | |
|---|---|---|---|---|---|
| | **2004** | **Percentage Change** | **2005** | **Percentage Change** | **2006** |
| | **(In thousands, except percentage data)** | | | | |
| Cost of revenue | $ 260,318 | 14.4% | $ 297,911 | 27.5% | $ 379,911 |
| Gross margin percentage | 32.1% | | 33.7% | | 33.8% |

Cost of revenue consists primarily of the following: the cost of finished products from our third-party contract manufacturers; overhead costs including purchasing, product planning, inventory control, warehousing and distribution logistics; inbound freight; and warranty costs associated with returned goods and write-downs for excess and obsolete inventory. We outsource our manufacturing, warehousing and distribution logistics. We believe this outsourcing strategy allows us to better manage our product costs and gross margin. Our gross margin can be affected by a number of factors, including sales returns, changes in net revenues due to changes in average selling prices, sales incentives, and changes in our cost of goods sold due to fluctuations in prices paid for components, net

of vendor rebates, warranty and overhead costs, inbound freight, conversion costs, and charges for excess or obsolete inventory and transitions from older to newer products.

Cost of revenue increased $82.0 million, or 27.5%, to $379.9 million for the year ended December 31, 2006, from $297.9 million for the year ended December 31, 2005. Our gross margin improved to 33.8% for the year ended December 31, 2006, from 33.7% for the year ended December 31, 2005.

Our gross margin is impacted by our sales incentives that are recorded as a reduction in revenue which grew at a relatively slower rate than overall net revenue, as most of our revenue increases relate to sales to service providers, which involve significantly lower sales incentive expenses. Additionally, we experienced decreased price protection claims, as well as relatively lower inbound freight during the year, as we were able to shift the mix of inbound shipments from our suppliers from more costly air freight to lower cost sea freight due to better supply chain planning. Furthermore, rebates from vendors were significantly higher in 2006. While we do not expect this higher level of rebates to continue in the future, we anticipate lower costs on these products.

These improvements were almost entirely offset by a number of factors. Incremental sales in 2006 came primarily from increased sales of products carrying lower gross margins to service providers. We also experienced increased warranty and sales returns costs, driven primarily by a higher scrap rate of warranty return units and an increase in reserves taken for future returns based on the increase in returns volume during the year. We also experienced higher costs related to inventory reserves and devaluation.

Additionally, stock-based compensation expense increased $283,000 to $430,000 for the year ended December 31, 2006, from $147,000 for the year ended December 31, 2005, as a result of the adoption of Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), Share-Based Payment ( SFAS 123R ).

Cost of revenue increased $37.6 million, or 14.4%, to $297.9 million for the year ended December 31, 2005 from $260.3 million for the year ended December 31, 2004. Our gross margin improved to 33.7% for the year ended December 31, 2005, from 32.1% for the year ended December 31, 2004, an increase of 1.6 percentage points. This increase was due primarily to a favorable shift in product mix and our product costs decreasing relatively more quickly than sales prices, offset by an increase in end-user customer rebates and other sales incentives, which reduce revenue along with increased inbound freight and conversion costs.

We were able to slow down the pace of erosion in our average selling prices on our relatively older products in 2005 in part due to our new minimum advertised price policy with our U.S. retailers, as well as a general slowdown in competitive pricing pressures. We have also had continued success in obtaining cost reductions and efficiencies from our vendors and manufacturers, and have pursued product redesigns when appropriate to further lower production costs. These decreasing costs, coupled with the relative slowing in the decrease of average selling prices, boosted margins on our older products, especially our G and Super G wireless adapters. Additionally, we have benefited from relatively higher standard margins on newer products, especially from our RangeMax family of products.

It is difficult to accurately forecast demand for our products across our markets and within specific countries. The shift in the mix of actual orders compared to forecasted demand resulted in a higher than normal reliance on more expensive air versus surface freight during the last quarter of 2005 as well as higher rework and other costs primarily related to product conversions among country-specific packaging.

Additionally, stock-based compensation expense decreased $16,000 to $147,000 for the year ended December 31, 2005, from $163,000 for the year ended December 31, 2004.

## Operating Expenses

### Research and development expense

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2004 | Percentage Change | 2005 | Percentage Change | 2006 |
| | (In thousands, except percentage data) | | | | |
| Research and development expense | $ 10,316 | 24.4% | $ 12,837 | 43.7% | $ 18,443 |
| Percentage of net revenue | 2.7% | | 2.8% | | 3.2% |

Research and development expenses consist primarily of personnel expenses, payments to suppliers for design services, tooling design costs, safety and regulatory testing, product certification expenditures to qualify our products for sale into specific markets, prototypes and other consulting fees. Research and development expenses are recognized as they are incurred. We have invested in building our research and development organization to enhance our ability to introduce innovative and easy to use products. We expect to continue to add additional employees in our research and development department. In the future we believe that research and development expenses will increase in absolute dollars as we expand into new product technologies, enhance the ease-of-use of our products, and broaden our core competencies.

Research and development expenses increased $5.6 million, or 43.7%, to $18.4 million for the year ended December 31, 2006, from $12.8 million for the year ended December 31, 2005. The increase was primarily due to higher salary and related payroll expenses of $2.1 million resulting from research and development related headcount growth, including $486,000 related to retention bonuses for certain employees associated with the acquisition of SkipJam. Employee headcount increased by 15% to 62 employees as of December 31, 2006 as compared to 54 employees as of December 31, 2005, in part due to employees obtained from the acquisition of SkipJam. The increase was also attributable to an increase of $2.1 million in engineering costs. These costs were incurred to improve the quality of our small business products. Additionally, stock-based compensation expense increased $826,000 to $1.1 million for the year ended December 31, 2006, from $293,000 for the year ended December 31, 2005, as a result of the adoption of SFAS 123R.

Research and development expenses increased $2.5 million, or 24.4%, to $12.8 million for the year ended December 31, 2005, from $10.3 million for the year ended December 31, 2004. The increase was primarily due to increased salary and payroll related expenses of $2.4 million resulting from research and development related headcount growth. Employee headcount increased by 35% to 54 employees as of December 31, 2005 as compared to 40 employees as of December 31, 2004. These headcount increases were primarily due to the expansion of our research and development facility in Taiwan and expansion of our focus on the broadband service provider market which often requires additional certifications and testing. Additionally, stock-based compensation expense decreased $107,000 to $293,000 for the year ended December 31, 2005, from $400,000 for the year ended December 31, 2004.

### Sales and marketing expense

| Year Ended December 31, | | |
|---|---|---|
| | Percentage | Percentage |

| | 2004 | Change | 2005 | Change | 2006 |
|---|---|---|---|---|---|
| | (In thousands, except percentage data) | | | | |
| Sales and marketing expense | $ 62,247 | 14.6% | $ 71,345 | 28.8% | $ 91,881 |
| Percentage of net revenue | 16.3% | | 15.9% | | 16.0% |

Sales and marketing expenses consist primarily of advertising, trade shows, corporate communications and other marketing expenses, product marketing expenses, outbound freight costs, personnel expenses for sales and marketing staff and technical support expenses. We believe that maintaining and building brand awareness is key to both net revenue growth and maintaining our gross margin. We also believe that maintaining widely available and high quality technical support is key to building and maintaining brand awareness. Accordingly, we expect sales and marketing expenses to increase in absolute dollars in the future, related to the planned growth of our business.

Sales and marketing expenses increased $20.6 million, or 28.8%, to $91.9 million for the year ended December 31, 2006, from $71.3 million for the year ended December 31, 2005. We note that sales and marketing expenses grew in line with revenue growth. Of this increase, $9.4 million was due to increased salary and payroll related expenses as a result of sales and marketing related headcount growth and increased commissions earned in EMEA due to substantial revenue growth. Employee headcount increased from 157 employees as of December 31, 2005 to 207 employees as of December 31, 2006. More specifically, 46 of the 50 incremental employees relate to expansion in EMEA and Asia Pacific, which represents our continued geographic expansion and increasing sales staffing in these regions. For example, we established a Technical Support Center in our Ireland office, which accounted for 7 new individuals. Outside service fees related to customer service and technical support also increased by $4.9 million, in support of higher call volumes related to increased units sold. We also incurred a $1.7 million increase in advertising, travel, and promotion expenses related to our expansion of marketing activities into new geographies. Outbound freight increased $1.6 million, reflecting our higher sales volume. Marketing costs classified as operating expenses remained relatively constant, as the majority of incremental marketing expenses related to rebates and other items classified as contra-revenue. Additionally, stock-based compensation expense increased $1.0 million to $1.4 million for the year ended December 31, 2006, from $375,000 for the year ended December 31, 2005, as a result of the adoption of SFAS 123R.

Sales and marketing expenses increased $9.1 million, or 14.6%, to $71.3 million for the year ended December 31, 2005, from $62.2 million for the year ended December 31, 2004. Of this increase, $5.1 million was due to product promotion, including intensified in-store staffing and training programs, advertising, and outside technical support expenses, all in support of increased volume. In addition, salary and related expenses for additional sales and marketing personnel increased by $2.7 million as a result of sales and marketing related headcount growth from 125 employees as of December 31, 2004 to 157 employees as of December 31, 2005. We attributed 28 of the 32 incremental employee additions to expansion in EMEA and Asia Pacific, where sales and marketing employee headcount grew 46% and 35%, respectively. The increase was also attributable to additional allocated overhead costs such as facilities and information systems costs amounting to $851,000, which reflects sales and marketing s larger relative headcount growth rate and correspondingly higher share of overhead costs. Additionally, stock-based compensation expense decreased $358,000 to $375,000 for the year ended December 31, 2005, from $733,000 for the year ended December 31, 2004.

**General and administrative expense**

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2004 | Percentage Change | 2005 | Percentage Change | 2006 |
| | (In thousands, except percentage data) | | | | |
| General and administrative expense | $ 14,905 | −2.3% | $ 14,559 | 43.6% | $ 20,905 |
| Percentage of net revenue | 3.9% | | 3.2% | | 3.7% |

General and administrative expenses consist of salaries and related expenses for executive, finance and accounting, human resources, professional fees, allowance for bad debts, and other corporate expenses. We expect general and administrative costs to increase in absolute dollars related to the general growth of the business, continued international expansion, and increased investments in infrastructure such as a new enterprise resource planning system.

General and administrative expenses increased $6.3 million, or 43.6%, to $20.9 million for the year ended December 31, 2006, from $14.6 million for the year ended December 31, 2005. The increase was primarily due to

higher salary and payroll related expenses of $3.3 million due to an increase in general and administrative related headcount. Employee headcount increased by 25% to 66 employees as of December 31, 2006 compared to 53 employees as of December 31, 2005. Of the incremental 13 additions, 8 personnel were hired into accounting and finance departments in our new Ireland office. We also incurred a $1.4 million increase in fees for outside professional services, which was in part related to an increase in IT consulting costs, tax consulting and general legal expenses. Additionally, stock-based compensation expense increased approximately $1.4 million to $1.6 million for the year ended December 31, 2006, from $249,000 for the year ended December 31, 2005, as a result of the adoption of SFAS 123R.

General and administrative expenses decreased approximately $300,000, or 2.3%, to $14.6 million for the year ended December 31, 2005, from $14.9 million for the year ended December 31, 2004. This decrease was primarily due to a decrease in fees for professional services aggregating $1.7 million and a decrease in net allocated overhead such as information systems costs aggregating $588,000, offset by an increase in employee related costs of $2.1 million. The decrease in fees for professional services resulted from decreases in consulting, outsourced accounting fees and legal fees, and costs associated with initial Sarbanes-Oxley 404 compliance documentation in 2004. The increase in employee related costs resulted from an increase in general and administrative related headcount, particularly in the finance area to support an increase in transactional processing due to increased revenue. Employee headcount increased by 43% to 53 employees as of December 31, 2005 as compared to 37 employees as of December 31, 2004. The decrease in net allocated overhead reflects the general and administrative function s slower headcount growth rate relative to other functional areas. Additionally, stock-based compensation expense decreased $142,000 to $249,000 for the year ended December 31, 2005, from $391,000 for the year ended December 31, 2004.

**In-process research and development**

During the year ended December 31, 2006, we expensed $2.9 million for in-process research and development related to intangible assets purchased in our acquisition of SkipJam. See Note 2 of the Notes to the Consolidated Financial Statements for additional information regarding the acquisition. In-process R&D is expensed upon an acquisition because technological feasibility has not been established and no future alternative uses exist. We acquired only one in-process R&D project, which is related to the development of a multimedia product that had not reached technological feasibility and had no alternative use. We incurred costs of approximately $725,000 to complete the project, of which approximately $575,000 was incurred through December 31, 2006. We completed the project in February 2007.

**Litigation reserves**

During the year ended December 31, 2005, we recorded an allowance of $802,000 for the estimated costs of settlement for the *Zilberman v. NETGEAR* lawsuit. The lawsuit was settled on May 26, 2006, and no material additional costs were incurred. No litigation reserves were recorded in the year ended December 31, 2006.

**Interest income and other income (expense)**

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2004 | 2005 | 2006 |
| | | (In thousands) | |
| Interest income | $ 1,593 | $ 4,104 | $ 6,974 |
| Other income (expense), net | (560) | (1,770) | 2,495 |
| Total interest income and other income (expense) | $ 1,033 | $ 2,334 | $ 9,469 |

Interest income represents amounts earned on our cash, cash equivalents and short-term investments.

Other income (expense), net, primarily represents gains and losses on transactions denominated in foreign currencies and other miscellaneous expenses.

Interest income increased $2.9 million, or 69.9%, to $7.0 million for the year ended December 31, 2006, from $4.1 million for the year ended December 31, 2005. The increase in interest income was a result of an increase in the average interest rate earned.

Other income (expense), net, increased to income of $2.5 million for the year ended December 31, 2006, from an expense of $1.8 million for the year ended December 31, 2005. The income of $2.5 million was primarily attributable to a net foreign exchange gain experienced in the year ended December 31, 2006 due to the weakening of the U.S. dollar against the Euro, the Great Britain Pound, and the Australian Dollar. The expense of $1.8 million in the year ended December 31, 2005 was primarily attributable to a net foreign exchange loss experienced due to the strengthening of the U.S. dollar against the Euro, Great Britain Pound and the Australian Dollar.

The aggregate of interest income, interest expense, and other expense amounted to net other income of $2.3 million for the year ended December 31, 2005, compared to net other income of $1.0 million for the year ended December 31, 2004. This change was primarily due to an additional $2.5 million in interest income for the year ended December 31, 2005, from the investment of our cash, cash equivalents, and short-term investments balance throughout the year. This was offset in part by an increase in other expense of $1.2 million consisting primarily of realized and unrealized losses associated with foreign currency denominated transactions due in part to currency volatility during the year as well as our billing in foreign currencies which began in the first quarter of 2005.

**Provision for Income Taxes**

Provision for income taxes increased $7.0 million, resulting in a provision of $27.9 million for the year ended December 31, 2006, from a provision of $20.9 million for the year ended December 31, 2005. The effective tax rate was approximately 40% for the year ended December 31, 2006 and approximately 38% for the year ended December 31, 2005. The effective tax rate for both periods differed from our statutory rate of approximately 35% due to non-deductible stock-based compensation, state taxes, other non-deductible expenses, and tax credits. The effective tax rate for the year ended December 31, 2006 was also impacted by non-deductible charges pertaining to in-process research and development as a result of the acquisition of SkipJam.

Provision for income taxes increased $8.0 million, to a provision of $20.9 million for the year ended December 31, 2005, from a provision of $12.9 million for the year ended December 31, 2004. The effective tax rate for the year ended December 31, 2005 was approximately 38% and differed from our statutory rate of approximately 35% due to state taxes, and other non-deductible expenses, offset in part by tax credits. The effective tax rate for the year ended December 31, 2004 was approximately 36% and differed from our statutory rate of approximately 35% due to non-deductible stock-based compensation, state taxes, and other non-deductible expenses, offset in part by a $1.5 million tax benefit from exercises of stock options and tax credits.

**Net Income**

Net income increased $7.5 million, to $41.1 million for the year ended December 31, 2006 from $33.6 million for the year ended December 31, 2005. This increase was due to an increase in gross profit of $42.0 million and an increase in interest and other income of $7.1 million, offset by an increase in operating expenses of $34.6 million and an increase in provision for income taxes of $7.0 million.

Net income increased $10.1 million, to $33.6 million for the year ended December 31, 2005 from $23.5 million for the year ended December 31, 2004. This increase was primarily due to an increase in gross profit of $28.9 million, offset by an increase in operating expenses of $12.0 million and an increase in provision for income taxes of $8.0 million.

**Liquidity and Capital Resources**

As of December 31, 2006 we had cash, cash equivalents and short-term investments totaling $197.5 million.

Our cash and cash equivalents balance decreased from $90.0 million as of December 31, 2005 to $87.7 million as of December 31, 2006. Our short-term investments, which represent the investment of funds available for current operations, increased from $83.7 million as of December 31, 2005 to $109.7 million as of December 31, 2006. Operating activities during the year ended December 31, 2006 generated cash of $23.1 million primarily due to an increase in net income. Investing activities during the year ended December 31, 2006 used $37.7 million, which includes the net purchase of short-term investments of $24.2 million, purchases of property and equipment amounting to $5.9 million, and payments made in connection with our acquisition of SkipJam of $7.6 million. During the year

ended December 31, 2006, financing activities provided $12.3 million, primarily resulting from the issuance of our common stock upon exercise of stock options and our employee stock purchase program.

Our days sales outstanding decreased from 77 days as of December 31, 2005 to 66 days as of December 31, 2006.

Our accounts payable increased from $38.9 million at December 31, 2005 to $39.8 million at December 31, 2006.

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Inventory increased by $26.0 million from $51.9 million at December 31, 2005 to $77.9 million at December 31, 2006. Ending inventory turns decreased, from approximately 6.5 turns in the quarter ended December 31, 2005, to 5.7 turns in the quarter ended December 31, 2006.

Based on our current plans and market conditions, we believe that our existing cash, cash equivalents and short-term investments will be sufficient to satisfy our anticipated cash requirements for the forseeable future. However, we cannot be certain that our planned levels of revenue, costs and expenses will be achieved. If our operating results fail to meet our expectations or if we fail to manage our inventory, accounts receivable or other assets, we could be required to seek additional funding through public or private financings or other arrangements. In addition, as we continue to expand our product offerings, channels and geographic presence, we may require additional working capital. In such event, adequate funds may not be available when needed or may not be available on favorable or commercially acceptable terms, which could have a negative effect on our business and results of operations.

**Backlog**

As of December 31, 2006, we had a backlog of approximately $42.7 million compared to approximately $15.7 million as of December 31, 2005. Our backlog consists of products for which customer purchase orders have been received and which are scheduled or in the process of being scheduled for shipment. While we expect to fulfill the order backlog within the current year, most orders are subject to rescheduling or cancellation with little or no penalties. Because of the possibility of customer changes in product scheduling or order cancellation, our backlog as of any particular date may not be an indicator of net sales for any succeeding period.

**Contractual Obligations and Off-Balance Sheet Arrangements**

***Contractual Obligations***

The following table describes our commitments to settle non-cancelable lease and purchase commitments as of December 31, 2006.

| | Less Than 1 Year | 1-3 Years | 3-5 Years | More Than 5 Years | Total |
|---|---|---|---|---|---|
| | | | (In thousands) | | |
| **Operating leases** | $ 2,371 | $ 2,016 | $ 1,053 | $ 3,214 | $ 8,654 |
| **Purchase obligations** | $ 55,227 | $ | $ | $ | $ 55,227 |
| | $ 57,598 | $ 2,016 | $ 1,053 | $ 3,214 | $ 63,881 |

We lease office space, cars and equipment under non-cancelable operating leases with various expiration dates through December 2026. Rent expense was $1.3 million for the year ended December 31, 2004, $1.5 million for the year ended December 31, 2005 and $2.2 million for the year ended December 31, 2006. The terms of some of the office leases provide for rental payments on a graduated scale. We recognize rent expense on a straight-line basis over the lease period, and have accrued for rent expense incurred but not paid. The amounts presented are consistent with contractual terms and are not expected to differ significantly, unless a substantial change in our headcount needs requires us to exit an office facility early or expand our occupied space.

We enter into various inventory-related purchase agreements with suppliers. Generally, under these agreements, 50% of the orders are cancelable by giving notice 46 to 60 days prior to the expected shipment date and 25% of orders are cancelable by giving notice 31-45 days prior to the expected shipment date. Orders are not cancelable within 30 days prior to the expected shipment date. At December 31, 2006, we had $55.2 million in non-cancelable purchase commitments with suppliers.

As part of our acquisition of SkipJam, we agreed to pay up to $1.4 million in cash contingent on the continued employment of certain former SkipJam employees with us. These payments will be recorded as compensation expense over a two-year period. During the year ended December 31, 2006, we have recorded $486,000 of additional compensation expense pursuant to this agreement, and expect to pay up to $933,000 over the remaining life of this agreement.

### *Off-Balance Sheet Arrangements*

As of December 31, 2006, we did not have any off-balance sheet arrangements as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

### Recent Accounting Pronouncements

See Note 1 of the Notes to Consolidated Financial Statements for recent accounting pronouncements.

### Item 7A. *Quantitative and Qualitative Disclosures About Market Risk*

We do not use derivative financial instruments in our investment portfolio. We have an investment portfolio of fixed income securities that are classified as available-for-sale securities. These securities, like all fixed income instruments, are subject to interest rate risk and will fall in value if market interest rates increase. We attempt to limit this exposure by investing primarily in short-term securities. Due to the short duration and conservative nature of our investment portfolio, a movement of 10% by market interest rates would not have a material impact on our operating results and the total value of the portfolio over the next fiscal year.

We are exposed to risks associated with foreign exchange rate fluctuations due to our international manufacturing and sales activities. We generally have not hedged currency exposures. These exposures may change over time as business practices evolve and could negatively impact our operating results and financial condition. In the second quarter of 2005 we began to invoice some of our international customers in foreign currencies including, but not limited to, the Euro, Great Britain Pound, Japanese Yen and the Australian dollar. As the customers that are currently invoiced in local currency become a larger percentage of our business, or to the extent we begin to bill additional customers in foreign currencies, the impact of fluctuations in foreign exchange rates could have a more significant impact on our results of operations. For those customers in our international markets that we continue to sell to in U.S. dollars, an increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and therefore reduce the demand for our products. Such a decline in the demand could reduce sales and negatively impact our operating results. Certain operating expenses of our foreign operations require payment in the local currencies. As of December 31, 2006, we had net assets in various local currencies. A hypothetical 10% movement in foreign exchange rates would result in an after tax positive or negative impact of $2.6 million to net income at December 31, 2006.

**Item 8.** ***Consolidated Financial Statements and Supplementary Data***

## Management s Report on Internal Control Over Financial Reporting

Management of NETGEAR, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rules 13a-15(f) and 15(d)-15(f) under the Securities Exchange Act of 1934. The Company s internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of management, including its principal executive officer and principal financial officer, the Company assessed the effectiveness of its internal control over financial reporting as of December 31, 2006. In conducting its evaluation, the Company used the criteria set forth in the *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on its evaluation and those criteria, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2006. The Company s independent registered public accounting firm, PricewaterhouseCoopers LLP, has audited management s assessment of the Company s internal control over financial reporting as of December 31, 2006 as stated in their report which appears herein.

## Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
of NETGEAR, Inc.:

We have completed integrated audits of NETGEAR, Inc. s consolidated financial statements and of its internal control over financial reporting as of December 31, 2006 in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

**Consolidated financial statements and financial statement schedule**

In our opinion, the consolidated financial statements listed in the accompanying index appearing under Item 15 (a)(1) present fairly, in all material respects, the financial position of NETGEAR, Inc. and its subsidiaries at December 31, 2006 and December 31, 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule appearing under Item 15 (a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 7 of the Notes to Consolidated Financial Statements, in accordance with the adoption of SFAS 123R, the Company changed the manner in which it accounts for share-based compensation in the year ended December 31, 2006.

**Internal control over financial reporting**

Also, in our opinion, management s assessment, included in Management s Report on Internal Control Over Financial Reporting appearing under Item 8, that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the COSO. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management s assessment and on the effectiveness of the Company s internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating

management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail,

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accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PRICEWATERHOUSECOOPERS LLP

San Jose, California
March 1, 2007

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**NETGEAR, INC.**

**CONSOLIDATED BALANCE SHEETS**

| | December 31, 2005 | December 31, 2006 |
|---|---|---|
| | (In thousands, except share and per share data) | |
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 90,002 | $ 87,736 |
| Short-term investments | 83,654 | 109,729 |
| Accounts receivable, net | 104,269 | 119,601 |
| Inventories | 51,873 | 77,932 |
| Deferred income taxes | 11,503 | 13,415 |
| Prepaid expenses and other current assets | 9,408 | 15,946 |
| Total current assets | 350,709 | 424,359 |
| Property and equipment, net | 4,702 | 6,568 |
| Intangibles, net | | 975 |
| Goodwill | 558 | 3,800 |
| Other non-current assets | 328 | 2,202 |
| Total assets | $ 356,297 | $ 437,904 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 38,912 | $ 39,818 |
| Accrued employee compensation | 7,743 | 11,803 |
| Other accrued liabilities | 66,279 | 75,909 |
| Deferred revenue | 4,304 | 8,215 |
| Income taxes payable | 3,055 | 7,737 |
| Total current liabilities | 120,293 | 143,482 |
| Commitments and contingencies (Note 6) | | |
| Stockholders equity: | | |
| Preferred stock: $0.001 par value; 5,000,000 shares authorized in 2005 and 2006; none outstanding in 2005 or 2006 | | |
| Common stock: $0.001 par value; 200,000,000 shares authorized in 2005 and 2006; shares issued and outstanding: 32,963,596 in 2005 and 33,960,506 in 2006 | 33 | 33 |
| Additional paid-in capital | 204,754 | 221,487 |
| Deferred stock-based compensation | (468) | |
| Cumulative other comprehensive loss | (90) | (5) |
| Retained earnings | 31,775 | 72,907 |

| | | |
|---|---|---|
| Total stockholders equity | 236,004 | 294,422 |
| Total liabilities and stockholders equity | $ 356,297 | $ 437,904 |

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

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**NETGEAR, INC.**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | | |
| | (In thousands, except per share data) | | | | |
| Net revenue | $ 383,139 | $ 449,610 | $ 573,570 | | |
| Cost of revenue(1) | — | | | | |
| Net income (loss) before income taxes | 12,721,503 | 20,731,796 | 26,329,775 | 8,095,074 | 10,817,604 |
| Income tax (expense) benefit | (4,041,655 ) | 7,248,977 | (93,335 ) | — | — |
| Net income | 8,679,848 | 27,980,773 | 26,236,440 | 8,095,074 | 10,817,604 |
| Net income attributable to non-controlling interests | — | (3,571,003 ) | (2,667,324 ) | (165,445 ) | (2,084,707 ) |
| Net income attributable to common stockholders | $ 8,679,848 | $ 24,409,770 | $23,569,116 | $ 7,929,629 | $8,732,897 |
| Earnings per common share (basic and diluted) | $ 0.85 | $ 2.38 | $2.22 | $ 0.74 | $0.78 |
| Dividends declared per common share | $ 0.38 | $ 0.32 | $0.41 | $ 0.27 | $0.25 |

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| Balance Sheet Data: | | | | | |
|---|---|---|---|---|---|
| Loans, net | $144,343,844 | $126,975,489 | $104,901,361 | $65,164,156 | $54,057,205 |
| Real estate held for sale | 56,110,472 | 75,843,635 | 100,191,166 | 59,494,339 | 5,890,131 |
| Real estate held for investment | 24,355,653 | 37,279,763 | 53,647,246 | 103,522,466 | 129,425,833 |
| Other assets | 14,201,304 | 19,463,568 | 13,254,472 | 13,742,960 | 17,268,412 |
| Total assets | 239,011,273 | 259,562,455 | 271,994,245 | 241,923,921 | 206,641,581 |
| Total indebtedness | 31,747,433 | 38,361,934 | 66,374,544 | 49,019,549 | 13,917,585 |
| Total liabilities | 38,021,546 | 44,034,578 | 72,485,398 | 53,177,310 | 20,415,275 |
| Non-controlling interests | — | — | 4,528,849 | 4,174,753 | 6,351,896 |
| Total equity | 200,989,727 | 215,527,877 | 199,508,847 | 188,746,611 | 186,226,306 |
| Book value per share | $22.10 | $21.03 | $19.03 | $17.14 | $16.66 |

## Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Forward Looking Statements

Some of the information in this Form 10-K may contain forward-looking statements. Words such as "may," "will," "should," "expect," "anticipate," "intend," "believe," "plan," "estimate," "continue" and variations of such words and similar expressions are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, uncertain events or assumptions, and other characterizations of future events, strategies or circumstances are forward-looking statements. These forward-looking statements are subject to risks and uncertainties, including those described throughout this filing and particularly in "Risk Factors" in Part I, Item 1A of this Form 10-K, that could cause actual results to differ materially from those projected or described in the forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management's analysis only as of the date hereof. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

### Overview and Background

We are a specialty finance company that focuses on the origination, investment and management of commercial real estate mortgage loans primarily in the Western U.S. We provide customized, short-term capital to small and middle-market investors and developers who require speed and flexibility. We are organized and conduct our operations to qualify as a real estate investment trust, or REIT, for U.S. federal income tax purposes. We are externally managed and advised by OFG, a specialized commercial real estate management company that has originated, serviced and managed alternative commercial real estate investments since 1951.

The Company is a Maryland corporation formed to reorganize the business of its predecessor, OMIF, into a publicly traded REIT. OMIF was a California Limited Partnership registered with the SEC that was formed in 1983 for the purposes of funding and servicing short-term commercial real estate loans. Beginning in 2009, OMIF experienced liquidity issues as its borrowers were unable to access credit sources to pay off its loans. OMIF eventually foreclosed on a substantial portion of its loan portfolio, repositioning many of the properties for investment or eventual sale. OMIF also experienced a significant increase in capital withdrawal requests that it was unable to honor due to insufficient cash, net of reserves, and restrictions under the terms of its bank line of credit. In addition, OMIF was restricted by provisions within the partnership agreement from making additional investments in mortgage loans while qualified redemption requests remained pending and unpaid. In addition to increasing investor liquidity through public

listing of its stock, the Company was created to provide the opportunity for resuming mortgage lending activities, with the goal of increasing income to stockholders.

On May 20, 2013, OMIF merged with and into the Company with the Company as the surviving entity, succeeding to and continuing the business and operations of OMIF. The Company now, by virtue of the Merger, directly or indirectly owns all of the assets and business formerly owned by OMIF. The Company is a deemed successor issuer to OMIF pursuant to Rule 12g-3(a) under the Exchange Act, and on July 1, 2013, the Company's Common Stock was listed on the NYSE American exchange. For accounting purposes, the Merger was treated as a transfer of assets and exchange of shares between entities under common control. The accounting basis used to initially record the assets and liabilities in the Company was the carryover basis of OMIF.

Our primary sources of revenue are interest income earned on our loan investment portfolio and revenues we generate from our operating real estate assets. We have resumed originating loans and believe the Company is well positioned to capitalize on lending opportunities as the economy continues to recover. However, there can be no assurances that we will be able to identify and make loans to suitable commercial real estate borrowers or have adequate capital and liquidity to fund such loans.

Our operating results are affected primarily by:

- the level of foreclosures and related loan and real estate losses experienced;
- the income or losses from foreclosed properties prior to the time of disposal;
- the amount of cash available to invest in loans;
- the amount of borrowing to finance loan investments and our cost of funds on such borrowing;
- the level of real estate lending activity in the markets serviced;
- the ability to identify and lend to suitable borrowers;
- the interest rates we are able to charge on loans; and
- the level of delinquencies on loans.

Between 2008 and 2013, we experienced increased delinquent loans and foreclosures which created substantial losses. As a result, we owned significantly more real estate than in the past, which has reduced cash flow and net income. As of December 31, 2017, approximately 6% of our loans were impaired and/or past maturity, up from 4% as of December 31, 2016. As of December 31, 2017, we owned approximately $80.5 million (book value) of real estate held for sale or investment, which is approximately 34% of total assets, a decrease of $32.7 million or 12.6% of total assets as compared to December 31, 2016. During 2017, we sold eight real estate properties (two partial) for aggregate net sales proceeds of $56,329,000 (including notes receivable totaling $450,000) and net gains totaling $14,729,000. We will continue to attempt to sell certain of our properties but may need to sell them for losses. In addition, under the REIT tax rules, we may be subject to a "prohibited transaction" penalty tax on tax gains from the sale of our properties in certain circumstances. In addition, we are also limited in the number and dollar amount of properties we can sell in a given year under the REIT tax rules.

Although management currently believes that only one of our delinquent loans will result in a credit loss to the Company (and has caused the Company to record a specific allowance for loan losses on such loan), real estate values could decrease further. Management continues to perform frequent evaluations of collateral values for our loans using internal and external sources, including the use of updated independent appraisals. As a result of these evaluations, the allowance for loan losses and our investments in real estate could increase or decrease in the near term, and such changes could be material.

Business Strategy

Our primary business objective is to provide our stockholders with attractive risk-adjusted returns by producing consistent and predictable dividends while maintaining a strong balance sheet. We believe we have positioned the Company for future growth and seek to increase distributions to stockholders through active portfolio management and execution of our business plan which is outlined below:

- Capitalize on market lending opportunity by leveraging existing origination network to expand our commercial real estate loan portfolio.
- Enhance and reposition our commercial real estate assets through the investment of capital and strategic management.
- Increase liquidity available for lending activities by focusing on opportunities to remove real estate assets from our balance sheet.
- Manage leverage to marginally expand sources of liquidity while maintaining a conservative balance sheet.

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Current Market Conditions, Risks and Recent Trends

Our ability to execute our business strategy, particularly the growth of our loan portfolio, is dependent on many factors, including our ability to access financing on favorable terms. The previous economic downturn had a significant negative impact on both us and our borrowers. If similar economic conditions recur in the future, it may limit our options for obtaining financing on favorable terms and may also adversely impact the creditworthiness of our borrowers which could result in their inability to repay their loans.

The commercial real estate markets continue to improve, but uncertainty remains as a result of global market instability, the current political climate, changes in the Federal tax code, regulatory reform and other matters and their potential impact on the U.S. economy and commercial real estate markets. In addition, the growth in multifamily rental rates seen over the past few years are showing signs of stabilizing. If real estate values decline again and/or rent growth subsides, it may limit our new loan originations since borrowers often use increases in the value of, and revenues produced from, their existing properties to support the purchase or investment in additional properties. Declining real estate values may also significantly increase the likelihood that we will have difficulty selling our existing real estate assets in a timely manner, and that we will incur losses on our loans in the event of default because the value of our collateral may be insufficient to cover our investment in the loan. Any sustained period of increased payment delinquencies, foreclosures or losses could adversely affect both our interest income from loans as well as our ability to originate loans, which would significantly impact our revenues, results of operations, financial condition, business prospects and our ability to make distributions to our stockholders.

The economic environment over the past few years has seen continued improvement in commercial real estate values which has generally increased payoffs and reduced the credit exposure in our loan portfolio. We have made, and continue to make, modifications and extensions to loans when it is economically feasible to do so. In some cases, a modification is a more viable alternative to foreclosure proceedings when a borrower cannot comply with loan terms. In doing so, lower borrower interest rates, combined with non-performing loans, would lower our net interest margins when comparing interest income to our costs of financing. If the markets were to deteriorate and another prolonged economic downturn was to occur, we believe there could be additional loan modifications and delinquencies, which may result in reduced net interest margins and additional losses throughout our sector.

We believe that improvement in commercial real estate values has also resulted in increased values of some of our real estate assets. Accordingly, as our real estate assets are carried at the lower of carrying value or fair value less costs to sell, it is possible that we have imbedded gains in certain of our real estate properties held for sale and investment that are not reflected in our financial statements or in the value of our stock.

Recent increases in market interest rates have increased interest expense under our Credit Facility and certain other of our borrowings that bear interest at variable rates. Due to competitive conditions in our markets, we have been unable to pass increases in our cost of funds through to our borrowers on the majority of our recent loan investments and, accordingly, the interest rates we receive on our loans has remained relatively unchanged. This increase in our cost of funds without corresponding increases in the rates we charge our borrowers will result in a smaller interest margin and, if these conditions continue, may adversely affect our results of operations in the future.

Critical Accounting Policies

We consider the accounting policies discussed below to be critical to an understanding of how we report our financial condition and results of operations because their application places the most significant demands on the judgment of our management.

Our consolidated financial statements are prepared in accordance with GAAP, which requires the use of estimates and assumptions that involve the exercise of judgment and affect the reported amounts of assets and liabilities as of the balance sheet dates and revenues and expenses for the reporting periods. Such estimates relate principally to the determination of (1) the allowance for loan losses, (2) the valuation of real estate held for sale and investment (at acquisition and subsequently) and 3) the recoverability of deferred income tax assets.

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Allowance for Loan Losses, Impaired Loans and Non-accrual Status

We maintain an allowance for loan losses on our investments in mortgage loans. A loan is impaired when it is probable that we may not collect all principal and interest payments according to the contractual terms of the loan agreement. As part of the detailed loan review, we consider many factors about the specific loan, including payment history, asset performance, borrower's financial capability and other characteristics. Management evaluates loans for non-accrual status each reporting period. A loan is placed on non-accrual status when the loan payment deficiencies exceed 90 days, or earlier if collection of principal and interest is substantially in doubt. When a loan is classified as nonaccrual, interest accruals discontinue and all past due interest remains accrued until the loan becomes current, is paid off or is foreclosed upon. Interest accruals are resumed on such loans only when they are brought fully current with respect to interest and principal and when, in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest. Cash receipts on nonaccrual loans are used to reduce any outstanding accrued interest, and then are recorded as interest income, except when such payments are specifically designated as principal reduction or when management does not believe our investment in the loan is fully recoverable. When a loan is considered impaired, management estimates impairment based on the fair value of the collateral less estimated costs to sell, generally through the use of appraisals. The determination of the general reserve for loans that are not considered impaired and are collectively evaluated for impairment is based on estimates made by management including consideration of historical losses by portfolio segment, internal asset classifications, and qualitative factors to include economic trends in our service areas, industry experience and trends, geographic concentrations, estimated collateral values, our underwriting policies, the character of the loan portfolio, and probable incurred losses inherent in the portfolio taken as a whole. The allowance is established through a provision for loan losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth but actual results may vary and there is no assurance that the allowance for loan losses will be sufficient. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance.

Real Estate Held for Sale

Real estate held for sale includes real estate acquired in full or partial settlement of loan obligations, generally through foreclosure, that is being marketed for sale. Real estate held for sale is recorded at acquisition at the property's estimated fair value less estimated costs to sell.

Classification as Held for Sale—A real estate asset is classified as held for sale in the period when (i) management approves a plan to sell the asset, (ii) the asset is available for immediate sale in its present condition, subject only to usual and customary terms, (iii) a program is initiated to locate a buyer and actively market the asset for sale at a reasonable price, and (iv) completion of the sale is probable within one year. Real estate held for sale is stated at the lower of its carrying amount or estimated fair value less disposal cost, with any write-down to fair value less estimated costs to sell recorded as an impairment loss. For any subsequent increase in fair value less disposal cost, the impairment loss may be reversed, but only up to the amount of cumulative loss previously recognized. Depreciation is not recorded on assets classified as held for sale.

If circumstances arise that were previously considered unlikely and, as a result, we decide not to sell the real estate asset previously classified as held for sale, the real estate asset is reclassified as held for investment. Upon reclassification, the real estate asset is measured at the lower of (i) its carrying amount prior to classification as held for sale, adjusted for depreciation expense that would have been recognized had the real estate been continuously classified as held for investment, or (ii) its estimated fair value at the time we decide not to sell.

Real Estate Sales—We evaluate if real estate sale transactions qualify for recognition under the full accrual method, considering whether, among other criteria, the buyer's initial and continuing investments are adequate to demonstrate a

commitment to pay, any receivable due to the Company is not subject to future subordination, the Company has transferred to the buyer the usual risks and rewards of ownership and the Company does not have a substantial continuing involvement with the sold real estate. At the time the sale is consummated, a gain or loss is recognized as the difference between the sale price less disposal cost and the carrying value of the real estate.

Real Estate Held for Investment

Real estate held for investment includes real estate purchased or acquired in full or partial settlement of loan obligations, generally through foreclosure, that is not being marketed for sale and is either being operated, such as rental properties; is being managed through the development process, including obtaining appropriate and necessary entitlements and permits and construction; or are idle properties awaiting more favorable market conditions or properties we cannot sell without placing our REIT status at risk or become subject to prohibited transactions penalty tax. Real estate held for investment is recorded at acquisition at the property's estimated fair value less estimated costs to sell. Depreciation of buildings and improvements is provided on the straight-line method over the estimated remaining useful lives of buildings and improvements. Depreciation of tenant improvements is provided on the straight-line method over the shorter of their estimated useful lives or the lease terms. Costs related to the improvement of real estate held for sale and investment are capitalized, whereas those related to holding the property are expensed. We evaluate real estate held for investment periodically or whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable. We evaluate cash flows and determine impairments on an individual property basis. In making this determination, we often obtain new appraisals and/or review, among other things, current and future cash flows associated with each property, market information, market prices of similar properties recently sold or currently being offered for sale, and other quantitative and qualitative factors. If an impairment indicator exists, we evaluate whether the expected future undiscounted cash flows is less than the carrying amount of the property, and if we determine that the carrying value is not recoverable, an impairment loss is recorded for the difference between the estimated fair value less estimated costs to sell and the carrying amount of the property.

Income Taxes

We have elected to be taxed as a REIT. As a result of our REIT qualification and distribution policy, we do not generally expect to pay U.S. federal corporate level income taxes. Many of the REIT requirements, however, are highly technical and complex. To qualify as a REIT, we must meet a number of organizational and operational requirements, including a requirement that we distribute annually at least 90% of our REIT taxable income, determined without regard to net capital gains, to our stockholders. If we have previously qualified as a REIT and fail to qualify as a REIT in any subsequent taxable year and do not qualify for certain statutory relief provisions, we will be subject to U.S. federal income taxes at regular corporate rates (including any applicable alternative minimum tax) and may be precluded from qualifying as a REIT for four subsequent taxable years. Even if we qualify for taxation as a REIT, we may be subject to certain U.S. federal, state, local and foreign taxes on our income and property and to U.S. federal income and excise taxes on our undistributed REIT taxable income.

We have elected (or may elect) to treat certain of our existing or newly created corporate subsidiaries as taxable REIT subsidiaries (each a "TRS"). In general, a TRS of a REIT may hold assets that the REIT cannot hold directly and, subject to certain exceptions related to hotels and healthcare properties, may engage in any real estate or non-real estate related business. A TRS is treated as a regular corporation and is subject to federal, state, local and foreign taxes on its income and property.

Deferred Income Taxes - Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities, if any. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A deferred tax asset is also recognized for net operating loss carryforwards of TRS entities. A valuation allowance, if needed, reduces deferred tax assets to the amount that is "more likely than not" to be realized. Realization of deferred tax assets is dependent on the Company's TRS entities generating sufficient taxable income in future periods or employing certain tax planning strategies to realize such deferred tax assets. The estimate of the amount of deferred tax assets more likely than not to be realized often requires significant judgment on the part of management because realization may be dependent on the outcome of property sales and/or other events that are difficult to forecast.

Tax Positions - The accounting guidance prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. A tax position is recognized as a benefit only if it is "more likely than not" that the position would be sustained in a tax examination, with a tax examination being presumed to occur. We have analyzed our various federal and state filing positions and believe that our income tax filing positions and deductions are well documented and supported. There was no reserve for uncertain tax positions recorded as of December 31, 2017 and 2016.

Significant Developments During 2017 and Subsequent Events

Loan Activity – We originated 26 new loans totaling $86,063,000 (when fully funded) with a weighted average interest rate of 7.7%.  We received full or partial repayment on 27 loans in the total amount of $69,723,000 with a weighted average interest rate of 8.1%.  We extended the maturity dates of 15 loans with outstanding principal balances aggregating $36,177,000 with a weighted average interest rate of 8.4%. We recorded charge-offs from the specific loan loss allowance on one impaired loan totaling $546,000 and recorded a net decrease in the general allowance for loan losses of $333,000 (net of $27,000 recovery of bad debts received), for a total decrease in the allowance of $879,000.

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Real Estate Property Sales – We sold eight real estate properties (two partially) for aggregate net sales proceeds of $56,329,000 (including notes receivable totaling $450,000) and net gains totaling $14,729,000. The sale of seven condominium units at ZRV in 2017 resulted in the repayment of the construction note payable totaling $10,580,000.

Real Estate Construction Projects – We completed the construction of the retail/condominium project owned by ZRV and incurred approximately $10,277,000 in additional capitalized costs during 2017.

Stock Repurchases – We repurchased 341,086 shares of our Common Stock during 2017 pursuant to the 2017 Repurchase Plan at a total cost of $5,820,000 and an average cost of $17.06 per share.

Freestone Settlement Agreement – We repurchased 669,058 of the Freestone Shares during 2017 pursuant to the Settlement Agreement at a total cost of $12,879,000. Approximately $2,168,000 of this amount was recorded as settlement expense and the remaining $10,712,000 as treasury stock. The remaining 141,879 of the Freestone Shares were purchased in January 2018 for a total cost of $2,731,000 ($2,271,000 treasury stock and $460,000 settlement expense) that was recorded as a forward contract liability as of December 31, 2017 (see below).

Interim Management Fee – Effective July 1, 2017, we adjusted the Existing Management Fee on an interim basis to equal the Interim Management Fee, which is a monthly management fee that equals 1/12th of 1.50% of the Company's Stockholders' Equity, subject to the additional details of the calculation as described in "Related Party Transactions – Management Fees and Expenses – Interim Fee Reduction and Amendment Proposal to Permanently Reduce Management Fees and Expenses" in Item 13 of this Annual Report. The Interim Management Fee is payable during the Interim Adjustment Period that commenced July 1, 2017 and ends on March 31, 2018, and on April 1, 2018 the management fee payable to the Manager will be permanently reduced as described in "Related Party Transactions – Management Fees and Expenses – Interim Fee Reduction and Amendment Proposal to Permanently Reduce Management Fees and Expenses" in Item 13 of this Annual Report. This adjustment resulted in a reduced management fee of approximately $440,000 during the last six months of 2017.

Subsequent Events – The following events have occurred during the first quarter of 2018 and are discussed in further detail in our consolidated financial statements under "Note 16 – Subsequent Events" in Item 8 of this Annual Report:

- We sold three condominium units at ZRV for net sales proceeds totaling $3,725,000 (proceeds used to repay the construction loan) and gains totaling $539,000.
- We repurchased 141,879 of the Freestone Shares pursuant to the Settlement Agreement in January 2018 at a total cost of $2,731,000 ($2,271,000 treasury stock and $460,000 settlement expense). This amount was accrued as a forward contract liability as of December 31, 2017.
- Effective February 28, 2018, the maturity date of our line of credit with California Bank & Trust, First Bank and Umpqua Bank was extended from March 1, 2018 to June 1, 2018.
- On March 12, 2018, the Board approved a quarterly dividend of $0.16 per share of Common Stock for the quarter ending March 31, 2018 (an increase from the $0.10 per share dividend paid for the quarter ending December 31, 2017). The dividend will be paid on April 13, 2018 to stockholders of record at the close of business on March 31, 2018.
- On March 13, 2018, we announced (1) that our Board and the Manager have agreed to make permanent, effective April 1, 2018, the Interim Management Fee adjustment along with an additional adjustment such that the monthly management fee payable will equal (i) one-twelfth (1/12) multiplied by (ii) (a) 1.50% of the first $300,000,000 of the Company's Stockholders' Equity and (b) 1.25% of the Company's Stockholders' Equity that is greater than $300,000,000, and (2) a non-binding agreement in principle to make certain additional changes to the Manager's compensation structure as described in the Amendment Proposal. See "Related Party Transactions – Management Fees and Expenses – Interim Fee Reduction and Amendment Proposal to Permanently Reduce Management Fees and Expenses" in Item 13 of this Annual Report.

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Comparison of Results of Operations for Years Ended 2017 and 2016

The following table sets forth our results of operations for the years ended December 31, 2017 and 2016:

| | Year Ended December 31, | | Increase/(Decrease) | |
|---|---|---|---|---|
| | 2017 | 2016 | Amount | Percent |
| Revenues: | | | | |
| Interest income on loans | $10,840,730 | $8,922,142 | $1,918,588 | 22 % |
| Rental and other income from real estate properties | 4,505,385 | 7,977,400 | (3,472,015) | (44) % |
| Other income | 187,013 | 179,449 | 7,564, | 4 % |
| Total revenues | 15,533,128 | 17,078,991 | (1,545,863) | (9) % |
| Expenses: | | | | |
| Management fees to Manager | 3,546,085 | 3,286,470 | 259,615 | 8 % |
| Servicing fees to Manager | 362,411 | 298,770 | 63,641 | 21 % |
| General and administrative expense | 2,234,230 | 1,568,890 | 665,340 | 42 % |
| Rental and other expenses on real estate properties | 4,980,900 | 7,060,526 | (2,079,626) | (29) % |
| Depreciation and amortization | 1,138,515 | 1,258,305 | (119,790) | (10) % |
| Interest expense | 1,587,695 | 2,859,294 | (1,271,599) | (44) % |
| (Recovery of) provision for loan losses | (360,012) | 1,284,896 | (1,644,908) | nm |
| Impairment losses on real estate properties | 1,423,286 | 3,227,807 | (1,804,521) | (56) % |
| Total expenses | 14,913,110 | 20,844,958 | (5,931,848) | (28) % |
| Operating income (loss) | 620,018 | (3,765,967) | 4,385,985 | nm |
| Gain on sales of real estate, net | 14,728,921 | 24,497,763 | (9,768,842) | (40) % |
| Settlement expense | (2,627,436) | — | (2,627,436) | 100 % |
| Net income before income taxes | 12,721,503 | 20,731,796 | (8,010,293) | (39) % |
| Income tax (expense) benefit | (4,041,655) | 7,248,977 | (11,290,632) | nm |
| Net income | 8,679,848 | 27,980,773 | (19,300,925) | (69) % |
| Net income attributable to non-controlling interests | — | (3,571,003) | 3,571,003 | (100) % |
| Net income attributable to common stockholders | $8,679,848 | $24,409,770 | $(15,729,922) | (64) % |

nm – not meaningful

<u>Revenues</u>

Interest income on loans increased $1,919,000 (22% increase) to $10,841,000 for the year ended December 31, 2017, as compared to $8,922,000 for the year ended December 31, 2016. The increase was primarily due to an increase in the average balance of performing loans between the year ended December 31, 2017 and the year ended December 31, 2016 of approximately 26%.

Rental and other income from real estate properties decreased $3,472,000 (44% decrease) to $4,505,000 for the year ended December 31, 2017, as compared to $7,977,000 for the year ended December 31, 2016, primarily due to the sale of four operating properties during the year ended December 31, 2016. These properties had rental income totaling approximately $3,424,000 during the year ended December 31, 2016. There was also a decrease in income from our golf course located in Auburn, California of approximately $166,000 during the year ended December 31, 2017 as compared to 2016.

<u>Expenses</u>

Management fees increased $260,000 (8% increase) and servicing fees increased $64,000 (21% increase) during the year ended December 31, 2017, as compared to 2016. The servicing fee increase was due to an increase in the average balance of loans in our portfolio of 21% during the year ended December 31, 2017, as compared to 2016. The management fees did not increase as much as the service fees as a result of the increased loan balances because, as discussed under "Significant Developments During 2017 and Subsequent Events" above, the Board and the Manager

agreed to adjust the Existing Management Fee during the Interim Adjustment Period, and the new Interim Management Fee calculation (which commenced on July 1, 2017 and is based on stockholders' equity) resulted in a management fee for the year ended December 31, 2017 that was approximately $440,000 lower than the fee that would have been payable to the Manager using the Existing Management Fee calculation.

General and administrative expense increased $665,000 (42% increase) during the year ended December 31, 2017, as compared to 2016. The increase was due primarily to higher legal and consulting expenses during the year ended December 31, 2017 as compared to 2016 relating to shareholder activism, regulatory compliance matters and evaluation of strategic options related to our external management structure.

Settlement expense increased $2,627,000 during the year ended December 31, 2017, as compared to 2016, as a result of the purchase pursuant to the Settlement Agreement, at $19.25 per share, of 669,058 Freestone Shares on December 29, 2017 and another 141,879 Freestone Shares on January 12, 2018. The market price of $16.01 per share for all 810,937 Freestone Shares purchased was recorded as treasury stock ($12,983,000 total), and the premium paid over the market price for those shares of $3.24 per share ($2,627,000 total) was recorded as settlement expense in the consolidated financial statements. See discussion under "Forward Contract Liability – Share Repurchase" below.

Rental and other expenses on real estate properties decreased $2,080,000 (29% decrease) during the year ended December 31, 2017, as compared to 2016, primarily due to the sale of four operating properties during 2016. These properties had rental expenses totaling approximately $2,766,000 during the year ended December 31, 2016. The decrease from the sale of these properties was offset by a one-time increase in property assessments levied on our mixed-use property located in Tacoma, Washington in the amount of approximately $268,000, disbursements of $285,000 related to certain operating expenses of our assisted living facility located in Bensalem, Pennsylvania and increased marketing and other operating costs related to the Zalanta condominiums at our property located in South Lake Tahoe, California during the year ended December 31, 2017. We will continue to have increased operating costs of the Zalanta property until such time as the remaining condominium units are sold and the commercial units are leased and/or sold.

Depreciation and amortization expense decreased $120,000 (10% decrease) during the year ended December 31, 2017, as compared to 2016, primarily due to the discontinuation of depreciation on certain properties that were moved to Held for Sale during 2016 and 2017.

Interest expense decreased $1,272,000 (44% decrease) during the year ended December 31, 2017 as compared to 2016, due to a decrease in the average balance on our line of credit during the year ended December 31, 2017, as compared to 2016, as we repaid the line of credit in full with the sale of the TSV land in April 2017 and did not advance on the line of credit again until the end of December 2017. The decrease was also due to the sale of the TOTB Miami properties and the repayment of the debt securing the properties during the third quarter of 2016, net of an increase in interest expense on the Zalanta construction loan as construction was completed in mid-2017 and capitalization of interest was discontinued.

The recovery of loan losses of $360,000 during the year ended December 31, 2017 was the result of an analysis performed on the loan portfolio. The general loan loss allowance decreased $333,000 during the year ended December 31, 2017 primarily due to a decrease in the balance of performing residential and land loans during the year which have a higher historical loss factor as compared to commercial loans. In addition, the Company received a recovery of bad debts of $27,000 during 2017.

The provision for loan losses of $1,285,000 during the year ended December 31, 2016 was the result of an analysis performed on the loan portfolio. The general loan loss allowance increased $590,000 during the year ended December 31, 2016 due to an increase in the balance of performing loans during the year, an increase in the historical loss percentage on commercial loans and an increase in land loans in the portfolio which loan segment has a higher loss factor than the other segments. The specific loan loss allowance also increased $694,000 (net) during the year ended December 31, 2016 due primarily to the recording of a specific loan loss allowance of $733,000 as of December 31, 2016 on one impaired loan as a result of an updated analysis of the collateral value completed based on actual sales of units during 2016.

The impairment losses on real estate properties of $1,423,000 and $3,228,000, respectively, during the years ended December 31, 2017 and 2016 were the result of agreements to sell certain of our properties for prices that were lower than the book value or the result of updated appraisals or other valuation information obtained on certain of our real estate properties during those years.

Gain on Sales of Real Estate

Gain on sales of real estate decreased $9,769,000 during the year ended December 31, 2017, as compared to 2016, as a result of the sale of eight real estate properties (two partially) during 2017, resulting in gains totaling $14,729,000 (see further detail under "Net Income Attributable to Non-Controlling Interests" and "Real Estate Properties Held for Sale and Investment" below). We sold seven real estate properties (three partially) during the year ended December 31, 2016, resulting in gains totaling $24,498,000.

We believe, from period to period in the near term, there will be fluctuations in net income resulting from the lag time between the sale of our real estate assets and deployment of the proceeds into new loan investments.

Income Tax (Expense) Benefit

We recorded income tax expense related to our taxable REIT subsidiaries of $4,042,000 during the year ended December 31, 2017 as compared to income tax benefit of $7,249,000 during the year ended December 31, 2016. The income tax expense during the year ended December 31, 2017 was primarily the result of an increase in the valuation allowance recorded against deferred tax assets as a result of higher construction costs and lower expected gains from the sales of ZRV assets in the future (Federal and state tax expense of $2,878,000) and due to a decrease in the Federal corporate tax rate from 34% to 21% in 2018 and beyond as a result of the Tax Cuts and Jobs Act signed into law by President Trump on December 22, 2017, which required us to remeasure our deferred tax assets at the lower rate (Federal tax expense of $1,358,000). The income tax benefit during the year ended December 31, 2016 was a result of the transfer of two properties into ZRV and conversion of ZRV into a taxable REIT subsidiary, which made the income (loss) from these real estate assets taxable. Due to differences between the book and tax basis of the assets, a deferred tax asset and related income tax benefit totaling $7,249,000 was recorded as of December 31, 2016. The Company's effective tax rate for 2017 differed from the statutory tax rate primarily due to an increase in the valuation allowance on deferred tax assets and the change in the Federal corporate tax rate as discussed above. The Company's effective tax rate for 2016 differed from the statutory tax rate because the three properties held within the ZRV TRS had differences between their respective book basis and tax basis and management projected that the Company would realize the benefits from deferred tax assets related to these basis differences. As a result, a $7,249,000 deferred tax benefit was recorded during 2016. Management has estimated future taxable gains and losses on sale of ZRV real estate assets to determine how much of the deferred tax assets are realizable. This realizability analysis is inherently subjective and actual results could differ from these estimates.

Net Income Attributable to Non-Controlling Interests

Net income attributable to non-controlling interests decreased $3,571,000 during the year ended December 31, 2017, as compared to 2016, because there was net income attributable to our joint venture partner (the Manager) in TOTB Miami, LLC of approximately $3,571,000 during the year ended December 31, 2016, as opposed to $0 during the year ended December 31, 2017, as the properties held within TOTB were sold in September 2016 and the LLC dissolved.

Comparison of Results of Operations for Years Ended 2016 and 2015

The following table sets forth our results of operations for the years ended December 31, 2016 and 2015:

| | Year Ended December 31, | | Increase/(Decrease) | |
|---|---|---|---|---|
| | 2016 | 2015 | Amount | Percent |
| Revenues: | | | | |
| Interest income on loans | $8,922,142 | $8,277,004 | $645,138 | 8 % |
| Rental and other income from real estate properties | 7,977,400 | 12,791,096 | (4,813,696) | (38) % |
| Income from investment in limited liability company | 179,449 | 175,451 | 3,998 | 2 % |
| Total revenues | 17,078,991 | 21,243,551 | (4,164,560) | (20) % |
| Expenses: | | | | |
| Management fees to Manager | 3,286,470 | 2,051,134 | 1,235,336 | 60 % |
| Servicing fees to Manager | 298,770 | 186,467 | 112,303 | 60 % |
| General and administrative expense | 1,568,890 | 1,278,994 | 289,896 | 23 % |
| Rental and other expenses on real estate properties | 7,045,848 | 8,510,110 | (1,464,262) | (17) % |
| Depreciation and amortization | 1,258,305 | 2,052,181 | (793,876) | (39) % |
| Interest expense | 2,859,294 | 1,938,113 | 921,181 | 48 % |
| Bad debt expense from uncollectible rent | 14,678 | 152,805 | (138,127) | (90) % |
| Provision for (recovery of) loan losses | 1,284,896 | (1,026,909) | 2,311,805 | nm |
| Impairment losses on real estate properties | 3,227,807 | 1,589,434 | 1,638,373 | 103 % |
| Total expenses | 20,844,958 | 16,732,329 | 4,112,629 | 25 % |
| Operating (loss) income | (3,765,967) | 4,511,222 | (8,277,189) | nm |
| Gain on sales of real estate, net | 24,497,763 | 21,818,553 | 2,679,210 | 12 % |
| Net income before income taxes | 20,731,796 | 26,329,775 | (5,597,979) | (21) % |
| Income tax benefit (expense) | 7,248,977 | (93,335) | 7,342,312 | nm |
| Net income | 27,980,773 | 26,236,440 | 1,744,333 | 7 % |
| Net income attributable to non-controlling interests | (3,571,003) | (2,667,324) | (903,679) | 34 % |
| Net income attributable to common stockholders | $24,409,770 | $23,569,116 | $840,654 | 4 % |

nm – not meaningful

Revenues

Interest income on loans increased $645,000 (8% increase) to $8,922,000 for the year ended December 31, 2016, as compared to $8,277,000 for the year ended December 31, 2015. The increase was primarily due to an increase in interest income from performing loans as the average balance of performing loans increased between 2015 and 2016 by approximately 70%. This increase was partially offset by the fact that the 2015 period included approximately $1,723,000 of interest income collected on an impaired loan that did not recur during 2016.

Rental and other income from real estate properties decreased $4,814,000 (38% decrease) to $7,977,000 for the year ended December 31, 2016, as compared to $12,791,000 for the year ended December 31, 2015, primarily due to the sale of four operating properties during 2015 and five during 2016.

Expenses

Management fees increased $1,235,000 (60% increase) and servicing fees increased $112,000 (60% increase) during the year ended December 31, 2016, as compared to 2015, due to an increase in the average balance of loans in our portfolio of 60% during 2016, as compared to 2015.

The maximum management and servicing fees were paid to the Manager during years ended December 31, 2016 and 2015. The maximum management fee permitted under the Company's charter is 2.75% per year of the average unpaid balance of loans and, accordingly, management fees have historically increased proportionately as we deployed capital into loans and increased our loan balances. For the years 2016, 2015, 2014, 2013 and 2012, the management fees were

2.75%, 2.75%, 2.75%, 2.74% and 2.67% of the average unpaid balance of loans, respectively. As discussed under "Significant Developments During 2017 and Subsequent Events" above, the Board and the Manager have agreed to adjust the Existing Management Fee during the Interim Adjustment Period and thereafter using a management fee calculation that is based on stockholders' equity.

General and administrative expense increased $290,000 (23% increase) during the year ended December 31, 2016, as compared to 2015, due primarily to higher legal, consulting, appraisal, director and audit fees during 2016 as compared to 2015.

Rental and other expenses on real estate properties decreased $1,464,000 (17% decrease) during the year ended December 31, 2016, as compared to 2015, primarily due to the sale of four operating properties during 2015 and five during 2016. This decrease was offset by an increase in property tax expense and other holding costs on the TOTB North apartment building held within TOTB Miami that could no longer be capitalized to the basis of the project once construction was completed in March 2016 (and before it was sold in September 2016) and also due to an increase in marketing related expenses for the ZRV property currently under construction during 2016.

Depreciation and amortization expense decreased $794,000 (39% decrease) during the year ended December 31, 2016, as compared to 2015, primarily due to the discontinuation of depreciation on certain properties that were moved to Held for Sale during 2015 and 2016.

Interest expense increased $921,000 (48% increase) during the year ended December 31, 2016 as compared to 2015, due to a higher amount of interest incurred on our lines of credit as the balances were higher during the year ended December 31, 2016 as compared to 2015, due to an additional $3,830,000 advance taken on the TSV loan with RaboBank (the "TSV Loan") during the third quarter of 2015 and due to the fact that interest incurred on the TOTB North construction loan could no longer be capitalized to the renovation project beginning in March 2016 as construction was completed (and before it was sold in September 2016).

The provision for loan losses of $1,285,000 during the year ended December 31, 2016 was the result of an analysis performed on the loan portfolio. The general loan loss allowance increased $590,000 during the year ended December 31, 2016 due to an increase in the balance of performing loans during the year, an increase in the historical loss percentage on commercial loans and an increase in land loans in the portfolio which loan segment has a higher loss factor than the other segments. The specific loan loss allowance also increased $694,000 (net) during the year ended December 31, 2016 due primarily to the recording of a specific loan loss allowance of $733,000 as of December 31, 2016 on one impaired loan as a result of an updated analysis of the collateral value completed based on actual sales of units during 2016.

The reversal of the provision for loan losses of $1,027,000 during the year ended December 31, 2015 was the result of an analysis performed on the loan portfolio. The general loan loss allowance increased $877,000 during the year ended December 31, 2015 due to an increase in the balance of performing loans during the year (net of payoffs). There was also an increase in the balance of both land and residential loans which have a higher historical loss factor for purposes of the general allowance calculation. The specific loan loss allowance decreased $1,904,000 during the year ended December 31, 2015, because new appraisals obtained during 2015 on two impaired loans reflected increased values of the underlying collateral, thus, resulting in a decrease in the specific allowance on these loans.

The impairment losses on real estate properties of $3,228,000 and $1,589,000, respectively, during the years ended December 31, 2016 and 2015 were the result of updated appraisals or other valuation information obtained on certain of our real estate properties during those years.

Gain on Sales of Real Estate

Gain on sales of real estate (excluding gain attributable to a non-controlling interest in 2016) increased $2,679,000 during the year ended December 31, 2016, as compared to 2015, as a result of the sale of seven real estate properties during 2016 (three partially), resulting in net gains totaling $24,498,000 (see further detail under "Net Income Attributable to Non-Controlling Interests" and "Real Estate Properties Held for Sale and Investment" below). The gain from the sale of one of these properties was offset by net income attributable to a non-controlling interest of

approximately $3,716,000, as a portion of the gain on sale of the property held within TOTB Miami, LLC was attributable to the non-controlling interest. During 2015, we sold eight real estate properties, resulting in gains totaling $21,666,000 and recognized $153,000 of deferred gain under the installment method related to the sale of the condominiums located in Santa Barbara, California in 2012 due to the remaining repayment of the carry back loan during 2015.

Income Tax Benefit
Income tax benefit increased $7,342,000 during the year ended December 31, 2016, as compared to 2015, as a result of the transfer of two properties into ZRV and conversion of ZRV into a taxable REIT subsidiary during the second quarter of 2016, which now makes the income (loss) from these real estate assets taxable. Due to differences between the book and tax basis of these assets and net losses experienced to date, a deferred tax asset and related income tax benefit totaling $7,249,000 was recorded as of December 31, 2016. The Company's effective tax rate for the year ended December 31, 2016 differed from the statutory tax rate because the properties held within the ZRV TRS had differences between their respective book and tax basis and management now projects that the Company will realize the benefits from deferred tax assets related to these basis differences. The Company also has approximately $5,514,000 of net Federal tax losses to date that can be carried forward to offset taxable income in future years. As a result, a $7,249,000 deferred tax benefit was recorded during the year ended December 31, 2016 (as compared to income tax expense of $93,000 during 2015).

Net Income Attributable to Non-Controlling Interests

Net income attributable to non-controlling interests increased $904,000 (34% increase) during the year ended December 31, 2016, as compared to 2015, due primarily to the sale of the condominium units and renovated apartment building owned by TOTB Miami, LLC during 2016 as a portion of the gain on sale of approximately $3,716,000 was attributable to our joint venture partner in TOTB Miami. During 2015, we sold the shopping center owned by 720 University and a portion of the gain on sale of approximately $2,479,000 was attributable to our joint venture partner in 720 University.

Financial Condition

December 31, 2017 and 2016

Loan Portfolio

Our portfolio of loan investments increased from 55 as of December 31, 2016 to 61 as of December 31, 2017, and the average loan balance increased from $2,358,000 as of December 31, 2016 to $2,396,000 as of December 31, 2017.

As of December 31, 2017 and 2016, we had nine and two impaired loans, respectively, totaling approximately $8,534,000 (5.8% of the portfolio) and $4,884,000 (3.8%), respectively. This included matured loans totaling $7,107,000 and $4,656,000 as of December 31, 2017 and 2016, respectively. In addition, seven loans of approximately $7,585,000 (5.2%) and $8,686,000 (6.7%) were past maturity but less than ninety days delinquent in monthly payments as of December 31, 2017 and 2016, respectively (combined total of $16,119,000 (11.0%) and $13,570,000 (10.5%), respectively, that are past maturity and/or impaired). Of the impaired and past maturity loans, none were in the process of foreclosure and none involved loans to borrowers who were in bankruptcy. We foreclosed on no loans during the year ended December 31, 2017. We foreclosed on one loan during the year ended December 31, 2016 with a principal balance of approximately $1,079,000 and obtained the property via the trustee sale.

Of the $4,884,000 in loans that were impaired as of December 31, 2016, both remained impaired as of December 31, 2017 (balance of $1,030,000 as of December 31, 2017).

As of December 31, 2017 and 2016, approximately $145,958,000 (99.9%) and $129,454,000 (99.8%) of our loans are interest only and/or require the borrower to make a "balloon payment" on the principal amount upon maturity of the loan. To the extent that a borrower has an obligation to pay loan principal in a large lump sum payment, its ability to satisfy this obligation may be dependent upon its ability to sell the property, obtain suitable refinancing or otherwise raise a substantial cash amount. As a result, these loans involve a higher risk of default than fully amortizing loans.

Borrowers occasionally are not able to pay the full amount due at the maturity date. We may allow these borrowers to continue making the regularly scheduled monthly payments for certain periods of time to assist the borrower in meeting the balloon payment obligation without formally filing a notice of default. These loans for which the principal and any accrued interest is due and payable, but the borrower has failed to make such payment of principal and/or accrued interest are referred to as "past maturity loans". As of December 31, 2017 and 2016, we had thirteen and eight past maturity loans totaling approximately $14,692,000 and $13,342,000, respectively.

There was one loan with a principal balance of $1,145,000 modified as a troubled debt restructuring during the year ended December 31, 2017. There were no loans modified as troubled debt restructurings during the years ended December 31, 2016 and 2015.

As of December 31, 2017 and 2016, we held the following types of loan investments:

| | December 31, 2017 | December 31, 2016 |
|---|---|---|
| By Property Type: | | |
| Commercial | $127,873,281 | $102,442,111 |
| Residential | 13,170,795 | 19,001,677 |
| Land | 5,127,574 | 8,238,523 |
| | $146,171,650 | $129,682,311 |
| By Position: | | |
| Senior loans | $142,782,492 | $126,873,673 |
| Junior loans | 3,389,158 | 2,808,638 |
| | $146,171,650 | $129,682,311 |

The types of property securing our commercial real estate loans are as follows as of December 31, 2017 and 2016:

| | December 31, 2017 | December 31, 2016 |
|---|---|---|
| Commercial Real Estate Loans: | | |
| Office | $29,480,103 | $33,608,898 |
| Retail | 32,329,395 | 19,959,635 |
| Storage | 15,807,016 | 13,015,175 |
| Apartment | 24,582,181 | 11,366,570 |
| Hotel | 11,777,351 | 9,567,143 |
| Industrial | 2,690,000 | 7,376,477 |
| Warehouse | 3,000,000 | — |
| Marina | 3,580,000 | 3,500,000 |
| Assisted care | 1,650,000 | 1,328,213 |
| Church | — | 1,175,000 |
| Golf course | 1,212,851 | 1,145,000 |
| Restaurant | 1,764,384 | 400,000 |
| | $127,873,281 | $102,442,111 |

Scheduled maturities of loan investments as of December 31, 2017 and the interest rate sensitivity of such loans are as follows:

| | Fixed Interest Rate | Variable Interest Rate | Total |
|---|---|---|---|
| Year ending December 31: | | | |
| 2017 (past maturity) | $14,692,398 | $— | $14,692,398 |
| 2018 | 75,454,727 | 9,790,059 | 85,244,786 |
| 2019 | 33,521,816 | 5,225,000 | 38,746,816 |
| 2020 | — | 7,273,602 | 7,273,602 |
| 2021 | — | — | — |
| 2022 | — | — | — |
| Thereafter (through 2028) | 214,048 | — | 214,048 |
| | $123,882,989 | $22,288,661 | $146,171,650 |

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Currently, our variable rate loans use as indices the Prime, three-month or six-month LIBOR rates (4.50%, 1.69% and 1.84% respectively, at December 31, 2017) or include terms whereby the interest rate we charge is increased at a later date. Premiums over these indices have varied from 3.0% to 9.0% and may be higher or lower depending upon market conditions at the time the loan is made.
The following is a schedule by geographic location of loan investments as of December 31, 2017 and 2016:

| | December 31, 2017 | | December 31, 2016 | |
|---|---|---|---|---|
| | Balance | Percentage | Balance | Percentage |
| California | $110,884,117 | 75.86% | $98,319,923 | 75.81% |
| Arizona | 815,890 | 0.56% | 4,655,517 | 3.59% |
| Colorado | 4,380,616 | 3.00% | 1,595,000 | 1.23% |
| Hawaii | 1,450,000 | 0.99% | 1,450,000 | 1.12% |
| Illinois | 1,364,384 | 0.93% | — | —% |
| Indiana | 388,793 | 0.27% | — | —% |
| Michigan | 10,714,764 | 7.33% | 10,337,157 | 7.97% |
| Nevada | 1,653,107 | 1.13% | 3,669,584 | 2.83% |
| Ohio | 3,755,000 | 2.57% | 3,627,506 | 2.80% |
| Texas | 6,625,000 | 4.53% | 6,027,624 | 4.65% |
| Washington | 3,159,460 | 2.16% | — | —% |
| Wisconsin | 980,519 | 0.67% | — | —% |
| | $146,171,650 | 100.00% | $129,682,311 | 100.00% |

As of December 31, 2017 and 2016, our loans secured by real property collateral located in Northern California totaled approximately 54% ($78,465,000) and 53% ($69,179,000), respectively, of the loan portfolio. The Northern California region (which includes Monterey, Fresno, Kings, Tulare and Inyo counties and all counties north) is a large geographic area which has a diversified economic base. The ability of borrowers to repay loans is influenced by the economic strength of the region and the impact of prevailing market conditions on the value of real estate.

Our investment in loans increased by $16,489,000 (12.7%) during the year ended December 31, 2017 as a result of new loan originations during the year, net of loan payoffs. As of December 31, 2017 and 2016, we had fourteen and twenty-two construction/rehabilitation loans in our portfolio with aggregate outstanding principal balances totaling $21,751,000 and $46,330,000, respectively.

Allowance for Loan Losses

The allowance for loan losses (decreased) increased by approximately $(879,000), $864,000 and $(1,027,000) (provision, net of reversals and charge-offs) during the years ended December 31, 2017, 2016 and 2015, respectively. The Manager believes that the allowance for loan losses is sufficient given the estimated underlying collateral values of impaired loans. There is no precise method used by the Manager to predict delinquency rates or losses on specific loans. The Manager has considered the number and amount of delinquent loans, loans subject to workout agreements and loans in bankruptcy in determining allowances for loan losses, but there can be no absolute assurance that the allowance is sufficient. Because any decision regarding the allowance for loan losses reflects judgment about the probability of future events, there is an inherent risk that such judgments will prove incorrect. In such event, actual losses may exceed (or be less than) the amount of any reserve. To the extent that we experience losses greater than the amount of its reserves, we may incur a charge to earnings that will adversely affect operating results and the amount of any dividends paid.

Changes in the allowance for loan losses for the years ended December 31, 2017, 2016 and 2015 were as follows:

| | 2017 | 2016 | 2015 |
|---|---|---|---|
| Balance, beginning of period | $2,706,822 | $1,842,446 | $2,869,355 |
| (Recovery of) provision for loan losses | (360,012 ) | 1,284,896 | (1,026,909) |
| Charge-offs | (546,004 ) | (447,520 ) | — |
| Recoveries | 27,000 | 27,000 | — |
| Balance, end of period | $1,827,806 | $2,706,822 | $1,842,446 |

As of December 31, 2017 and 2016, there was a general allowance for loan losses of $1,641,098 and $1,974,110, respectively, and a specific allowance for loan losses on one loan in the amount of $186,708 and $732,712, respectively.

Real Estate Properties Held for Sale and Investment

As of December 31, 2017, we held title to sixteen properties that were acquired through foreclosure, with a total carrying amount of approximately $80,466,000 (including properties held in four limited liability companies and two corporations), net of accumulated depreciation of $3,317,000. As of December 31, 2017, properties held for sale total $56,110,000 and properties held for investment total $24,356,000. We foreclosed on no loans during the year ended December 31, 2017. We foreclosed on one loan during the year ended December 31, 2016 with a principal balance of approximately $1,079,000 and obtained the property via the trustee sale. When we acquire property by foreclosure, we typically earn less income on those properties than could be earned on loans and we may not be able to sell the properties in a timely manner.

Changes in real estate held for sale and investment during the years ended December 31, 2017, 2016 and 2015 were as follows:

| | 2017 | 2016 | 2015 |
|---|---|---|---|
| Balance, beginning of period | $113,123,398 | $153,838,412 | $163,016,805 |
| Real estate acquired through foreclosure | — | 700,800 | — |
| Investments in real estate properties | 11,274,904 | 29,061,735 | 25,274,125 |
| Amortization of deferred financing costs capitalized to construction project | 76,260 | 119,471 | 207,347 |
| Sales of real estate properties | (41,505,148 ) | (66,183,589 ) | (31,099,086 ) |
| Impairment losses on real estate properties | (1,423,286 ) | (3,227,807 ) | (1,589,434 ) |
| Depreciation of properties held for investment | (1,080,003 ) | (1,185,624 ) | (1,971,345 ) |
| Balance, end of period | $80,466,125 | $113,123,398 | $153,838,412 |

Eight of our sixteen properties do not currently generate revenue. Seven of the Company's twenty-three commercial leases are set to expire during 2018. All of the Company's twelve residential leases are either on a month-to-month basis or will expire in 2018. The Company expects that new leases will be signed with existing or new tenants for the majority of these spaces and at rental rates that are at market and are at or above expiring rental amounts.

For purposes of assessing potential impairment of value during 2017, 2016 and 2015, we obtained updated appraisals or other valuation support on several of our real estate properties held for sale and investment, which resulted in additional impairment losses on three, three and one property(ies), respectively, in the aggregate amount of approximately $1,423,000, $3,228,000 and $1,589,000, respectively, recorded in the consolidated statements of operations.

2017 Sales Activity

During the year ended December 31, 2017, we sold eight real estate properties (two partially) and 1,000 square feet of commercial floor coverage area with details as follows:

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| | Net Sales Proceeds** | Gain (Loss) |
|---|---|---|
| Commercial and residential land under development, South Lake Tahoe, California (held within Tahoe Stateline Venture, LLC) | $42,329,110 | $13,210,826 |
| Seven condominium units, South Lake Tahoe, California (held within Zalanta Resort at the Village, LLC) | 10,578,517 | 997,239 |
| Two office condominium units, Roseville, California | 978,431 | 515,959 |
| Marina with 52 boat slips and campground, Bethel Island, California (held within Sandmound Marina, LLC) | 967,825 | (1,646) |
| Office condominium complex, Oakdale, California (held within East G, LLC) | 732,389 | (150) |
| Undeveloped, residential land, Marysville, California | 398,483 | (4,717) |
| One improved, residential lot, West Sacramento, California* | 154,901 | 3,108 |
| Unimproved, residential and commercial land, Gypsum, Colorado | 139,467 | (31) |
| 1,000 square feet of commercial floor coverage area (held within Tahoe Stateline Venture, LLC) | 50,000 | 8,333 |
| | $56,329,123 | $14,728,921 |

* There is deferred gain related to this sale of $93,233 as of December 31, 2017.
** Includes carryback notes receivable totaling $450,000.

2016 Sales Activity

During the year ended December 31, 2016, we sold seven real estate properties (two partially) with details as follows:

| | Net Sales Proceeds** | Gain (Loss) |
|---|---|---|
| Light industrial building, Paso Robles, California | $6,023,679 | $4,557,979 |
| Commercial building in building complex, Roseville, California | 455,132 | 280,836 |
| 169 condominium units and 160 unit renovated and unoccupied apartment building, Miami, Florida (held within TOTB Miami, LLC)* | 74,072,951 | 19,292,364 |
| 61 condominium units, Lakewood, Washington (held within Phillips Road, LLC) | 5,030,384 | 846,998 |
| 2 improved, residential lots, Auburn, California (held within Zalanta Resort at the Village, LLC) | 186,353 | 89,675 |
| Medical office condominium complex, Gilbert, Arizona (held within Zalanta Resort at the Village, LLC) | 3,793,870 | (30,010) |
| Unimproved, residential and commercial land, Gypsum, Colorado (three separate sales) | 1,434,273 | (540,079) |
| | $90,966,642 | $24,497,763 |

* $32,881,000 of proceeds were used to pay off debt securing the properties and $7,934,000 was distributed to the non-controlling interest.
** Includes carryback note receivable of $1,595,000.

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2015 Sales Activity

During the year ended December 31, 2015, we sold eight real estate properties with details as follows:

| | Net Sales Proceeds** | Gain |
|---|---|---|
| Retail complex, Greeley, Colorado (held within 720 University, LLC)* | $20,318,559 | $ 8,642,156 |
| 133 condominium units, Phoenix, Arizona (held within 54th Street Condos, LLC) | 8,930,112 | 2,077,122 |
| Industrial building, Sunnyvale, California (held within Wolfe Central, LLC) | 8,284,081 | 4,920,957 |
| Storage facility/business, Stockton, California | 7,479,080 | 3,695,248 |
| Commercial buildings, Sacramento, California | 5,153,713 | 1,262,745 |
| Undeveloped, residential land, Madera County, California | 1,704,122 | 977,542 |
| Retail buildings, San Jose, California | 1,108,820 | 52,820 |
| Marina, Oakley, California (held within The Last Resort and Marina, LLC) | 273,841 | 37,341 |
| | $53,252,328 | $ 21,665,931 |

* $9,771,000 of proceeds were used to pay off debt securing the property and $2,479,000 was distributed to the non-controlling interest.
** Including carryback note receivable of $4,650,000.

In addition to the above table, we recognized gain of approximately $153,000 during the year ended December 31, 2015 that had previously been deferred related to the sale of a real estate property in 2012. The gain on the sale of this property was being accounted for under the installment method.

2017 Foreclosure Activity

The Company foreclosed on no loans during the year ended December 31, 2017.

2016 Foreclosure Activity

During the year ended December 31, 2016, the Company foreclosed on one loan secured by an office property located in Oakdale, California with a principal balance of approximately $1,079,000 and obtained the property via the trustee's sale. In addition, accrued interest and advances made on the loan (for items such as legal fees and delinquent property taxes) in the total amount of approximately $70,000 were capitalized to the basis of the property. A specific loan allowance has been previously established on this loan of approximately $495,000. This amount was then recorded as a charge-off against the allowance for loan losses at the time of foreclosure, after a reduction of the previously established allowance in the amount of approximately $47,000 as a result of an updated appraisal obtained (net charge-off of $448,000). The property, along with a unit in the building purchased by the Company in 2015, was contributed into a new taxable REIT subsidiary, East G, LLC, in June 2016. The property was sold during 2017 and the LLC was dissolved.

2015 Foreclosure Activity

The Company foreclosed on no loans during the year ended December 31, 2015.

Majority-Owned Limited Liability Companies

720 University, LLC

We had an investment in a limited liability company, 720 University, LLC (720 University), which owned a commercial retail property located in Greeley, Colorado. We received 65% of the profits and losses in 720 University after priority return on partner contributions was allocated at the rate of 10% per annum. The assets, liabilities, income and expenses of 720 University were consolidated into the accompanying consolidated financial statements of the Company.

In November 2014, 720 University entered into a Real Estate Sale Agreement pursuant to which 720 University agreed to sell the property for $20,750,000. On January 30, 2015, an initial closing was held for the purpose of refinancing the existing 720 University note payable, and the buyer extended a new loan to 720 University to repay the existing note payable to the bank. The principal amount of the new loan was $9,771,263 and accrued interest at 6.0% per annum until paid off upon the closing of the sale of the property to the buyer. The sale closed in June 2015 resulting in gain on sale of approximately $8,642,000 ($6,163,000 to the Company after the gain attributable to the non-controlling interest or approximately $2,479,000).

The net income to the Company from 720 University was approximately $6,437,000 during the year ended December 31, 2015. 720 University was dissolved in December 2015.

TOTB Miami, LLC

During the year ended December 31, 2011, the Company and two co-lenders (which included OFG and PRC Treasures, LLC, or PRC) foreclosed on a participated, first mortgage loan secured by a condominium complex located in Miami, Florida with a principal balance to the Company of approximately $26,257,000 and obtained an undivided interest in the properties via the trustee's sale. The Company and the other lenders formed a Florida limited liability company, TOTB Miami, to own and operate the complex. The complex consisted of three buildings, two of which were renovated and being leased, and in which 169 units remained unsold and one which has been contributed to a wholly-owned subsidiary of TOTB, TOTB North, and contained 160 vacant units that were recently renovated.

In March 2012, we made a priority capital contribution to TOTB in the amount of $7,200,000. TOTB then purchased PRC's member interest in TOTB for $7,200,000. Thus, the remaining members in TOTB are now the Company and OFG. On the same date, the Company and OFG executed an amendment to the TOTB operating agreement to set the percentage of capital held by each at 80.74% for the Company and 19.26% for OFG based on the dollar amount of capital invested in TOTB. Income and loss allocations were made based on these percentages.

During 2014, TOTB contributed the vacant and unimproved 160 unit apartment building to a new wholly-owned entity, TOTB North. TOTB North then entered into a construction loan agreement which provided up to $21,304,000 for the purpose of renovating and improving the apartment building. The construction project was substantially completed in March 2016. The loan was repaid in full with the closing of the sale of the TOTB property in September 2016 (see below).

During 2014, TOTB entered into a loan agreement whereby it borrowed $13,000,000 secured by the 154 renovated and leased condominium units in the Pointe building. The loan bore interest at the floating daily three month LIBOR rate of interest plus 4.0% per annum, but in no event lower than 4.25%. Principal and interest was payable monthly with principal amortizing over 300 months. The loan was repaid in full with the closing of the sale of the TOTB property in September 2016 (see below).

All of the TOTB and TOTB North properties were sold in September 2016 for net sales proceeds of approximately $74,073,000, resulting in gain of approximately $19,292,000 ($15,577,000 to the Company after the gain attributable to the non-controlling interest of approximately $3,716,000).

The net income to the Company from TOTB was approximately $14,977,000 and $311,000 during the years ended December 31, 2016 and 2015, respectively.

Equity Method Investment in Limited Liability Company

1850 De La Cruz, LLC

During 2008, we entered into an Operating Agreement of 1850 De La Cruz LLC, a California limited liability company ("1850"), with Nanook Ventures LLC ("Nanook"), an unrelated party. The purpose of the joint venture is to acquire, own and operate certain industrial land and buildings located in Santa Clara, California that were owned by the Company. At the time of closing in July 2008, the two properties were separately contributed to two new limited liability companies, Nanook Ventures One LLC and Nanook Ventures Two LLC that are wholly owned by 1850. The Company and Nanook are the Members of 1850 and NV Manager, LLC is the manager.

During the years ended December 31, 2017, 2016 and 2015, we received capital distributions from 1850 in the total amount of $185,000, $180,000 and $177,000, respectively. The net income to the Company from its investment in 1850 De La Cruz was approximately $185,000, $179,000 and $175,000 for the years ended December 31, 2017, 2016

and 2015, respectively.

Cash, Cash Equivalents and Restricted Cash

Cash and cash equivalents and restricted cash decreased from approximately $6,934,000 as of December 31, 2016 to approximately $5,671,000 as of December 31, 2017 ($1,263,000 or 18.2% decrease) due primarily to cash used totaling $157,341,000 for investment in loans and real estate properties, net repayment of debt, purchase of treasury stock and dividends paid, which was offset by cash received totaling $155,634,000 from the sale of real estate properties, principal collected on loans and advances from notes payable and the line of credit.

Interest and Other Receivables

Interest and other receivables increased from approximately $2,164,000 as of December 31, 2016 to $2,430,000 as of December 31, 2017 ($266,000 or 12.3% increase) due primarily due primarily to growth in the loan portfolio during 2017.

Deferred Financing Costs

Deferred financing costs accounted for as assets decreased from approximately $172,000 as of December 31, 2016 to $27,000 as of December 31, 2017 ($145,000 or 84.4% decrease) due primarily to amortization of deferred financing costs during 2017.

Deferred Tax Assets, Net

Deferred tax assets decreased from $7,249,000 as of December 31, 2016 to approximately $3,207,000 as of December 31, 2017 ($4,042,000 or 55.8% decrease) due primarily to an increase in the valuation allowance recorded against deferred tax assets as a result of higher construction costs and lower expected gains from the sales of ZRV assets in the future and also due to a decrease in the Federal corporate tax rate from 34% to 21% in 2018 and beyond as a result of the Tax Cuts and Jobs Act signed into law by President Trump on December 22, 2017, which required us to remeasure our net deferred tax asset at the lower rate.

Dividends Payable

Dividends payable increased from approximately $1,402,000 as of December 31, 2016 to $1,572,000 as of December 31, 2017 ($170,000 or 12.1% increase) primarily due to an increase in Federal income taxes paid on undistributed capital gains on behalf of shareholders. In January 2017 a tax payment in the amount $583,000 was made (for 2016 undistributed capital gains), whereas in January 2018 a tax payment in the amount of $640,000 was made (for 2017 undistributed capital gains). In addition, there was an increase of $112,000 in the regular quarterly dividend between the fourth quarter of 2016 and the fourth quarter of 2017.

Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities decreased from approximately $3,700,000 as of December 31, 2016 to $1,390,000 as of December 31, 2017 ($2,310,000 or 62.4% decrease), due primarily to decreased payables related to the construction activities on the property owned by ZRV now that construction has been completed.

Forward Contract Liability – Share Repurchase

Forward contract liability increased from $0 as of December 31, 2016 to $2,731,000 as of December 31, 2017 due to the Settlement Agreement between the Company and Freestone for the purchase of 810,937 of the Freestone Shares. As of December 31, 2017, 669,058 of the Freestone Shares had been repurchased and the remaining 141,879 shares

were repurchased on January 12, 2018; thus, requiring the Company to record a liability as of December 31, 2017.

Line of Credit Payable

Line of credit payable decreased from $4,976,000 as of December 31, 2016 to $1,555,000 as of December 31 2017 ($3,421,000 or 68.8% decrease) due primarily to repayments on the line of credit as a result of net proceeds received on the sales of real estate properties, net of new loan investments during the year ended December 31, 2017.

Notes and Loans Payable on Real Estate

Notes and loans payable decreased from approximately $33,386,000 as of December 31, 2016 to approximately $30,192,000 as of December 31, 2017 ($3,194,000 or 9.6% decrease) due primarily to principal payments of approximately $13,580,000 made on ZRV's construction loan primarily from the sales of seven condominium units, net of additional advances for construction and interest totaling $10,543,000 during 2017.

Asset Quality

A consequence of lending activities is that losses will be experienced and that the amount of such losses will vary from time to time, depending on the risk characteristics of the loan portfolio as affected by economic conditions and the financial experiences of borrowers. Many of these factors are beyond the control of the Company or its management. There is no precise method of predicting specific losses or amounts that ultimately may be charged off on specific loans or on segments of the loan portfolio.

The conclusion that a Company loan may become uncollectible, in whole or in part, is a matter of judgment. Although supervised lenders are subject to regulations that, among other things, require them to perform ongoing analyses of their loan portfolios (including analyses of loan-to-value ratios, reserves, etc.), and to obtain current information regarding their borrowers and the securing properties, we are not subject to these regulations and have not adopted these practices. Rather, management, in connection with the quarterly closing of our accounting records and the preparation of the financial statements, evaluates our loan portfolio. The allowance for loan losses is established through a provision for loan losses based on management's evaluation of the risk inherent in our loan portfolio and current economic conditions. Such evaluation, which includes a review of all loans on which management determines that full collectability may not be reasonably assured, considers among other matters:

- prevailing economic conditions;
- our historical loss experience;
- the types and dollar amounts of loans in the portfolio;
- borrowers' financial condition and adverse situations that may affect the borrowers' ability to pay;
- evaluation of industry trends;
- review and evaluation of loans identified as having loss potential; and
- estimated net realizable value or fair value of the underlying collateral.

Based upon this evaluation, a determination is made as to whether the allowance for loan losses is adequate to cover probable incurred credit losses in the Company's loan portfolio. Additions to the allowance for loan losses are made by charges to the provision for loan losses. Loan losses deemed to be uncollectible are charged against the allowance for loan losses. Recoveries of previously charged off amounts are credited to the allowance for loan losses. As of December 31, 2017, management believes that the allowance for loan losses of approximately $1,828,000 is adequate in amount to cover probable incurred credit losses. Because of the number of variables involved, the magnitude of the swings possible and management's inability to control many of these factors, actual results may and do sometimes differ significantly from estimates made by management. As of December 31, 2017, nine loans totaling approximately $8,534,000 were impaired. Six of these loans of approximately $7,107,000 were past maturity. During the year ended December 31, 2017, we recorded a net decrease in the allowance for loan losses of approximately $879,000 (charge-off against the specific loan loss allowance of $546,000 and decrease in general allowance of $333,000, net of recovery of bad debts of $27,000). Management believes that the allowance for loan losses is sufficient given the estimated fair value of the collateral underlying impaired and past maturity loans and based on historical loss and delinquency factors applied to performing loans by class.

Liquidity and Capital Resources

Liquidity is a measure of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund and maintain our assets and operations, make distributions to our stockholders and other general business needs.



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We believe our available cash and restricted cash balances, other financing arrangements, and cash flows from operations will be sufficient to fund our liquidity requirements for the next 12 months.

We require liquidity to:
- fund future loan investments;
- to develop, improve and maintain real estate properties;
- to repay principal and interest on our borrowings;
- to pay our expenses, including compensation to our Manager;
- to pay U.S. federal, state, and local taxes of our TRSs;
- to distribute annually a minimum of 90% of our REIT taxable income and to make investments in a manner that enables us to maintain our qualification as a REIT; and
- to make tax payments associated with undistributed capital gains.

We intend to meet these liquidity requirements primarily through the following:
- the use of our cash and cash equivalent balances of $2,171,000 as of December 31, 2017;
- cash generated from operating activities, including interest income from our loan portfolio and income generated from our real estate properties;
- proceeds from the sales of real estate properties;
- proceeds from our line of credit;
- proceeds from future borrowings including additional lines of credit; and
- proceeds from potential future offerings of our equity securities.

The following table summarizes our cash flow activity for the periods presented:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Net cash (used in) provided by operating activities | $(1,880,167) | $(943,292) | $5,880,684 |
| Net cash provided by (used in) investing activities | 31,256,852 | 41,447,991 | (9,376,732) |
| Net cash (used in) provided by financing activities | (27,640,112) | (41,326,298) | 3,338,345 |

During the years ended December 31, 2017 and 2016, our unrestricted cash and cash equivalents increased (decreased) approximately $1,737,000 and $(822,000), respectively. The increase during 2017 was primarily due to more cash received from the sales of real estate properties and principal payments on loans as compared to cash used for investment for loans and improvements to real estate properties during the year. The decrease during 2016 was primarily due to more cash used for investments in loans and real estate properties and net repayment of debt as compared to cash received from the sales of real estate properties and principal payments on loans during the year.

Operating Activities

Cash flows from operating activities are primarily rental and other income from real estate properties, net of real estate expenses, and interest received from our investments in loans, partially offset by payment of operating expenses. For the years ended December 31, 2017 and 2016, cash flows received from operating activities decreased $937,000 and $6,824,000, respectively, as compared to the previous year. The decrease during 2017 reflects the settlement expense related to the purchase of the Freestone Shares and higher management and service fees and general and administrative expenses, net of increased interest income earned on loans and lower interest expense during 2017, as compared to 2016. The decrease during 2016 reflects decreased cash flow from rental properties as a result of the sale of four operating properties during 2015 and five during 2016 and higher management and service fees, general and administrative expenses and interest expense during 2016 as compared to 2015.

Investing Activities

Net cash provided by (used in) investing activities for the periods presented reflect our investing activity. For the years ended December 31, 2017 and 2016, cash flows from investing activities decreased $10,191,000 and increased $50,825,000, respectively, as compared to the previous year. Approximately $31,257,000 was provided by investing activities during 2017 as $128,145,000 was received from the sales of real estate properties, the payoff of loans and transfer from restricted cash, which was partially offset by an aggregate of $97,057,000 that was used for investment in loans and improvements to real estate properties during the year. Approximately $41,448,000 was provided by investing activities during 2016 as $145,977,000 was received from the sales of real estate properties, the payoff of loans and transfer from restricted cash, which was partially offset by an aggregate of $104,679,000 that was used for investment in loans and improvements to real estate properties during the year.

Financing Activities

Net cash used in financing activities during 2017 totaled approximately $27,640,000 and consisted primarily of $6,850,000 of net repayments on our lines of credit and notes payable, $16,532,000 of treasury stock purchases and $4,245,000 of dividends paid to stockholders. Net cash used in financing activities during 2016 totaled approximately $41,326,000 and consisted primarily of $28,354,000 of net repayments on our lines of credit and notes payable, $8,144,000 of distributions to non-controlling interests and $4,593,000 of dividends paid to stockholders.

Dividends

We intend to make regular quarterly distributions to holders of our Common Stock. U.S. federal income tax law generally requires that a REIT annually distribute at least 90% of its REIT taxable income, determined without regard to the deduction for dividends paid and excluding net capital gains, and to the extent that it annually distributes less than 100% of its REIT taxable income, including capital gains, in any taxable year, that it pay tax at regular corporate rates on that undistributed portion. We intend to make regular quarterly distributions to our stockholders in an amount equal to or greater than our REIT taxable income, excluding net capital gains, if and to the extent authorized by our Board of Directors. Before we make any distributions, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service on our debt payable. If our cash available for distribution is less than our REIT taxable income, we could be required to sell assets or borrow funds to make cash distributions or we may make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities.

Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured investment vehicles, special purpose entities or VIEs, established to facilitate off-balance sheet arrangements or other contractually narrow or limited purposes. Further, we have not guaranteed any obligations of unconsolidated entities or entered into any commitment or intend to provide additional funding to any such entities.

Contractual Obligations and Commitments

The table below summarizes our known contractual obligations as of December 31, 2017 and in future periods in which we expect to settle such obligations. The table does not reflect the effect of actual repayments or draws on the obligations or any new financing obtained subsequent to year end.

| | Payment due by Period | | | | |
|---|---|---|---|---|---|
| Contractual Obligations | Total | Less Than 1 Year | 1-3 Years | 3-5 Years | More Than 5 Years |

| | | | | | |
|---|---|---|---|---|---|
| Recourse indebtedness: | | | | | |
| Line of credit payable (1) | $1,555,000 | $ 1,555,000 | $ — | $ — | $ — |
| Loan payable on real estate | 13,242,514 | 369,959 | 790,927 | 12,081,628 | — |
| Construction loan payable (2) | 17,176,288 | 17,176,288 | — | — | — |
| Total recourse indebtedness | 31,973,802 | 19,101,247 | 790,927 | 12,081,628 | — |
| Non-recourse indebtedness: | | | | | |
| Notes payable on real estate | — | — | — | — | — |
| Total non-recourse indebtedness | — | — | — | — | — |
| Total indebtedness | 31,973,802 | 19,101,247 | 790,827 | 12,081,628 | — |
| Interest payable (3) | 2,261,845 | 1,164,433 | 1,054,925 | 42,487 | — |
| Funding commitments to borrowers (4) | 30,494,873 | 30,494,873 | — | — | — |
| Total Obligations | $64,730,520 | $ 50,760,553 | $ 1,845,852 | $ 12,124,115 | $ — |

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(1) As of December 31, 2017, the Company had the ability to borrow $27,259,000 on its line of credit.
(2) Total available to advance for construction, interest and related costs as of December 31, 2017 is $243,000 and this amount was advanced in January 2018.
(3) Variable-rate indebtedness assumes a prime rate of 4.5% (actual rate at December 31, 2017) through the original maturity date of the financing. Interest payable is based on balances outstanding as of December 31, 2017.
(4) Amounts represent the commitments we have made to fund borrowers in our existing lending arrangements as of December 31, 2017.

The table above does not reflect amounts due to the Manager pursuant to our charter or the Interim Management Fee, as described below, as the charter (or the calculation pursuant to the Interim Management Fee) does not provide for a fixed and determinable payment.

Management Agreement and Charter

The Manager provides services to the Company pursuant to the Management Agreement with the Manager dated May 20, 2013, and is entitled to receive a management fee, servicing fee, late fees, other miscellaneous fees, and the reimbursement of certain expenses as described in the Company's charter. In consideration of the management services rendered to the Company, up until July 1 ,2017. OFG was entitled to receive from the Company the Existing Management Fee payable monthly, subject to a maximum of 2.75% per annum of the average unpaid balance of the mortgage loans at the end of each month in the calendar year. In August 2017, however, the Board and the Manager agreed to adjust the Existing Management Fee on an interim basis to the Interim Management Fee, which is a monthly management fee that equals 1/12$^{th}$ of 1.50% of the Company's Stockholders' Equity, subject to the additional details of the calculation as described in "Related Party Transactions – Management Fees and Expenses – Interim Fee Reduction and Amendment Proposal to Permanently Reduce Management Fees and Expenses" in Item 13 of this Annual Report. The Interim Management Fee is payable during the Interim Adjustment Period commencing July 1, 2017 and ending on March 31, 2018, and is intended to reduce the management fees payable by the Company during the Interim Adjustment Period.

OFG is also entitled to a monthly loan servicing fee, which, when added to all other fees paid in connection with the servicing of a particular loan, does not exceed the lesser of the customary, competitive fee paid in the community where the loan is placed for the provision of such services on that type of loan, or up to 0.25% per annum of the unpaid principle balance of the loans. Pursuant to the charter, OFG also receives all late payment charges from borrowers on loans owned by the Company, as well as, other miscellaneous fees which are collected from loan payments, loan payoffs or advances from loan principal, payable in cash on a monthly basis following the end of each month.

In addition, OFG is reimbursed by the Company for the actual cost of goods, services and materials used for or by the Company and paid by OFG and the salary and related salary expense of OFG's non-management and non-supervisory personnel performing services for the Company which could be performed by independent parties, including tax, accounting, and legal expenses (subject to certain limitations in the Management Agreement). Expense reimbursements to OFG are made in cash on a monthly basis following the end of each month. The Company's reimbursement obligation is not subject to any dollar limitation.
By their terms, the Management Agreement and the terms of the charter compensation and expense reimbursement, subject to permitted amendments, remain in effect for the duration of the existence of the Company, unless earlier terminated by the affirmative vote of the holders of a majority of the outstanding shares of Common Stock, automatically, or by OFG, or by the Company in accordance with the Agreement.
On March 13, 2018, we announced that our Board and the Manager have reached a non-binding agreement in principle to amend the Management Agreement to make the following changes to the Manager's compensation structure as further detailed in the Amendment Proposal: (1) to make permanent the Interim Management Fee adjustment along with an additional adjustment such that the monthly management fee payable will equal (i)

one-twelfth (1/12) multiplied by (ii) (a) 1.50% of the first $300,000,000 of the Company's Stockholders' Equity and (b) 1.25% of the Company's Stockholders' Equity that is greater than $300,000,000, (2) to share with the Company 30% of all loan origination, acquisition and other fees and late payment charges paid in connection with our loans, with the remaining 70% of such fees and charges to be paid to the Manager, (3) to eliminate the payment of servicing fees to the Manager for the Manager's services as servicing agent with respect to our loans, and (4) to eliminate the expense reimbursement to the Manager for certain expenses, including the salary and related salary expense of the Manager's non-management and non-supervisory personnel. While the Company and the Manager caution that no assurances can be made regarding the timing or certainty of entering a definitive agreement relating to the Amendment Proposal, if a definitive agreement implementing the Amendment Proposal is not executed by March 31, 2018, the Manager has agreed that the Company will only be obligated to pay, and the Manager will only be entitled to receive, the reduced management fee contemplated under paragraph (1) above of the Amendment Proposal from and after April 1, 2018.  The foregoing summary of the Amendment Proposal is subject to the additional details as described in "Related Party Transactions – Management Fees and Expenses – Interim Fee Reduction and Amendment Proposal to Permanently Reduce Management Fees and Expenses" in Item 13 of this Annual Report.

Company Debt

The terms of the Company debt are discussed in further detail in our consolidated financial statements under "Note 7 – Lines of Credit Payable" and "Note 8 – Notes and Loans Payable on Real Estate" in Item 8 of this Annual Report.

CB&T Line of Credit

As of December 31, 2017, the Company has one credit facility and as of that date, the total amount available to borrow under the CB&T Credit Facility was $27,259,000 and the balance outstanding was $1,555,000 (leaving $25,704,000 available). As of March 9, 2018, the total amount available to borrow under the CB&T Credit Facility is $33,518,000 and the balance outstanding is $12,002,000 (leaving $21,516,000 available). Interest on borrowings under the CB&T Credit Facility are payable monthly. Pursuant to the agreement of the parties, entered effective February 28, 2018, to extend the maturity date, all amounts outstanding under the facility are to be repaid not later than June 1, 2018 and advances may be made up to that date. The Company intends to renew this credit facility on a long-term basis by June 1, 2018.

Tahoe Stateline Venture, LLC Loan Payable
The balance of the TSV Loan was approximately $13,243,000 as of December 31, 2017 and $13,152,000 as of March 9, 2018. TSV borrowed $10,445,000 at the first closing under the TSV Loan and an additional $3,830,000 in September 2015. No further funds are available to borrow under this loan agreement. TSV makes monthly payments of principal and accrued interest and the balance of the loan is due on the maturity date, which is January 1, 2021.

ZRV Construction Loan
The balance of the ZRV Loan was approximately $17,176,000 as of December 31, 2017 and approximately $13,689,000 as of March 9, 2018. As of December 31, 2017, there was approximately $243,000 available to borrow on the ZRV Loan. Monthly interest only payments are required from an established interest reserve. In addition, commencing on August 18, 2017 and continuing on the last day of each quarter thereafter during the term of the Loan, $6 million of principal is required to be repaid. The balance of the ZRV Loan is due on August 3, 2018. The Company expects to repay the balance of the ZRV loan in full with proceeds from the sales of condominium units by the maturity date. If the Company is not able to fully repay the ZRV Loan by that date, then it will use its cash reserves and/or advances on the CB&T Credit Facility to repay the remaining balance.

Commitments and Contingencies

As of December 31, 2017, we have commitments to advance additional funds to borrowers of construction, rehabilitation and other loans (including interest reserves) in the total amount of approximately $30,495,000.
Contingency Reserves

We are required to maintain cash, cash equivalents and marketable securities as contingency reserves in an aggregate amount of at least 1.50% of Capital (as defined in our charter). Although the Manager believes the contingency reserves are adequate, it could become necessary for us to sell or otherwise liquidate certain of our investments or other assets to cover such contingencies on terms which might not be favorable to the Company. The contingency reserves held in restricted cash and/or cash and cash equivalents were approximately $3,464,000 and $3,738,000 as of December 31, 2017 and 2016, respectively.

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Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and real estate values. The primary market risks that we are exposed to are interest rate risk and real estate risk.

Interest Rate Risk

Interest rate risk is highly sensitive to many factors, including governmental monetary tax policies, domestic and international economic and political considerations and other factors beyond our control.

Our operating results are exposed to the risks related to interest rate fluctuations as the results depend to a significant extent on the differences between income from our loans and our borrowing costs. We generally originate fixed rate loan investments and partially finance those investments with floating rate liabilities. Our investments in fixed rate assets are generally exposed to changes in value due to interest rate fluctuations; however, the short maturity and low debt to investments of our loan portfolio are intended to partially offset that risk. Our average weighted maturity of fixed rate loans as of December 31, 2017 was approximately 9 months though in the past we have extended the maturity date on certain loans which would increase our exposure to interest rate risk. In addition, our outstanding variable rate debt to loan investments as of December 31, 2017 was 13%. All of our variable rate investment loans and certain of our borrowings are subject to various interest rate floors. As a result, the impact of a change in interest rates may be different on our interest income than it is on our interest expense. As a result of the floors on our variable rate investment loans (which are a small part of our loan portfolio), and the short term nature of these loans, the impact of a change in prevailing interest rates on our income is unlikely to be material.

The following table projects the potential impact on our interest expense for a 12-month period assuming an instantaneous increase of 100 basis points in the LIBOR interest rate curve and one percent in the Prime Rate based on balances outstanding as of December 31, 2017:

| | As of or for the year ended December 31, 2017 | | |
|---|---|---|---|
| | Variable Rate Loans tied to LIBOR | Variable Rate Loans tied to Prime Rate | Total |
| Aggregate Principal Balance of Debt | $— | $18,731,288 | $18,731,288 |
| Effect of 100 basis point increase in the LIBOR Curve | $— | $— | $— |
| Effect of one percent increase in the Prime Rate | — | 187,313 | 187,313 |
| Totals | $— | $187,313 | $187,313 |

In the event of a significant rising interest rate environment and/or economic downturn, default on our loan portfolio could increase and result in losses to us. Such delinquencies or defaults could also have an adverse effect on the spreads between interest-earning assets and interest-bearing liabilities.

Credit Risks

Our loans and investments are also subject to credit risk. The performance and value of our loans and investments depend upon the borrowers' ability to operate the properties that serve as our collateral so that they produce cash flows adequate to pay interest and principal due to us and the borrowers' ability to refinance the loans or sell the underlying collateral upon maturity. To monitor this risk, our Manager's asset management team reviews our investment portfolios and in certain instances is in regular contact with our borrowers, monitoring performance of the collateral and enforcing our rights as necessary.

In addition, we are exposed to the risks generally associated with the commercial real estate market, including variances in occupancy rates, capitalization rates, absorption rates, and other macroeconomic factors beyond our control. We seek to manage these risks through our underwriting and asset management processes.

Counterparty Risk

The nature of our business requires us to hold our cash and cash equivalents and obtain financing from various financial institutions. This exposes us to the risk that these financial institutions may not fulfill their obligations to us under these various contractual arrangements. We mitigate this exposure by depositing our cash and cash equivalents and entering into financing and agreements with high credit quality institutions.

The nature of our loans and investments also expose us to the risk that our counterparties do not make required interest and principal payments on scheduled due dates. We seek to manage this risk through our credit analysis prior to making an investment and actively monitoring the asset portfolios that serve as our collateral.

Real Estate Risk

Commercial mortgage assets may be viewed as exposing an investor to greater risk of loss than residential mortgage assets since such assets are typically secured by larger loans to fewer obligors than residential mortgage assets. Multi-family and commercial property values and net operating income derived from such properties are subject to volatility and may be affected adversely by a number of factors, including, but not limited to, events such as natural disasters including hurricanes and earthquakes, acts of war and/or terrorism and others that may cause unanticipated and uninsured performance declines and/or losses to us or the owners and operators of the real estate securing our investment; national, regional and local economic conditions (which may be adversely affected by industry slowdowns and other factors); local real estate conditions (such as an oversupply of housing, retail, industrial, office or other commercial space); changes or continued weakness in specific industry segments; construction quality, construction delays, construction cost, age and design; demographic factors; retroactive changes to building or similar codes; and increases in operating expenses (such as energy costs). In the event net operating income decreases, a borrower may have difficulty repaying our loans, which could result in losses to us. In addition, decreases in property values reducing the value of collateral, and a lack of liquidity in the market, could reduce the potential proceeds available to a borrower to repay our loans, which could also cause us to suffer losses. Even when the net operating income is sufficient to cover the related property's debt service, there can be no assurance that this will continue to be the case in the future.

Prepayment Risk

Our revenue and earnings may be affected by prepayment rates on our existing investment loans. When we originate our investment loans, we anticipate that we will generate an expected yield. When borrowers prepay their loans faster than we expect, there are no prepayment penalties and we may be unable to replace these loans with new investment loans that will generate yields which are as high as the prepaid mortgage loans.

Item 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

OWENS REALTY MORTGAGE, INC.
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Stockholders and the Board of Directors of Owens Realty Mortgage, Inc.
Walnut Creek, California

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Owens Realty Mortgage, Inc. (the "Company") as of December 31, 2017 and 2016, the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2017, and the related notes and financial statement schedules III and IV (collectively referred to as the "financial statements"). We also have audited the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in the 2013 Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2017 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on criteria established in the 2013 Internal Control – Integrated Framework issued by COSO.

Basis for Opinions

The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's financial statements and an opinion on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.  A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Crowe Horwath LLP

We have served as the Company's auditor since 2011.

Sacramento, California
March 13, 2018

OWENS REALTY MORTGAGE, INC.

Consolidated Balance Sheets
December 31,

| Assets | 2017 | 2016 |
|---|---|---|
| Cash and cash equivalents | $2,170,816 | $434,243 |
| Restricted cash | 3,500,000 | 6,500,000 |
| Loans, net of allowance for loan losses of $1,827,806 in 2017 and $2,706,822 in 2016 | 144,343,844 | 126,975,489 |
| Interest and other receivables | 2,430,457 | 2,164,335 |
| Other assets, net of accumulated depreciation and amortization of $309,686 in 2017 and $251,729 in 2016 | 725,341 | 803,676 |
| Deferred financing costs, net of accumulated amortization of $265,276 in 2017 and $107,744 in 2016 | 26,823 | 171,855 |
| Deferred tax assets, net | 3,207,322 | 7,248,977 |
| Investment in limited liability company | 2,140,545 | 2,140,482 |
| Real estate held for sale | 56,110,472 | 75,843,635 |
| Real estate held for investment, net of accumulated depreciation of $3,316,753 in 2017 and $3,151,427 in 2016 | 24,355,653 | 37,279,763 |
| Total assets | $239,011,273 | $259,562,455 |
| Liabilities and Equity | | |
| Liabilities: | | |
| Dividends payable | $1,572,047 | $1,402,496 |
| Due to Manager | 277,671 | 360,627 |
| Accounts payable and accrued liabilities | 1,390,329 | 3,699,859 |
| Deferred gains | 302,895 | 209,662 |
| Forward contract liability – share repurchase | 2,731,171 | — |
| Line of credit payable | 1,555,000 | 4,976,000 |
| Notes and loans payable on real estate | 30,192,433 | 33,385,934 |
| Total liabilities | 38,021,546 | 44,034,578 |
| Commitments and Contingencies (Note 15) | | |
| Equity: | | |
| Stockholders' equity: | | |
| Preferred stock, $.01 par value per share, 5,000,000 shares authorized, no shares issued and outstanding at December 31, 2017 and 2016 | — | — |
| Common stock, $.01 par value per share, 50,000,000 shares authorized, 11,198,119 shares issued, 9,095,454 and 10,247,477 shares outstanding at December 31, 2017 and 2016 | 111,981 | 111,981 |
| Additional paid-in capital | 182,437,522 | 182,437,522 |
| Treasury stock, at cost – 2,102,665 and 950,642 shares at December 31, 2017 and 2016 | (31,655,119 ) | (12,852,058 ) |
| Retained earnings | 50,095,343 | 45,830,432 |
| Total stockholders' equity | 200,989,727 | 215,527,877 |
| Total liabilities and equity | $239,011,273 | $259,562,455 |

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

OWENS REALTY MORTGAGE, INC.

Consolidated Statements of Income
Years Ended December 31,

| | 2017 | 2016 | 2015 |
|---|---|---|---|
| Revenues: | | | |
| Interest income on loans | $10,840,730 | $8,922,142 | $8,277,004 |
| Rental and other income from real estate properties | 4,505,385 | 7,977,400 | 12,791,096 |
| Other income | 187,013 | 179,449 | 175,451 |
| Total revenues | 15,533,128 | 17,078,991 | 21,243,551 |
| Expenses: | | | |
| Management fees to Manager | 3,546,085 | 3,286,470 | 2,051,134 |
| Servicing fees to Manager | 362,411 | 298,770 | 186,467 |
| General and administrative expense | 2,234,230 | 1,568,890 | 1,278,994 |
| Rental and other expenses on real estate properties | 4,980,900 | 7,060,526 | 8,510,110 |
| Depreciation and amortization | 1,138,515 | 1,258,305 | 2,052,181 |
| Interest expense | 1,587,695 | 2,859,294 | 1,938,113 |
| Bad debt expense from uncollectible rent | — | — | 152,805 |
| (Recovery of) provision for loan losses | (360,012 ) | 1,284,896 | (1,026,909 ) |
| Impairment losses on real estate properties | 1,423,286 | 3,227,807 | 1,589,434 |
| Total expenses | 14,913,110 | 20,844,958 | 16,732,329 |
| Operating income (loss) | 620,018 | (3,765,967 ) | 4,511,222 |
| Gain on sales of real estate, net | 14,728,921 | 24,497,763 | 21,818,553 |
| Settlement expense | (2,627,436 ) | — | — |
| Net income before income tax expense | 12,721,503 | 20,731,796 | 26,329,775 |
| Income tax (expense) benefit | (4,041,655 ) | 7,248,977 | (93,335 ) |
| Net income | 8,679,848 | 27,980,773 | 26,236,440 |
| Less: Net income attributable to non-controlling interests | — | (3,571,003 ) | (2,667,324 ) |
| Net income attributable to common stockholders | $8,679,848 | $24,409,770 | $23,569,116 |
| Per common share data: | | | |
| Basic and diluted earnings per common share | $0.85 | $2.38 | $2.22 |
| Basic and diluted weighted average number of common shares outstanding | 10,162,496 | 10,247,477 | 10,594,807 |
| Dividends declared per share of common stock | $0.38 | $0.32 | $0.41 |

The accompanying notes are an integral part of these consolidated financial statements.
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OWENS REALTY MORTGAGE, INC.

Consolidated Statements of Stockholders' Equity
Years Ended December 31, 2017, 2016 and 2015

| | Common Stock | | Additional Paid-in | Treasury Stock | | Retained | Total Stockholders' | Non-controllin |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Capital | Shares | Amount | Earnings | Equity | Interests |
| Balances, January 1, 2015 | 11,198,119 | $ 111,981 | $ 182,437,522 | (430,118 ) | $(5,349,156 ) | $7,371,511 | $184,571,858 | $4,174,753 |
| Net income | — | — | — | —— | — | 23,569,116 | 23,569,116 | 2,667,324 |
| Dividends declared | — | — | — | —— | — | (4,344,417 ) | (4,344,417 ) | — |
| Tax payment made on behalf of stockholders (Note 9) | — | — | — | — | — | (1,313,657 ) | (1,313,657 ) | — |
| Purchase of treasury stock | — | — | — | (520,524 ) | (7,502,902 ) | — | (7,502,902 ) | — |
| Contribution from non-controlling interest | — | — | — | — | — | — | — | 279,184 |
| Distributions to non-controlling interests | — | — | — | —— | — | — | — | (2,592,41 |
| Balances, December 31, 2015 | 11,198,119 | $ 111,981 | $ 182,437,522 | (950,642 ) | $(12,852,058) | $25,282,553 | $194,979,998 | $4,528,849 |
| Net income | — | — | — | — | — | 24,409,770 | 24,409,770 | 3,571,003 |
| Dividends declared | — | — | — | — | — | (3,279,193 ) | (3,279,193 ) | — |
| Tax payment made on behalf of stockholders (Note 9) | — | — | — | — | — | (582,698 ) | (582,698 ) | — |
| Contribution from non-controlling interest | — | — | — | — | — | — | — | 44,207 |
| Distributions to non-controlling interests | — | — | — | — | — | — | — | (8,144,05 |
| Balances, December 31, 2016 | 11,198,119 | $111,981 | $182,437,522 | (950,642 ) | $(12,852,058) | $45,830,432 | $215,527,877 | $— |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Net income | — | — | — | — | — | 8,679,848 | 8,679,848 | — |
| Dividends declared | — | — | — | — | — | (3,774,670 ) | (3,774,670 ) | — |
| Tax payment made on behalf of stockholders (Note 9) | — | — | — | — | — | (640,267 ) | (640,267 ) | — |
| Purchase of treasury stock | — | — | — | (1,152,023) | (18,803,061) | — | (18,803,061 ) | — |
| Balances, December 31, 2017 | 11,198,119 | $ 111,981 | $ 182,437,522 | (2,102,665) | $(31,655,119) | $50,095,343 | $200,989,727 | $— |

The accompanying notes are an integral part of these consolidated financial statements
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OWENS REALTY MORTGAGE, INC.
Consolidated Statements of Cash Flows
Years ended December 31,

| | 2017 | 2016 | 2015 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net income | $8,679,848 | $27,980,773 | $26,236,440 |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: | | | |
| Gain on sales of real estate, net | (14,728,921) | (24,497,763) | (21,818,553) |
| Deferred income tax benefit | 4,041,655 | (7,248,977) | — |
| Income from investment in limited liability company | (185,063) | (179,450) | (175,451) |
| (Reversal of) provision for loan losses | (360,012) | 1,284,896 | (1,026,909) |
| Impairment losses on real estate properties | 1,423,286 | 3,227,807 | 1,589,434 |
| Depreciation and amortization | 1,138,515 | 1,258,305 | 2,052,181 |
| Amortization of deferred financing costs | 317,419 | 456,168 | 367,471 |
| Accretion of discount on loans | — | — | (536,816) |
| Changes in operating assets and liabilities: | | | |
| Interest and other receivables | (266,122) | (441,985) | (282,538) |
| Other assets | 34,172 | (420,759) | (122,622) |
| Accounts payable and accrued liabilities | (2,351,676) | (2,314,291) | (526,952) |
| Due to Manager | (82,956) | (48,016) | 124,999 |
| Forward contract liability | 459,688 | — | — |
| Net cash (used in) provided by operating activities | (1,880,167) | (943,292) | 5,880,684 |
| | | | |
| Cash flows from investing activities: | | | |
| Principal collected on loans | 69,266,337 | 55,849,884 | 35,216,165 |
| Investments in loans | (85,824,680) | (78,272,140) | (68,739,645) |
| Investment in real estate properties | (11,232,758) | (26,406,879) | (23,607,553) |
| Net proceeds from disposition of real estate properties | 55,879,123 | 89,401,642 | 48,602,328 |
| Purchases of vehicles and equipment | (16,170) | (29,887) | (48,402) |
| Distribution received from investment in limited liability company | 185,000 | 180,000 | 177,000 |
| Transfer from (to) restricted cash, net | 3,000,000 | 725,371 | (976,625) |
| Net cash provided by (used in) investing activities | 31,256,852 | 41,447,991 | (9,376,732) |
| | | | |
| Cash flows from financing activities | | | |
| Advances on notes payable | 10,543,172 | 23,966,383 | 28,603,251 |
| Repayments on notes payable | (13,972,820) | (36,380,880) | (20,055,762) |
| Advances on lines of credit | 19,945,000 | 79,416,793 | 69,247,500 |
| Repayments of lines of credit | (23,366,000) | (95,356,293) | (59,782,000) |
| Payment of deferred financing costs | (12,500) | (279,599) | (41,735) |
| Distributions to non-controlling interests | — | (8,144,059) | (2,592,412) |
| Contribution from non-controlling interest | — | 44,207 | 279,184 |
| Purchase of treasury stock | (16,531,578) | — | (7,502,902) |
| Dividends paid | (4,245,386) | (4,592,850) | (4,816,779) |
| Net cash (used in) provided by financing activities | (27,640,112) | (41,326,298) | 3,338,345 |
| | | | |
| Net increase (decrease) in cash and cash equivalents | 1,736,573 | (821,599) | (157,703) |
| | | | |
| Cash and cash equivalents at beginning of year | 434,243 | 1,255,842 | 1,413,545 |

| | | | |
|---|---|---|---|
| Cash and cash equivalents at end of year | $2,170,816 | $434,243 | $1,255,842 |
| | | | |
| Supplemental Disclosures of Cash Flow Information | | | |
| Cash paid during the year for interest (excluding amounts capitalized) | $1,291,743 | $2,495,000 | $1,570,887 |
| Cash paid during the year for interest that was capitalized | 472,357 | 555,453 | 393,591 |
| Cash paid during the year for income taxes | — | — | 93,335 |

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OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

| Supplemental Disclosure of Non-Cash Activity | | | |
|---|---|---|---|
| Increase in real estate from loan foreclosures | — | 700,800 | — |
| Decrease in loans, net of allowance for loan losses, from loan foreclosures | — | (631,232) | — |
| Decrease in interest and other receivables from adding balances to loans | — | (69,568) | — |
| Decrease in interest and other receivables from loan foreclosures | — | — | — |
| Increase in loans from sales of real estate | 450,000 | 1,595,000 | 4,650,000 |
| Amortization of deferred financing costs capitalized to construction project | (76,260) | (119,471) | (207,347) |
| Capital expenditures financed through accounts payable | (42,146) | (2,654,856) | (1,666,572) |
| Dividends declared but not paid | (1,572,047) | (1,402,496) | (2,133,455) |
| Repurchase of treasury stock accrued as forward contract liability | (2,271,483) | — | — |

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

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

NOTE 1 – ORGANIZATION

Owens Realty Mortgage, Inc. (the "Company") was incorporated on August 9, 2012, under the laws of the State of Maryland. The Company is authorized to issue 50,000,000 shares of its $0.01 par value common stock (the "Common Stock"). In addition, the Company is authorized to issue 5,000,000 shares of preferred stock at $0.01 par value per share. The Company was created to effect the merger (the "Merger") of Owens Mortgage Investment Fund, a California Limited Partnership ("OMIF") with and into the Company as described in the Registration Statement on Form S-4, as amended, of the Company, declared effective on February 12, 2013 (File No. 333-184392). The Merger was part of a plan to reorganize the business operations of OMIF so that it could elect to qualify as a real estate investment trust for Federal income tax purposes. The Merger was approved by OMIF limited partners on April 16, 2013 and was completed on May 20, 2013. The Company now, by virtue of the Merger, directly or indirectly owns all of the assets and business formerly owned by OMIF and is a deemed successor issuer to OMIF pursuant to Rule 12g-3(a) under the Securities Exchange Act of 1934, as amended. For accounting purposes, the merger of OMIF with and into the Company was treated as a transfer of assets and exchange of shares between entities under common control. The accounting basis used to initially record the assets and liabilities in the Company was the carryover basis of OMIF. The consolidated financial statements reflect the extinguishment of OMIF's partners' capital and replacement with 11,198,119 shares of Common Stock and additional paid –in capital as if the Merger occurred on January 1, 2013.

The Company has elected to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986, as amended (the "Code. As a REIT, the Company is permitted to deduct distributions made to its stockholders, allowing its operating income represented by such distributions to avoid taxation at the entity level and to be taxed generally only at the stockholder level. The Company currently intends to distribute all of its REIT taxable income, excluding net capital gains. As a REIT, however, the Company is subject to separate, corporate-level tax, including potential 100% penalty taxes under various circumstances, as well as certain state and local taxes. In addition, the Company's taxable REIT subsidiaries are subject to full corporate income tax. Furthermore, the Company's ability to continue to qualify as a REIT will depend upon its continuing satisfaction of various requirements, such as those related to the diversity of its stock ownership, the nature of its assets, the sources of its income and the distributions to its stockholders, including a requirement that the Company distribute to its stockholders at least 90% of its REIT taxable income on an annual basis (determined without regard to the dividends paid deduction and by excluding net capital gain).

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its majority and wholly owned limited liability companies. All significant inter-company transactions and balances have been eliminated in consolidation. The Company also has a 50% ownership interest in a limited liability company accounted for under the equity method (see Note 4). The Company is in the business of providing mortgage lending services and manages its business as one operating segment. Due to foreclosure activity, the Company also owns and manages real estate assets.

Certain reclassifications have been made to the 2015 and 2016 consolidated financial statements to conform to the 2017 presentation. None of the reclassifications had an impact on net income or equity.

Management Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Such estimates are inherently imprecise and actual results could differ significantly from such estimates.

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OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

Recently Issued Accounting Standards

In January 2017, the FASB issued Accounting Standards Update ("ASU") 2017-01, "Business Combinations (Topic 805) – Clarifying the Definition of a Business", or ASU 2017-01. The amendments in ASU 2017-01 clarify the definition of a business by more clearly outlining the requirements for an integrated set of assets and activities to be considered a business and by establishing a practical framework to determine when the integrated set of assets and activities is a business. This standard is effective for interim and annual reporting periods beginning after December 15, 2017. The Company does not believe that adoption of ASU 2017-01 will have a material impact on its consolidated financial statements.

In November 2016, the FASB issued Accounting Standards Update ("ASU") 2016-18, "Statement of Cash Flows (Topic 230) – Restricted Cash", or ASU 2016-18. The amendments in ASU 2016-18 require that a statement of cash flows explain the change during the period in the total of cash, cash equivalents and amounts generally described as restricted cash and cash equivalents together when reconciling the beginning and end of period total amounts shown on the statement of cash flows. This standard is effective for interim and annual reporting periods beginning after December 15, 2017 on a retrospective basis to each period presented. The adoption of ASU 2016-18 will result in the Company including its restricted cash with cash and cash equivalents when reconciling the beginning and ending amounts shown on its consolidated statement of cash flows.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230) – Classification of Certain Cash Receipts and Cash Payments", or ASU 2016-15. The amendments in ASU 2016-15 reflect eight targeted changes to how cash receipts and cash payments are presented and classified in the statement of cash flows. This standard is effective for interim and annual reporting periods beginning after December 15, 2017 and requires adoption on a retrospective basis to each period presented, unless it is impracticable to apply, in which case, the amendment is required to be applied prospectively as of the earliest date practicable. Presently, the Company believes that the only impact from the adoption of ASU 2016-15 will be that distributions it receives from its equity method investment will be reported in cash flows from operating activities rather than financing activities on its consolidated statement of cash flows.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments – Credit Losses (Topic 326) – Measurement of Credit Losses on Financial Instruments", or ASU 2016-13. The amendments in ASU 2016-13 eliminate the probable and incurred credit loss recognition threshold in current GAAP and, instead, reflect an entity's current estimate of all expected credit losses. The amendments in ASU 2016-13 broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. The use of forecasted information incorporates more timely information in the estimate of expected credit loss. This standard is effective for interim and annual reporting beginning after December 15, 2019, with early adoption permitted for interim and annual reporting beginning after December 15, 2018. While the Company is currently evaluating the impact that ASU 2016-13 will have on its consolidated financial statements, the adoption is not expected to result in a material increase in the amount of allowance for loan losses based on the short maturity of loans in the Company's portfolio. However, if the Company makes longer term loans, the impact may be greater.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)," or ASU 2014-09. ASU 2014-09 broadly amends the accounting guidance for revenue recognition. ASU 2014-09's effective date was deferred one year by ASU 2015-14, and it is now effective for the first interim or annual period beginning after December 15, 2017, and is to be applied retrospectively to all periods presented or retrospectively with the cumulative effect recognized at the date of the initial application. The Company plans to adopt the standard using the modified retrospective method. The Company expects that the majority of its revenue will not be impacted by the

adoption of this accounting standard since the standard will not change its accounting policy for the recognition of interest income. The Company does not anticipate its revenue from real estate properties and related disclosures will be significantly impacted by this standard, as rental income from leasing arrangements is specifically excluded from ASU 2014-09, and will be evaluated with the adoption of the lease accounting standard, ASU 2016-02, discussed below. The Company anticipates the primary effects of the new standard will be associated with the Company's non-lease revenue streams, which represented less than 4% of consolidated total revenues in 2017. In addition, under ASU 2014-09, gain or loss on the sale of real estate when such sale is financed by the Company will be impacted for future transactions entered into and management expects that the Company will need to reevaluate four past real estate sales transactions and retroactively apply the provisions of ASU 2014-09 as of January 1, 2018, which is not likely to result in a material change to the Company's consolidated financial statements.

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In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)" or ASU 2016-02, which sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract (i.e., lessees and lessors). ASU 2016-02 amends existing guidance related to leases, primarily by requiring the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under the current accounting guidance. This standard is effective for interim and annual reporting beginning after December 15, 2018, with early adoption permitted. The Company does not currently have any lease obligations. The Company expects that its operating leases where it is the lessor will be accounted for on its balance sheet similar to its current accounting with the underlying leased asset recognized as real estate. The Company expects that executory costs and certain other non-lease components will need to be accounted for separately from the lease component of the lease with the lease component continuing to be recognized on a straight-line basis over the lease term and the executory costs and certain other non-lease components being accounted for under the new revenue recognition guidance in ASU 2014-09. The Company does not believe that adoption of ASU 2016-02 will have a material impact on its consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments- Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities", or ASU 2016-01. ASU 2016-01 enhances the reporting model for financial instruments to provide users of financial statements with more decision-useful information. This Update contains several provisions, including but not limited to 1) requiring equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income; 2) simplifying the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; 3) eliminating the requirement to disclose the method(s) and significant assumptions used to estimate fair value; and 4) requiring separate presentation of financial assets and liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements. ASU 2016-01 also changes certain financial statement disclosure requirements, including requiring disclosures of the fair value of financial instruments be made on the basis of exit price. ASU 2016-01 is effective for public entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Management does not expect adoption of this accounting standard will have a significant impact on the Company's consolidated financial statements, however management expects the requirement to use an exit price methodology could impact the disclosures the Company makes related to fair value of its financial instruments. Disclosure of the fair value of the Company's loans is likely to be impacted the most by this change.

Cash and Cash Equivalents

Cash and cash equivalents include funds on deposit with financial institutions.

Restricted Cash

Restricted cash includes contingency reserves required pursuant to the Company's charter and non-interest bearing deposits required pursuant to the Company's lines of credit (see Note 7).

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents and loans. The Company places its cash and cash equivalents with financial institutions and, at times, cash held may exceed the Federal Deposit Insurance Corporation, or "FDIC", insured limit. The Company has exposure to credit risk on its loans and other investments. The Company's Manager, OFG, will seek to manage credit risk by performing analysis of underlying collateral assets.

Loans and Allowance for Loan Losses

Loans are generally stated at the principal amount outstanding. Advances under the terms of a loan to pay property taxes, insurance, legal and other costs are generally capitalized and reported as interest and other receivables. The Company's portfolio consists primarily of real estate loans generally collateralized by first, second and third deeds of trust. Interest income on loans is accrued using the simple interest method. Loans are generally placed on nonaccrual status when the borrowers are past due greater than ninety days or when full payment of principal and interest is not expected. When a loan is classified as nonaccrual, interest accruals discontinue and all past due interest is included in the recorded investment in the impaired loan that is measured as described below. Interest accruals are resumed on such loans only when they are brought fully current with respect to interest and principal and when, in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest. Cash receipts on nonaccrual loans are used to reduce any outstanding accrued interest, and then are recorded as interest income, except when such payments are specifically designated as principal reduction or when management does not believe the Company's investment in the loan is fully recoverable. The Company does not incur origination costs and does not earn or collect origination fees from borrowers as OFG is entitled to all such fees (see Note 12).

Loans and the related accrued interest and advances are analyzed by management on a periodic basis for ultimate recovery. The allowance for loan losses is management's estimate of probable credit losses inherent in the Company's loan portfolio that have been incurred as of the balance sheet date. The allowance is established through a provision for loan losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of two primary components: specific reserves related to impaired loans that are individually evaluated for impairment and general reserves for inherent losses related to loans that are not considered impaired and are collectively evaluated for impairment.

Regardless of the loan type, a loan is considered impaired when, based on current information and events, management believes it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. All loans determined to be impaired are individually evaluated for impairment. When a loan is considered impaired, management estimates impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, management may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. These valuations are generally updated during the fourth quarter but may be updated during interim periods if deemed appropriate by management.

A restructuring of a debt constitutes a troubled debt restructuring ("TDR") if the Company for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform

according to the original contractual terms. Loans that are reported as TDR's are considered impaired and measured for impairment as described above.

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The determination of the general reserve for loans that are not considered impaired and are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, and qualitative factors to include economic trends in the Company's service areas, industry experience and trends, geographic concentrations, estimated collateral values, the Company's underwriting policies, the character of the loan portfolio, and probable incurred losses inherent in the portfolio taken as a whole.

The Company maintains a separate allowance for each portfolio segment (loan type). These portfolio segments include commercial real estate, residential real estate and land loans. The allowance for loan losses attributable to each portfolio segment, which includes both impaired loans that are individually evaluated for impairment and loans that are not considered impaired and are collectively evaluated for impairment, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet. The allowance for loans that are not considered impaired consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk, (2) historical losses, and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below.

Land Loans – These loans generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified costs and time lines. Trends in the construction industry significantly impact the credit quality of these loans as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

Commercial and Residential Real Estate Loans – Adverse economic developments or an overbuilt market impact commercial and residential real estate projects and may result in troubled loans. Trends in vacancy rates of properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

Management monitors the credit quality of the Company's loan portfolio on an ongoing basis using certain credit quality indicators including a loan's delinquency status and internal asset classification. A loan is considered classified when it meets the definition of impaired as described above.

Other Assets

Other assets primarily include deferred rent, capitalized lease commissions, prepaid expenses, deposits and inventory. Amortization of lease commissions is provided on the straight-line method over the lives of the related leases.

Deferred Financing Costs

Issuance and other costs related to the Company's lines of credit and certain notes payable are capitalized and amortized to interest expense under either the straight-line or effective interest methods over the terms of the respective debt instruments. Deferred financing costs related to the construction loan in Zalanta Resort at the Village, LLC were amortized to the construction project under the straight-line method over the term of construction/renovation.

Rental Income

The Company leases multifamily rental units under operating leases with terms of generally one year or less. Rental revenue is recognized, net of rental concessions, on a straight-line method over the related lease term. Rental income on commercial property is recognized on a straight-line basis over the term of each operating lease.



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Notes to Consolidated Financial Statements

Real Estate Held for Sale

Real estate held for sale includes real estate acquired in full or partial settlement of loan obligations, generally through foreclosure, that is being marketed for sale. Real estate held for sale is recorded at acquisition at the property's estimated fair value less estimated costs to sell. Any excess of the recorded investment in the loan over the net realizable value is charged against the allowance for loan losses. Any excess of the net realizable value over the recorded investment in the loan is credited first to the allowance for loan losses as a recovery to the extent charge-offs had been recorded previously and, then to earnings as gain on foreclosure of loan.

After acquisition, costs incurred relating to the development and improvement of property are capitalized to the extent they do not cause the recorded value to exceed the net realizable value, whereas costs relating to holding and disposition of the property are expensed as incurred. After acquisition, real estate held for sale is analyzed periodically for changes in fair values and any subsequent write down is charged to impairment losses on real estate properties. Any recovery in the fair value subsequent to such a write down is recorded (not to exceed the net realizable value at acquisition) as an offset to impairment losses on real estate properties.

Gains on the sale of real estate are recorded using the full accrual method whereby the amount by which the net sale proceeds exceeds the property's carrying amount is recorded as gain in full on the date of sale if the following criteria are met:

- The gain is determinable, that is, the collectability of the sales price is reasonably assured or the amount that will not be collectible can be estimated.
- The earnings process is virtually complete, that is, the Company is not obliged to perform significant activities after the sale in order to earn the gain.

Sales of real estate properties that do not meet the criteria for the full accrual method are accounted for as follows:

- Deposit method – If it is determined a sale has not consummated, the Company does not derecognize its recorded investment in the property and the transaction is accounted for under the deposit method whereby any initial investment from the buyer is accounted for as a deposit liability.
- Cost recovery method – If recovery of the cost of the property is not reasonably assured if the buyer defaults or if cost has already been recovered and collection of additional amounts is uncertain, the cost recovery method is used whereby no gain is recognized until cash payments from the buyer exceed the Company's recorded investment in the property sold.
- Installment method – If the buyer's initial investment is inadequate, as measured by its composition and its size compared with the sales value of the property, and if recovery of the carrying amount of the property is reasonably assured if the buyer defaults, the transaction is accounted for under the installment method whereby each cash receipt and principal payment by the buyer on debt assumed is allocated between cost recovered and gain. This allocation is in the same ratio as total cost and total gain bear to the sales value.
- Reduced profit method – If the buyer's initial investment is adequate but the buyer's continuing investment is inadequate, as measured by the annual payments required by the buyer compared to a 20-year fully-amortizing payment if the sold property is land and the a fully-amortizing payment at a customary amortization term of a first mortgage loan by an independent established lending institution if the sold property is other real estate, the gain is recognized using the reduced profit method whereby gain is determined by discounting the receivable from the buyer to the present value of the lowest level of annual payments required by the sales contract over a maximum period (20 years for land and customary underwriting terms for other real estate) and excluding requirements to pay lump sums.

The present value is calculated using an appropriate interest rate, but not less than the rate stated in the sales contract. In order for the reduced profit method to be used, payments by the buyer each year must at least cover a) the interest and principal amortization on the maximum first mortgage loan that could be obtained on the property, and b) interest, at an appropriate rate, on the excess of the aggregate actual debt on the property over such a maximum first mortgage loan. If such criteria are not met, the Company may recognize gain on the sale using the installment method or cost recovery method.

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Notes to Consolidated Financial Statements

Real Estate Held for Investment

Real estate held for investment includes real estate acquired in full or partial settlement of loan obligations, generally through foreclosure, that is not being marketed for sale and is either being operated, such as rental properties; is being managed through the development process, including obtaining appropriate and necessary entitlements, permits and construction; or are idle properties awaiting more favorable market conditions or properties the Company cannot sell without placing the Company's REIT status at risk or becoming subject to prohibited transactions penalty tax. Real estate held for investment is recorded at acquisition at the property's estimated fair value, less estimated costs to sell.

After acquisition, costs incurred relating to the development and improvement of the property are capitalized, whereas costs relating to operating or holding the property are expensed. Subsequent to acquisition, management periodically compares the carrying value of real estate to expected undiscounted future cash flows for the purpose of assessing the recoverability of the recorded amounts. If the carrying value exceeds future undiscounted cash flows, the assets are reduced to estimated fair value through an impairment loss charged to earnings. Subsequent increases in the fair value of such properties are not recorded unless they are realized.

Depreciation of real estate properties held for investment is provided on the straight-line method over the estimated remaining useful lives of buildings and improvements (5-39 years). Depreciation of tenant improvements is provided on the straight-line method over the shorter of their estimated useful lives or the lease terms.
The Company reclassifies real estate properties from held for investment to held for sale in the period in which all of the following criteria are met: 1) Management commits to a plan to sell the property; 2) The property is available for immediate sale in its present condition; 3) An active program to locate a buyer has been initiated; 4) The sale of the property is probable and the transfer of the property is expected to qualify for recognition as a completed sale, within one year; and 5) Actions required to complete the plan indicate it is unlikely that significant changes to the plan will be made or the plan will be withdrawn. Such real estate properties are recorded at the time of reclassification at their carrying amounts prior to reclassification or fair value, whichever is lower. This establishes the initial basis at which the properties are accounted for as held for sale, as described above.
If circumstances arise that previously were considered unlikely, and, as a result, the Company decides not to sell a real estate property classified as held for sale, the property is reclassified to held for investment. The property is then measured individually at the lower of its carrying amount, adjusted for depreciation or amortization expense that would have been recognized had the property been continuously classified as held for investment, or its fair value at the date of the subsequent decision not to sell.
Earnings per Common Share

The Company calculates basic earnings per common share by dividing net income attributable to common stockholders for the period by the weighted-average shares of Common Stock outstanding for that period. Diluted earnings per common share take into effect any dilutive instruments, unless if when doing so such effect would be anti-dilutive. At the present time, the Company has not issued any restricted stock or restricted stock units and has no other dilutive instruments.
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Income Taxes

Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities, if any. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount that is "more likely than not" to be realized.

The Company has elected to be taxed as a REIT. As a result of the Company's REIT qualification and its distribution policy, the Company does not generally expect to pay U.S. federal corporate level income taxes. Many of the REIT requirements, however, are highly technical and complex. To qualify as a REIT, the Company must meet a number of organizational and operational requirements, including a requirement that the Company distribute annually at least 90% of the Company's REIT taxable income, determined without regard to net capital gains, to the Company's stockholders. If the Company has previously qualified as a REIT and fails to qualify as a REIT in any subsequent taxable year and does not qualify for certain statutory relief provisions, the Company will be subject to U.S. federal income taxes at regular corporate rates (including any applicable alternative minimum tax) and may be precluded from qualifying as a REIT for the Company's four subsequent taxable years. Even if the Company qualifies for taxation as a REIT, the Company may be subject to certain U.S. federal, state, local and foreign taxes on the Company's income and property and to U.S. federal income and excise taxes on the Company's undistributed REIT taxable income.

The Company has elected or may elect to treat certain of its existing or newly created corporate subsidiaries as taxable REIT subsidiaries (each a "TRS"). In general, a TRS of a REIT may hold assets that the REIT cannot hold directly and, subject to certain exceptions related to hotels and healthcare properties, may engage in any real estate or non-real estate related business. A TRS is treated as a regular corporation and is subject to federal, state, local and foreign taxes on its income and property.

Gains on sales of certain properties may be taxable to the Company if such properties were held primarily for sale to customers in the ordinary course of business, as contemplated by Internal Revenue Code Section 1221(a)(1), or were identified as foreclosure property under the related REIT taxation rules.

The accounting guidance prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. A tax position is recognized as a benefit only if it is "more likely than not" that the position would be sustained in a tax examination, with a tax examination being presumed to occur. The Company has analyzed its various federal and state filing positions and believes that its income tax filing positions and deductions are well documented and supported. There was no reserve for uncertain tax positions recorded as of December 31, 2017 and 2016. Interest and penalties related to income tax matters, if any, are recorded as part of income tax expense in the consolidated statement of income.

Certain entities included in the Company's consolidated financial statements are subject to certain state and local taxes. These taxes are recorded as general and administrative expenses in the accompanying consolidated financial statements.

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

NOTE 3 - LOANS AND ALLOWANCE FOR LOAN LOSSES

The following tables show the changes in the allowance for loan losses by portfolio segment for the years ended December 31, 2017, 2016 and 2015 and the allocation of the allowance for loan losses and loans as of December 31, 2017 and 2016 by portfolio segment and by impairment methodology:

| 2017 | Commercial | Residential | Land | Total |
|---|---|---|---|---|
| Allowance for loan losses: | | | | |
| Beginning balance | $864,971 | $1,331,318 | $510,533 | $2,706,822 |
| Charge-offs | — | (546,004) | — | (546,004) |
| Recoveries | 27,000 | — | — | 27,000 |
| Provision (Reversal) | 177,487 | (333,777) | (203,722) | (360,012) |
| Ending balance | $1,069,458 | $451,537 | $ 306,811 | $ 1,827,806 |
| Ending balance: individually evaluated for impairment | $— | $186,708 | $— | $186,708 |
| Ending balance: collectively evaluated for impairment | $1,069,458 | $264,829 | $306,811 | $1,641,098 |
| Ending balance | $1,069,458 | $451,537 | $306,811 | $1,827,806 |
| Loans: | | | | |
| Ending balance | $127,873,281 | $ 13,170,795 | $5,127,574 | $146,171,650 |
| Ending balance: individually evaluated for impairment | $1,212,851 | $ 7,321,359 | $— | $8,534,210 |
| Ending balance: collectively evaluated for impairment | $126,660,430 | $ 5,849,436 | $5,127,574 | $137,637,440 |

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Notes to Consolidated Financial Statements

| 2016 | Commercial | Residential | Land | Total |
|---|---|---|---|---|
| Allowance for loan losses: | | | | |
| Beginning balance | $ 1,140,530 | $455,587 | $246,329 | $1,842,446 |
| Charge-offs | (447,520 ) | — | — | (447,520) |
| Recoveries | 27,000 | — | — | 27,000 |
| Provision | 144,961 | 875,731 | 264,204 | 1,284,896 |
| Ending balance | $ 864,971 | $1,331,318 | $ 510,533 | $ 2,706,822 |
| Ending balance: individually evaluated for impairment | $— | $732,712 | $— | $732,712 |
| Ending balance: collectively evaluated for impairment | $ 864,971 | $598,606 | $510,533 | $1,974,110 |
| Ending balance | $864,971 | $1,331,318 | $510,533 | $2,706,822 |
| Loans: | | | | |
| Ending balance | $ 102,442,111 | $ 19,001,677 | $8,238,523 | $129,682,311 |
| Ending balance: individually evaluated for impairment | $— | $ 4,883,866 | $— | $4,883,866 |
| Ending balance: collectively evaluated for impairment | $ 102,442,111 | $ 14,117,811 | $ 8,238,523 | $124,798,445 |

| 2015 | Commercial | Residential | Land | Total |
|---|---|---|---|---|
| Allowance for loan losses: | | | | |
| Beginning balance | $ 888,260 | $ 1,975,112 | $5,983 | $2,869,355 |
| Charge-offs | — | — | — | — |
| Provision (Reversal) | 252,270 | (1,519,525 ) | 240,346 | (1,026,909) |
| | 1,140,530 | $455,587 | $ 246,329 | $ 1,842,446 |

| Ending balance | $ |
|---|---|

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The following tables show an aging analysis of the loan portfolio by the time monthly payments are past due at December 31, 2017 and 2016. All of the loans that were 90 days or more past due in payments as listed below were on non-accrual status as of December 31, 2017 and 2016.

| December 31, 2017 | Loans 30-59 Days Past Due | Loans 60-89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due Loans | Current Loans | Total Loans |
|---|---|---|---|---|---|---|
| Commercial | $1,212,851 | $ — | $ — | $1,212,851 | $ 126,660,430 | $127,873,281 |
| Residential | — | 4,676,433 | 2,644,926 | 7,321,359 | 5,849,436 | 13,170,795 |
| Land | — | — | — | — | 5,127,574 | 5,127,574 |
| | $1,212,851 | $4,676,433 | $2,644,926 | $8,534,210 | $ 137,637,440 | $ 146,171,650 |

The above table as of December 31, 2017 includes seven past maturity loans in the Current Loan category of approximately $7,585,000 ($4,585,000 Commercial of which $3,000,000 was 30-59 days past maturity and $1,585,000 was greater than 90 days past maturity and $3,000,000 Residential of which all was less than 30 days past maturity). These loans were current in making monthly interest payments and in the process of being extended, paid off or refinanced. In addition, of the delinquent loans above, $7,107,000 of Residential loans were past maturity.

| December 31, 2016 | Loans 30-59 Days Past Due | Loans 60-89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due Loans | Current Loans | Total Loans |
|---|---|---|---|---|---|---|
| Commercial | $ — | $ — | $ — | $ — | $ 102,442,111 | $102,442,111 |
| Residential | 1,983,247 | — | 4,883,866 | 6,867,113 | 12,134,564 | 19,001,677 |
| Land | 1,080,000 | — | — | 1,080,000 | 7,158,523 | 8,238,523 |
| | $3,063,247 | $ — | $4,883,863 | $7,947,113 | $ 121,735,198 | $ 129,682,311 |

The above table as of December 31, 2016 includes past maturity loans of approximately $8,686,000 in the Current Loan category ($3,675,000 Commercial of which $2,500,000 is less than 30 days and $1,175,000 is 30-59 days past maturity and $5,011,000 Residential all of which is greater than 90 days past maturity). These loans were current in making monthly interest payments and in the process of being extended, paid off or refinanced.

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Notes to Consolidated Financial Statements

The following tables show information related to impaired loans as of and for the years ended December 31, 2017, 2016 and 2015:

| | As of December 31, 2017 | | | Year Ended December 31, 2017 | |
|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded: | | | | | |
| Commercial | $1,222,499 | $1,212,851 | $— | $101,875 | $19,189 |
| Residential | 6,610,216 | 6,505,469 | — | 753,711 | 50,369 |
| Land | — | — | — | — | — |
| | $7,832,715 | $7,718,320 | $— | $855,586 | $69,559 |
| With an allowance recorded: | | | | | |
| Commercial | $— | $— | $— | $— | $— |
| Residential | 1,302,707 | 815,890 | 186,708 | 3,188,101 | — |
| Land | — | — | — | — | — |
| | $1,302,707 | 815,890 | $186,708 | $3,188,101 | $— |
| Total: | | | | | |
| Commercial | $1,222,499 | $1,212,851 | $— | $101,875 | $19,189 |
| Residential | 7,912,923 | 7,321,359 | 186,708 | 3,941,813 | 50,369 |
| Land | — | — | — | — | — |
| | $9,135,422 | $8,534,210 | $186,708 | $4,043,688 | $69,559 |

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| | As of December 31, 2016 | | | Year Ended December 31, 2016 | |
|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded: | | | | | |
| Commercial | $— | $— | $ — | $1,684,877 | $38,187 |
| Residential | 228,349 | 228,349 | — | 236,042 | 20,598 |
| Land | — | — | — | — | — |
| | $228,349 | $ 228,349 | $ | $1,920,919 | $58,785 |
| With an allowance recorded: | | | | | |
| Commercial | $— | $ — | $ — | $865,285 | $— |
| Residential | 5,145,712 | 4,655,517 | 732,712 | 6,209,540 | — |
| Land | — | — | — | — | — |
| | $5,145,712 | 4,655,517 | $ 732,712 | $7,074,825 | $— |
| Total: | | | | | |
| Commercial | $— | $ — | $— | $2,550,162 | $38,187 |
| Residential | 5,374,061 | 4,883,866 | 732,712 | 6,445,582 | 20,598 |
| Land | — | — | — | — | — |
| | $5,374,061 | $ 4,883,866 | $ 732,712 | $8,995,744 | $58,785 |

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OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

| | Year Ended December 31, 2015 | |
|---|---|---|
| | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded: | | |
| Commercial | $2,300,846 | $639,935 |
| Residential | 8,217,114 | 192,491 |
| Land | 310,011 | 216,904 |
| | $10,827,971 | $1,049,330 |
| With an allowance recorded: | | |
| Commercial | $ 1,119,594 | $ 49,442 |
| Residential | — | — |
| Land | — | — |
| | $1,119,594 | $49,442 |
| Total: | | |
| Commercial | $3,420,440 | $ 689,377 |
| Residential | 8,217,114 | 192,491 |
| Land | 310,011 | 216,904 |
| | $11,947,565 | $1,098,772 |

The recorded investment balances presented in the above tables include amounts advanced in addition to principal on impaired loans (such as property taxes, insurance and legal charges) that are reimbursable by borrowers and are included in interest and other receivables in the accompanying consolidated balance sheets. Interest income recognized on a cash basis for impaired loans approximates the interest income recognized as reflected in the tables above. The average recorded investment and interest income recognized on impaired loans for which no related allowance was recorded presented in the above tables are disclosed as such, even if these impaired loans may have had an allowance recorded at some point during the year. In addition, the calculations of average recorded investment and interest income recognized in the above tables include loans that had been outstanding for some period of time during the year, but for which there was no recorded investment at the end of the year.

Troubled Debt Restructurings

The Company had recorded specific loan loss allowances of approximately $187,000 and $733,000 on loans totaling $2,739,000 and $5,374,000 (recorded investments before allowance) to borrowers whose loan terms had been modified in troubled debt restructurings as of December 31, 2017 and 2016, respectively. The Company has not committed to lend additional amounts to any of these borrowers, other than discussed below.

During the year ended December 31, 2017, the terms of one impaired loan with a principal balance of $1,145,000 were modified as a troubled debt restructuring. The maturity date was extended by one year and the Company agreed to advance another $165,000 (of which $68,000 was advanced at the time of modification) to the borrower to cover past due and future interest payments. All other terms of the loan remained the same. The loan and related collateral were analyzed and it was determined that no specific loan loss allowance was required as of December 31, 2017.

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Notes to Consolidated Financial Statements

There were no loans modified as troubled debt restructurings during the years ended December 31, 2016 and 2015.

The following table shows information related to the loan modification made by the Company during the year ended December 31, 2017 that constituted a troubled debt restructuring:

| | Modifications During the Year Ended December 31, 2017 | | |
|---|---|---|---|
| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| Troubled Debt Restructurings That Occurred During the Year | | | |
| Commercial | 1 | $1,173,625 | $1,212,851 |

There were no loans modified as troubled debt restructurings during the previous twelve months that defaulted during the years ended December 31, 2017, 2016 and 2015. Generally, the Company considers a loan as having defaulted if its payments are delinquent 90 days or more.

## NOTE 4 – INVESTMENT IN LIMITED LIABILITY COMPANY

During 2008, the Company entered into an Operating Agreement of 1850 De La Cruz LLC, a California limited liability company ("1850"), with Nanook Ventures LLC ("Nanook"), an unrelated party. The purpose of the joint venture is to acquire, own and operate certain industrial land and buildings located in Santa Clara, California that were owned by the Company. At the time of closing in July 2008, the two properties were separately contributed to two new limited liability companies, Nanook Ventures One LLC and Nanook Ventures Two LLC, which are wholly owned by 1850. The Company and Nanook are the Members of 1850 and NV Manager, LLC is the Manager.

During the years ended December 31, 2017, 2016 and 2015, the Company received capital distributions from 1850 in the total amount of $185,000, $180,000 and $177,000, respectively. The net income to the Company from its investment in 1850 De La Cruz was approximately $185,000, $179,000 and $175,000 for the years ended December 31, 2017, 2016 and 2015, respectively.

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

NOTE 5 - REAL ESTATE HELD FOR SALE

Real estate properties held for sale as of December 31, 2017 and 2016 consisted of properties acquired through foreclosure classified by property type as follows:

| | December, 2017 | December 31, 2016 |
|---|---|---|
| Residential | $24,627,710 | $— |
| Land (including land under development) | 14,389,620 | 73,140,659 |
| Retail | 7,632,893 | — |
| Golf course | 1,999,449 | 1,970,437 |
| Marina | 2,207,675 | — |
| Assisted care | 5,253,125 | — |
| Office | — | 732,539 |
| | $56,110,472 | $75,843,635 |

Note: The ZRV mixed-use residential/retail project was completed during 2017. Thus, the related book value included in Land as of December 31, 2016 was transferred to the Residential and Retail categories as of December 31, 2017 in the table above.

Transfers

During the year ended December 31, 2017, the Company transferred seven properties with carrying amounts totaling approximately $13,423,000 (four land, two marina and one assisted care) from "Held for Investment" to "Held for Sale" as the properties were listed for sale and sales were expected within a one year period. In addition, during the year ended December 31, 2017, the Company transferred one land property of approximately $1,915,000 from "Held for Sale" to "Held for Investment" as it was not expected to be sold within one year. Impairment losses totaling $1,423,000 were recorded on four properties during 2017 (two marina, one land and one assisted care) as a result of the transfers or subsequent to the transfers.

During the year ended December 31, 2016, the Company transferred four properties with carrying amounts totaling approximately $10,052,000 (one land, one office unit, one golf course and one condominium) from "Held for Investment" to "Held for Sale" as the properties were listed for sale and sales were expected within a one year period.

During the year ended December 31, 2015, the Company transferred one property (golf course) with a carrying amount of approximately $1,954,000 from "Held for sale" to "Held for investment" because the property was no longer listed for sale and a sale was not likely within the next year. In addition, during the year ended December 31, 2015, the Company transferred seven properties (two industrial, two residential, one land, one storage and one marina) with carrying amounts totaling approximately $64,628,000 from "Held for investment" to "Held for sale" as the properties were listed for sale and sales were expected within the next year.

No losses were recorded as a result of transfers between "Held for sale" and "Held for investment" categories for the years ended December 31, 2017, 2016 and 2015, however, an impairment loss of $146,000 was recorded on the land property mentioned above prior to its transfer from "Held for sale" to "Held for investment".

Impairment Losses

During the year ended December 31, 2017, the Company recorded impairment losses totaling $1,423,000 on the marina located in Bethel Island, California ($495,000), the marina located in Isleton, California ($315,000), the undeveloped land located in San Jose, California ($146,000) and the assisted care property located in Bensalem, Pennsylvania ($467,000) due to new appraisals obtained, reductions in the fair market value estimated by management and/or related to agreements signed by the Company to sell the properties at prices that were lower than the book values of the properties. See "Sales" below.



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OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

During the year ended December 31, 2016, the Company recorded impairment losses totaling $3,228,000 on the unimproved residential and commercial land located in Gypsum, Colorado ($2,110,000), the medical office condominium property located in Gilbert, Arizona ($1,094,000) and the office condominium complex located in Oakdale, California ($24,000) due to reductions in the fair market value estimated by management and/or related to agreements signed by the Company to sell the properties at prices that were lower than the book values of the properties. See "Sales" below.

During the year ended December 31, 2015, the Company recorded impairment losses totaling approximately $1,589,000 on the unimproved residential and commercial land located in Gypsum, Colorado due to a new appraisal obtained as of December 31, 2015 and a decrease in the listing price of the property.

Sales

During the year ended December 31, 2017, the Company sold eight real estate properties (four land, one partial residential, two partial office and one marina) for aggregate net sales proceeds of approximately $55,879,000 and carryback notes totaling $450,000, resulting in net gain on sales of real estate totaling approximately $14,729,000. All but one of the gains from 2017 sales were accounted for using the full accrual method. One sale resulted in the recording of deferred gain of approximately $93,000.

During the year ended December 31, 2016, the Company sold seven real estate properties (two office, one industrial, two residential and two land) for aggregate net sales proceeds of approximately $89,402,000 and a carryback note in the amount of $1,595,000, resulting in net gain on sales of real estate totaling approximately $24,498,000 ($20,782,000 to the Company after $3,716,000 gain attributable to non-controlling interest). All of the gains from 2016 sales were accounted for using the full accrual method.

During the year ended December 31, 2015, the Company sold eight real estate properties (three retail, one residential, one storage, one industrial, one land and one marina) for aggregate net sales proceeds of approximately $48,602,000 and a carryback note in the amount of $4,650,000, resulting in gain on sales of real estate totaling approximately $21,666,000 ($19,187,000 to the Company after $2,479,000 gain attributable to non-controlling interest). All of the gains from 2015 sales were accounted for using the full accrual method. In addition, the Company recognized gain of approximately $153,000 during the year ended December 31, 2015 that had previously been deferred related to the sale of a real estate property in 2012. The gain on the sale of that property was being accounted for under the installment method.

Foreclosures

There were no foreclosures during the years ended December 31, 2017 and 2015.

During the year ended December 31, 2016, the Company foreclosed on one loan secured by an office property located in Oakdale, California with a principal balance of approximately $1,079,000 and obtained the property via the trustee's sale. In addition, accrued interest and advances made on the loan (for items such as legal fees and delinquent property taxes) in the total amount of approximately $70,000 were capitalized to the basis of the property. It was determined that the fair value of the property was lower than the Company's investment in the loan and a specific loan allowance was previously established of approximately $495,000. This amount was then recorded as a charge-off against the allowance for loan losses at the time of foreclosure, after a reduction of the previously established allowance in the

amount of approximately $47,000 as a result of an updated appraisal obtained (net charge-off of $448,000). The property, along with a unit in the building purchased by the Company in 2015, was contributed into a new taxable REIT subsidiary, East G, LLC, in June 2016. The property was sold during 2017.

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OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

NOTE 6 - REAL ESTATE HELD FOR INVESTMENT

Real estate held for investment as of December 31, 2017 and 2016 consisted of properties acquired through foreclosure classified by property type as follows:

| | December 31, 2017 | December 31, 2016 |
|---|---|---|
| Retail | $16,623,238 | $16,829,995 |
| Land | 2,018,068 | 4,234,806 |
| Residential | 2,356,995 | 2,405,439 |
| Assisted care | — | 5,820,709 |
| Office | 3,357,352 | 3,962,869 |
| Marina | — | 4,025,945 |
| | $24,355,653 | $37,279,763 |

The balances of land and the major classes of depreciable property for real estate held for investment as of December 31, 2017 and 2016 are as follows:

| | December 31, 2017 | December 31, 2016 |
|---|---|---|
| Land and land improvements | $5,112,063 | $11,520,339 |
| Buildings and improvements | 22,560,343 | 28,910,851 |
| | 27,672,406 | 40,431,190 |
| Less: Accumulated depreciation and amortization | (3,316,753 ) | (3,151,427 ) |
| | $24,355,653 | $37,279,763 |

It is the Company's intent to sell its real estate properties held for investment, but expected sales are not probable to occur within the next year.

Depreciation expense was approximately $1,080,000, $1,186,000 and $1,971,000 for the years ended December 31, 2017, 2016 and 2015, respectively.

Foreclosures

There was no real estate held for investment acquired through foreclosure during the years ended December 31, 2017, 2016 and 2015.

NOTE 7 – LINE OF CREDIT PAYABLE

The Company borrows funds under the California Bank & Trust ("CB&T") Line of Credit and, until its termination in 2016, a line of credit that was in place with Opus Bank ("Opus"). As of December 31, 2017 and 2016, the outstanding balances and total commitments under the CB&T Line of Credit consisted of the following:

| | December 31, 2017 | | December 31, 2016 | |
|---|---|---|---|---|
| | Outstanding Balance | Total Commitment | Outstanding Balance | Total Commitment |
| CB&T Line of Credit | $1,555,000 | $27,259,000 | $4,976,000 | $22,625,000 |

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Notes to Consolidated Financial Statements

CB&T Line of Credit

In February 2014, the Company entered into a Credit Agreement and Advance Formula Agreement and related agreements with CB&T as the lender (the "CB&T Credit Facility").The agreements were amended and restated in April 2015, March 2016 and June 2017 to add First Bank and Umpqua Bank as additional lenders and to increase the maximum borrowings available (total commitment) under the facility to the lesser of a $75,000,000 maximum or the amount determined pursuant to a borrowing base calculation described in the Advance Formula Agreement (the "Total Current Commitment"). Borrowings under the CB&T Credit Facility now mature on June 1, 2018, and advances can be made up to that date, pursuant to the parties' agreement to extend the maturity date entered effective February 28, 2018 (see Note 16). The Company is required to keep $3,500,000 in a non-interest bearing account with CB&T that is reported as restricted cash in the accompanying consolidated balance sheets.

Such borrowings bear interest payable monthly at the prime rate of interest established by CB&T from time-to-time plus one quarter percent (.25%) per annum (4.75% at December 31, 2017). Upon a default such interest rate increases by 2.00%. The original CB&T Credit Facility required the payment of an origination fee of $100,000 and other issuance costs totaling $177,000 that were capitalized to deferred financing costs and were being amortized to interest expense using the straight-line method through the maturity date of the CB&T Credit Facility (fully amortized as of December 31, 2017). The First Amendment required the payment of an origination fee and other costs totaling $255,000 that were capitalized to deferred financing costs and were being amortized to interest expense using the straight-line method through the new maturity date. The Company is also subject to certain ongoing administrative fees and expenses.

Interest expense on the CB&T Credit Facility was approximately $312,000, $881,000 and $431,000 during the years ended December 31, 2017, 2016 and 2015, respectively (including $158,000, $131,000 and $126,000, respectively, in amortization of deferred financing costs).

Borrowings under the CB&T Credit Facility are secured by certain assets of the Company. These collateral assets include the grant to the lenders of first-priority deeds of trust on certain real property assets and trust deeds of the Company to be specified by the parties from time-to-time and all personal property of the Company, which collateral includes the assets described in the Security Agreement and in other customary collateral agreements that will be entered into by the parties from time-to-time.

As of December 31, 2017, the carrying amount and classification of loans securing the CB&T Credit Facility were as follows:

| Loans: | December 31, 2017 |
|---|---|
| Commercial | $40,829,143 |
| Residential | 1,653,107 |
| Total | $42,482,250 |

The CB&T Credit Facility agreements contain financial covenants which are customary for a loan of this type. Management is not aware of any breach of these covenants as of December 31, 2017.

Opus Bank Line of Credit

In April 2014, the Company entered into a Secured Revolving Credit Loan Agreement (the "Opus Credit Agreement") and related agreements with Opus as the lender (the "Opus Credit Facility"). The Company repaid the Opus Credit Facility in full in September 2016 and the facility has terminated.

The Opus Credit Facility required the payment of an origination fee of $100,000 and other issuance costs totaling $231,000 that were capitalized as deferred financing costs and were being amortized to interest expense using the straight-line method through the maturity date. The Company was also subject to certain ongoing administrative fees and expenses. Interest expense on the Opus Credit Facility was approximately $364,000 and $126,000 during the years ended December 31, 2016 and 2015, respectively (including $103,000 and $77,000, respectively, in amortization of deferred financing costs). The amount of unamortized deferred financing costs expensed immediately on termination of the Opus Credit Facility was approximately $45,000 during the year ended December 31, 2016.
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Notes to Consolidated Financial Statements

NOTE 8 - NOTES AND LOANS PAYABLE ON REAL ESTATE

The Company had the following notes and loans payable outstanding as of December 31, 2017 and 2016:

| | December 31, 2017 | Interest Rate | December 31, 2016 | Interest Rate | Payment Terms/Frequency | Maturity Date |
|---|---|---|---|---|---|---|
| Tahoe Stateline Venture, LLC Loan Payable | $13,242,514 | 4.22% | $13,634,889 | 3.47% | Amortizing Monthly | January 2021 |
| Zalanta Construction Loan Payable | 17,176,288 | 6.00% | 20,213,560 | 5.25% | Interest Monthly Principal Quarterly | August 2018 |
| Principal amount | $30,418,802 | | $33,848,449 | | | |
| Less unamortized deferred financing costs | (226,369) | | (462,515) | | | |
| Notes and loans payable, net | $30,192,433 | | $33,385,934 | | | |

The following table shows maturities by year on these notes and loans payable as of December 31, 2017:

| Years ending December 31: | |
|---|---|
| 2018 | $17,546,247 |
| 2019 | 387,135 |
| 2020 | 403,792 |
| 2021 | 12,081,628 |
| 2022 | — |
| Thereafter | — |
| | $30,418,802 |

Tahoe Stateline Venture, LLC Loan Payable
In December 2014, Tahoe Stateline Ventures, LLC ("TSV") entered into a Credit Agreement (the "Credit Agreement") and related documents with RaboBank, N.A. as the lender ("Lender") providing TSV with a loan (the "TSV Loan") of up to $14,500,000. TSV borrowed $10,445,000 at the first closing under the TSV Loan and an additional $3,830,000 was borrowed in September 2015.

The maturity date of the TSV Loan is January 1, 2021 (the "Maturity Date"). All outstanding borrowings under the TSV Loan documents bear interest initially at a rate of 3.47% per annum (the "Long Term Adjustable Rate"), and on January 1, 2018 the Long Term Adjustable Rate was reset to Lender's then current market rate for three year fixed rate loans from comparable commercial real estate secured transactions, as determined by Lender in its sole discretion (4.22%). Upon a default under the TSV Loan documents, the interest rate on the outstanding principal balance increases by an additional five percent (5.00%) per annum, and the rate on any other outstanding obligations thereunder increases to ten percent (10.00%) per annum. Prepayments under the TSV Loan documents are subject to certain prepayment fees; provided that during the 90 day period immediately prior to January 1, 2018, and the 90 day period immediately prior to the Maturity Date, TSV may prepay the entire unpaid balance of the Loan in full, without any Prepayment Fee or penalty.

During the term of the TSV Loan, TSV will make equal combined payments of principal and accrued interest on the first day of each month in an amount calculated to fully amortize the original principal amount over a period of 300 months, subject to certain adjustments and the balance of the TSV Loan is due on the Maturity Date.

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

The Credit Agreement required the payment of a closing fee of $108,750 and certain administrative fees totaling approximately $218,000. The majority of these costs were paid out of proceeds from the loan and capitalized to deferred financing costs and are being amortized to interest expense using the effective interest method through the Maturity Date. During the years ended December 31, 2017, 2016 and 2015, approximately $502,000, $515,000 and $427,000, respectively, of interest expense was incurred (including approximately $36,000, $36,000 and $36,000, respectively, of deferred financing costs amortized to interest expense).

The TSV Loan documents contain financial covenants which are customary for loans of this type. Management is not aware of any breach of these covenants as of December 31, 2017.

Zalanta Construction Loan Payable
In August 2016, Zalanta Resort at the Village, LLC ("ZRV") and Zalanta Resort at the Village - Phase II, LLC ("ZRV II" and, together with ZRV, the "Borrowers") entered into a Construction Loan Agreement (the "Loan Agreement") and related documents with Western Alliance Bank as the lender ("Lender") providing the Borrowers with a loan (the "ZRV Loan") of up to $31,000,000, subject to the terms and conditions of the ZRV Loan documents, for the purpose of financing the construction of a new mixed-use retail and residential condominium building (the "Project") on land (the "Premises") owned by ZRV in South Lake Tahoe.

Borrowings under the ZRV Loan documents are only for payment or reimbursement of approved Project costs and such borrowings are subject to customary conditions for loans of this type. The borrowings under the ZRV Loan may not exceed the lesser of (i) 60% of the value of the Project, determined on an "as is" basis; or (ii) 65% of the Borrowers' total costs of the Project, to be calculated in accordance with the Loan Agreement. All outstanding borrowings under the ZRV Loan will bear interest at the Wall Street Journal Prime Rate plus 1.50% (calculated on a floating daily basis) (the "Note Rate"), but in no event will the Note Rate be lower than the floor rate of five percent (5.0%) per annum. The Note Rate as of December 31, 2017 was 6.00%. Upon a default under the Loan Agreement, the Note Rate increases by an additional five percent (5.0%) per annum.

Interest only payments are payable monthly from an established interest reserve. In addition, commencing on August 18, 2017 and continuing on the last day of each quarter thereafter during the term of the ZRV Loan, Borrowers are required to make a quarterly repayment of $6 million of principal (the "Curtailment Requirement"). Any repayments in excess of $6 million during one quarter can be applied to the Curtailment Requirement in the succeeding quarter(s). The balance of the ZRV Loan is due on August 3, 2018.

Borrowings are secured by: (i) a first mortgage lien on the Premises and certain additional property (the "Additional Premises") held by ZRV II and all improvements, amenities and appurtenances to the Premises and the Additional Premises, (ii) an assignment of all personal property, sales contracts, rents, leases, and ground leases associated with the Premises, and (iii) all design, development, service, management, leasing and construction contracts associated with the Premises. In addition, ZRV established a deposit account with Lender of $3,000,000 to be held as additional collateral for the ZRV Loan that was reported as restricted cash in the accompanying consolidated balance sheets. The deposit was released during 2017 and the $3,000,000 applied as a repayment of the loan payable.

The ZRV Loan documents contain provisions that allow for the sale of individual condominiums in the Project during the term of the ZRV Loan, and the removal of those units from the collateral base, in exchange for payment of proceeds of the sales to Lender. Any such payment of sales proceeds to Lender will be applied to reduce the principal balance of the ZRV Loan and will reduce the quarterly Curtailment Requirement. Principal payments totaling

approximately $13,580,000 were made during the year ended December 31, 2017 from the sale of seven condominium units and from the released deposit account.



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The Loan Agreement required the payment of an origination fee of $310,000 and other issuance costs totaling approximately $400,000. The majority of these costs were paid out of the loan proceeds and capitalized to deferred financing costs and are being amortized to the Project using the straight-line method through the maturity date. During the years ended December 31, 2017 and 2016, approximately $76,000 and $83,000, respectively, of deferred financing costs was amortized to the Project. During the years ended December 31, 2017 and 2016, approximately $472,000 and $272,000, respectively, of interest was incurred which was capitalized to the Project. During the year ended December 31, 2017, approximately $774,000 of interest was expensed (including approximately $124,000 of deferred financing costs amortized to interest expense).

The ZRV Loan documents contain financial covenants which are customary for loans of this type. Management is not aware of any breach of these covenants as of December 31, 2017.

NOTE 9 – STOCKHOLDERS' EQUITY

Dividends

The following table presents the tax treatment for dividends paid by the Company on its Common Stock for the years ended December 31, 2017, 2016 and 2015:

| | | | Dividends Classified as Ordinary Income | | | Capital Gain Distribution | | Dividends Classified as Return of Capital | |
|---|---|---|---|---|---|---|---|---|---|
| Year | Total Dividends Paid(4) | Dividends Paid Per Share | Percent | Dividends Paid Per Share | Qualified Dividend Income(5) | Percent | Dividend Paid Per Share | Percent | Dividends Paid Per Share |
| Common Stock: | | | | | | | | | |
| 2017 (1) | $3,789,108 | $ 0.380 | 87.67 % | $ 0.333 | — | 12.33 % | $ 0.047 | — % | $ 0.000 |
| 2016 (2) | $3,279,193 | $ 0.320 | 15.05 % | $ 0.048 | — | 84.95 % | $ 0.272 | — % | $ 0.000 |
| 2015 (3) | $4,347,331 | $ 0.410 | 100.00 % | $ 0.410 | — | — % | $ — | — % | $ 0.000 |

1) Dividends declared and paid in 2017 per above do not include $640,267 which represented capital gains tax on 2017 undistributed capital gains paid on behalf of shareholders to the U.S. Treasury in January 2018 (and recorded as dividends paid and payable in the consolidated financial statements).

(2) Dividends declared and paid in 2016 per above do not include $582,698 which represented capital gains tax on 2016 undistributed capital gains paid on behalf of shareholders to the U.S. Treasury in January 2017 (and recorded as dividends paid and payable in the consolidated financial statements).

(3) Dividends declared and paid in 2015 per above do not include $1,313,657 which represented capital gains tax on 2015 undistributed capital gains paid on behalf of shareholders to the U.S. Treasury in January 2016 (and recorded as dividends paid and payable in the consolidated financial statements) and exclude the $1,292,160 dividend discussed in (3) below.

(4) Includes $14,438 and $2,914 for 2017 and 2015, respectively, of dividends on shares repurchased under the stock repurchase plans discussed below that were in transit with respect to the deposit/withdrawal at custodian process and therefore not yet held as treasury shares on the record date of the dividends. When such funds were subsequently received by the Company they were posted to retained earnings such that dividends reflected on the consolidated statement of stockholders' equity are net of these amounts.

(5) Qualified dividend income is eligible for reduced dividend rates.

Stock Repurchases and Repurchase Programs

On May 27, 2015, the Board of Directors authorized a Rule 10b5-1 stock repurchase plan (the "2015 Repurchase Plan") which authorized the Company to purchase up to $7.5 million of its Common Stock subject to certain price, volume and timing constraints specified in the brokerage agreement. During the year ended December 31, 2015, the Company repurchased 520,524 shares of its Common Stock under this plan for a total cost of approximately $7,503,000 (including commissions) and an average cost of $14.41 per share and the repurchased shares were returned to the status of authorized but unissued shares of Common Stock. The authorized funding for the 2015 Repurchase Plan was exhausted in 2015.

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Notes to Consolidated Financial Statements

On December 11, 2015, the Board of Directors authorized a new Rule 10b5-1 stock repurchase plan (the "2016 Repurchase Plan") which authorized the Company to purchase up to $7.5 million of its Common Stock, subject to certain price, volume and timing constraints specified in the brokerage agreement. No shares were repurchased under the 2016 Repurchase Plan and it expired on March 31, 2017.

On June 9, 2017, the Board of Directors authorized a Rule 10b5-1 stock repurchase plan (the "2017 Repurchase Plan") which authorized the Company to purchase up to $10 million of its Common Stock. Under the 2017 Repurchase Plan, repurchases were to be funded from available working capital, and the repurchased shares return to the status of authorized but unissued shares of Common Stock. The 2017 Repurchase Plan provided for stock repurchases to commence on July 13, 2017 and was subject to certain price, volume and timing constraints specified in the brokerage agreement. During the year ended December 31, 2017, the Company repurchased 341,086 shares of its Common Stock under the 2017 Repurchase Plan for a total cost of approximately $5,820,000 (including commissions) and an average cost of $17.06 per share and repurchased another 4,000 shares in January 2018 (subsequent to year end) for a total cost of approximately $65,000 (including commissions) and an average cost of $16.18 per share. The 2017 Repurchase Plan was terminated effective December 29, 2017.

On December 29, 2017, the Company entered into a settlement agreement (the "Settlement Agreement") with Freestone Capital Management, LLC and certain of its affiliates (collectively, "Freestone"), pursuant to which the Company purchased the 669,058 shares of Common Stock held by Freestone (the "Freestone Shares") in December 2017 and another 141,879 in January 2018 (for a total of 810,937 shares) in a privately negotiated transaction for $19.25 per share, resulting in an aggregate purchase price of approximately $15.6 million. Approximately $4.1 million of the purchase price paid for the Freestone Shares was made with the remaining balance of the Company's 2017 Repurchase Plan following its termination. Pursuant to the terms of the Settlement Agreement, for a period of five years following the date of the Settlement Agreement, Freestone agreed to customary standstill restrictions relating to share purchases, support of proxy contests and other activist campaigns, calling of special meetings, and related matters. For a period of two years following the date of the Settlement Agreement, the Company and Freestone also agreed to abide by customary covenants not to sue and non-disparagement provisions. In addition, the Company and Freestone each released the other from all claims that the releasing party has, had or may have against the released party that relate to the investment by Freestone in the Company. The Company recorded as treasury stock the purchase of 810,937 Freestone Shares at the December 29, 2017 market price of $16.01 per share (approximately $12,983,000 total) and recorded as settlement expense the premium paid over the market price for those shares of $3.24 per share (approximately $2,627,000 total) in the accompanying consolidated financial statements. The purchase of 141,879 of the Freestone Shares settled in January 2018, and the Company recorded a forward contract liability for those repurchased shares of $2,731,000 as of December 31, 2017.

NOTE 10 – CONTINGENCY RESERVES

In accordance with its charter, the Company is required to maintain cash, cash equivalents and marketable securities as contingency reserves in an aggregate amount of 1.50% of Capital as defined in the charter. Although the Manager believes the contingency reserves are adequate, it could become necessary for the Company to sell or otherwise liquidate certain of its investments or other assets to cover such contingencies on terms which might not be favorable to the Company, which could lead to unanticipated losses upon sale of such assets.

The contingency reserves required per the charter as of December 31, 2017 and 2016 were approximately $3,464,000 and $3,738,000 and are reported as restricted cash and/or cash and cash equivalents in the accompanying consolidated balance sheets.

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Notes to Consolidated Financial Statements

NOTE 11 - INCOME TAXES

The Company operates in such a manner as to qualify as a REIT, under the provisions of the Internal Revenue Code of 1986, as amended (the "Code"); therefore, applicable REIT taxable income is included in the taxable income of its shareholders, to the extent distributed by the Company. To maintain REIT status for federal income tax purposes, the Company is generally required to distribute at least 90% of its REIT taxable income to its shareholders as well as comply, generally, with certain other qualification requirements as defined under the Code. As a REIT, the Company is not subject to federal corporate income tax to the extent that it distributes 100% of its REIT taxable income each year. During 2017, 2016 and 2015, the Company distributed at or in excess of 100% of its REIT taxable income to its stockholders. During 2017, 2016 and 2015, the Company had net capital gains from the sales of real estate properties totaling approximately $2,297,000, $4,451,000 and $3,753,000, respectively. Management decided to retain all or a portion of capital gains in 2017, 2016 and 2015 within the Company and not distribute them as is permitted for REITs. However, the retention of capital gains required the Company to make a payment to the U.S. Treasury Department on behalf of shareholders at the highest corporate tax rate (35%) in the total amount of approximately $640,000, $583,000 and $1,314,000 in January 2018, 2017 and 2016, respectively. This tax payment was accrued as dividends payable in the Company's financial statements as of December 31, 2017, 2016 and 2015. Shareholders' pro-rata portion of the amount paid is to be reflected as tax payments on the individual shareholders' tax returns.

Taxable income from non-REIT activities managed through the Company's taxable REIT subsidiaries ("TRS") (Lone Star Golf, Inc., Zalanta Resort at the Village, LLC and East G, LLC) is subject to federal, state and local income taxes. The Company did not record a provision for current income taxes related to Lone Star for the years ended December 31, 2017, 2016 and 2015 as it was in a net loss position. In addition, deferred taxes related to temporary differences in book and taxable income as well as net operating losses ("NOLs") of Lone Star would likely not be realizable due to Lone Star's loss history (full amount of deferred tax assets offset by a valuation allowance). The NOLs totaled approximately $785,000 for Federal and California as of December 31, 2017 and expire between 2033 and 2037.

During 2016, the Company established a new entity, East G, LLC ("East G") and contributed an office property that was obtained via foreclosure of a loan in 2016 into this new entity along with a unit in the same building that had been purchased in 2015. The Company then converted East G into a TRS. No taxes have been recorded. Deferred taxes related to temporary differences in book and taxable income were not significant and tax loss carryforwards are not significant and the deferred taxes will not be realized. The Company sold the East G property during 2017 and dissolved the LLC.

During 2016, the Company converted ZRV into a TRS and contributed two additional real estate assets into ZRV. These properties included 75 improved, residential lots previously held within Baldwin Ranch Subdivision, LLC and a medical office condominium complex previously held within AMFU, LLC. The conversion of ZRV into a TRS and contribution of the additional real estate assets resulted in the Company recording a deferred tax asset and income tax benefit in the amount of approximately $7,249,000 primarily due to a $15,450,000 aggregate remaining difference between the book and tax basis of the subject real estate assets as of December 31, 2016. During 2017, ZRV recorded income tax expense of $4,041,655 that was primarily the result of an increase in the valuation allowance recorded against deferred tax assets as a result of higher construction costs and lower expected gains from the sales of ZRV assets in the future and due to a decrease in the Federal corporate tax rate from 34% to 21% in 2018 and beyond as a result of the Tax Cuts and Jobs Act signed into law by President Trump on December 22, 2017, which required ZRV to remeasure its net deferred tax asset at the lower rate.

During the year ended December 31, 2015, the Company had a $267,000 taxable gain on sale of a real estate property. The gain was taxable because the subject property was designated as foreclosure property pursuant to the related REIT

taxation rules. As a result, the Company recorded income tax expense of approximately $93,000 for the year ended December 31, 2015.

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Notes to Consolidated Financial Statements

As of December 31, 2017 and 2016, the Company has not recorded a reserve for any uncertain income tax positions. There has been no interest or penalties incurred to date.

As of December 31, 2017, income tax returns for the calendar years ended 2013 through 2017 remain subject to examination by IRS and/or any state or local taxing jurisdiction. Additionally, certain state tax returns from the predecessor entity (OMIF) remain open for the short year ended May 19, 2013.

The components of the income tax expense (benefit) as it relates to the Company's taxable income (loss) from domestic TRSs during the years ended December 31, 2017 and 2016 were as follows:

| | Year Ended December 31, 2017 | | |
|---|---|---|---|
| | Federal | State and Local | Total |
| Change in valuation allowance | $2,602,441 | $418,020 | $3,020,461 |
| Reduction in Federal corporate tax rate | 1,358,272 | — | 1,358,272 |
| Other | (293,814) | (43,264) | (337,078) |
| Income tax expense (benefit) | $3,666,899 | $374,756 | $4,041,655 |

| | Year Ended December 31, 2016 | | |
|---|---|---|---|
| | Federal | State and Local | Total |
| Deferred expense (benefit) | $(6,655,774) | $(1,387,947) | $(8,043,721) |
| Change in valuation allowance | 794,744 | — | 794,744 |
| Income tax expense (benefit) | $(5,861,030) | $(1,387,947) | $(7,248,977) |

A reconciliation of the income tax provision (benefit) based upon the statutory tax rates to the effective rates of our taxable REIT subsidiaries is as follows for the year ended December 31, 2017 and 2016:

| | Year Ended December 31, 2017 | Year Ended December 31, 2016 |
|---|---|---|
| Tax (benefit) expense at Federal statutory rate | $(149,766) | $(423,847) |
| State income tax expense (benefit), net of Federal effect | 250,193 | (916,045) |
| Real estate basis differences at TRS conversion | — | (6,753,272) |
| Other | (19,485) | 49,443 |
| Change in Federal valuation allowance | 2,602,441 | 794,744 |
| Reduction in Federal corporate tax rate | 1,358,272 | — |
| Income tax expense (benefit) | $4,041,655 | $(7,248,977) |

Significant components of the Company's deferred tax assets (liabilities) for its TRS entities are as follows as of December 31, 2017 and 2016:

| Deferred tax assets (liabilities): | December 31, 2017 | December 31, 2016 |
|---|---|---|
| Real estate basis differences | $4,255,681 | 6,154,411 |
| Net operating losses | 1,380,138 | 1,889,310 |
| Total deferred tax assets | 5,635,819 | 8,043,721 |

| | | |
|---|---|---|
| Valuation allowance | (2,428,497) | (794,744) |
| Net deferred tax assets | $3,207,322 | 7,248,977 |

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Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts for income tax purposes, as well as operating loss and tax credit carryforwards. The Company evaluates the realizability of its deferred tax assets and recognizes a valuation allowance if, based on the available evidence, both positive and negative, it is more likely than not that some portion or all of its deferred tax assets will not be realized. When evaluating the realizability of its deferred tax assets, the Company considers, among other matters, estimates of expected future taxable income, nature of current and cumulative losses and tax planning strategies available.

Management has estimated future taxable gains and losses on sale of ZRV real estate assets to determine how much of the deferred tax assets are realizable. This realizability analysis is inherently subjective and actual results could differ from these estimates. Based on an assessment of all factors, it was determined that a valuation allowance of $2,428,000 and $795,000 related to Federal and State NOLs and differences in the book and tax basis of assets in ZRV was required as of December 31, 2017 and 2016, respectively, as management does not expect that ZRV will generate enough taxable income in the future to realize all of the NOL and basis benefits. The Company's Federal and California NOLs within ZRV totaled $6,245,000 and $982,000, respectively, as of December 31, 2017. ZRV has Arizona NOLs of $3,511,000 as of December 31, 2017; however, ZRV did not record a deferred tax asset related to the Arizona NOLs as it does not expect to file another Arizona tax return, and thus, the NOLs will not be used. All of the NOLs expire in 2036 and 2037.

NOTE 12 - TRANSACTIONS WITH AFFILIATES

OFG is entitled to receive from the Company a management fee of up to 2.75% per annum of the average unpaid balance of the Company's loans at the end of the twelve months in the calendar year for services rendered as Manager of the Company (the "Existing Management Fee").

All of the Company's loans are serviced by OFG, in consideration for which OFG receives a monthly fee, which, when added to all other fees paid in connection with the servicing of a particular loan, does not exceed the lesser of the customary, competitive fee in the community where the loan is placed for the provision of such mortgage services on that type of loan or up to 0.25% per annum of the unpaid principal balance of the loans.

OFG, at its sole discretion may, on a monthly basis, adjust the Existing Management Fee and servicing fees as long as they do not exceed the allowable limits calculated on an annual basis. Even though the fees for a month may exceed $^{1}/_{12}$ of the maximum limits, at the end of the calendar year the sum of the fees collected for each of the 12 months must be equal to or less than the stated limits. Management fees amounted to approximately $3,546,000, $3,286,000 and $2,051,000 for the years ended December 31, 2017, 2016 and 2015, respectively, and are included in the accompanying consolidated statements of income. Servicing fees amounted to approximately $362,000, $299,000 and $186,000 for the years ended December 31, 2017, 2016 and 2015, respectively, and are included in the accompanying consolidated statements of income. As of December 31, 2017 and 2016, the Company owed management and servicing fees to OFG in the amount of approximately $245,000 and $324,000, respectively.

During the first six months of the year ended December 31, 2017 and for the years ended December 31, 2016 and 2015, OFG elected to take the maximum compensation that it is able to take pursuant to the Company's charter. However, in August 2017, the Manager agreed to take less than the maximum compensation and instead compute the management fee based on a percentage of stockholders' equity for periods beginning on July 1, 2017 and ending on the final day of the month in which the Company's next stockholders' meeting is held.

Pursuant to the charter, OFG receives all late payment charges from borrowers on loans owned by the Company, with the exception of those loans participated with outside entities. The amounts paid to or collected by OFG for such charges on Company loans totaled approximately $83,000, $83,000 and $30,000 for the years ended December 31, 2017, 2016 and 2015, respectively. In addition, the Company remits other miscellaneous fees to OFG, which are

collected from loan payments, loan payoffs or advances from loan principal (i.e. funding, demand and partial release fees). Such fees remitted to OFG totaled approximately $23,000, $20,000 and $7,000 for the years ended December 31, 2017, 2016 and 2015, respectively.

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OFG originates all loans the Company invests in and receives loan origination fees from borrowers. Such fees earned by OFG amounted to approximately $2,492,000, $2,514,000 and $1,956,000 on loans originated, rewritten or extended of approximately $122,240,000, $101,594,000 and $80,448,000 for the years ended December 31, 2017, 2016 and 2015, respectively. Such fees as a percentage of loans originated, rewritten or extended by the Company were 2.0%, 2.5% and 2.4% for the years ended December 31, 2017, 2016 and 2015, respectively.

OFG is reimbursed by the Company for the actual cost of goods, services and materials used for or by the Company and obtained from unaffiliated entities and the salary and related salary expense of OFG's non-management and non-supervisory personnel performing services for the Company which could be performed by independent parties (subject to certain limitations in the Management Agreement). The amounts reimbursed to OFG by the Company were $381,000, $440,000 and $590,000 during the years ended December 31, 2017, 2016 and 2015, respectively. As of December 31, 2016 and 2015, there was approximately $32,000 and $36,000, respectively, payable to OFG for reimbursable expenses and other fees owed. The Company also reimbursed certain of OFG's officers for allowed expenses in the total amount of $2,000, $0 and $1,000 during the years ended December 31, 2017, 2016 and 2015, respectively.

The Company paid Investor's Yield, Inc. (a wholly owned subsidiary of OFG) approximately $1,000, $9,000 and $10,000 in trustee's fees related to certain foreclosure proceedings and other miscellaneous fees on Company loans during the years ended December 31, 2017, 2016 and 2015, respectively.

During 2015, the Company purchased OFG's full interest in a loan secured by an industrial property located in San Ramon, California with a principal balance of $1,499,000 at face value.

NOTE 13 - RENTAL INCOME

The Company's real estate properties held for sale and investment are leased to tenants under noncancellable leases with remaining terms ranging from one to ten years. Certain of the leases require the tenant to pay all or some operating expenses of the properties. The future minimum rental income from noncancellable operating leases due within the five years subsequent to December 31, 2017, and thereafter is as follows:

| Year ending December 31: | |
|---|---|
| 2018 | $2,130,167 |
| 2019 | 1,606,224 |
| 2020 | 806,807 |
| 2021 | 760,279 |
| 2022 | 544,115 |
| Thereafter (through 2027) | 1,096,713 |
| Total | $6,944,305 |

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

NOTE 14 - FAIR VALUE

The Company measures its financial and nonfinancial assets and liabilities pursuant to ASC 820 – Fair Value Measurements and Disclosures. ASC 820 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements.

Fair value is defined in ASC 820 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in active markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities

Level 3 Unobservable inputs that are supported by little or no market activity, such as the Company's own data or assumptions

Level 3 inputs include unobservable inputs that are used when there is little, if any, market activity for the asset or liability measured at fair value. In certain cases, the inputs used to measure fair value fall into different levels of the fair value hierarchy. In such cases, the level in which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input requires judgment and considers factors specific to the asset or liability being measured.

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

The following is a description of the Company's valuation methodologies used to measure and disclose the fair values of its financial and nonfinancial assets and liabilities on a recurring and nonrecurring basis.

Impaired Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement or when monthly payments are delinquent greater than ninety days. Once a loan is identified as impaired, management measures impairment in accordance with ASC 310-10-35. Impairment is estimated by either the present value of expected cash flows discounted at the note rate or, as a practical expedient, the loan's observable market price (if available) or the fair value of the underlying collateral, if collateral dependent. The fair value of the loan's collateral is determined by third party appraisals, broker price opinions, comparable property sales or other indications of value. Those impaired loans not requiring an allowance represent loans for which the fair

value of the collateral exceed the recorded investments in such loans. At December 31, 2017 and 2016, the majority of the total impaired loans were evaluated based on the fair value of the collateral by obtaining third party appraisals that valued the collateral primarily by utilizing an income or market approach or some combination of the two. In accordance with ASC 820, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser using observable market data, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available, when an appraisal includes significant unobservable inputs and assumptions or when management determines an adjustment to the appraised value is necessary in order to reflect management's estimate of the fair value of the collateral, the Company records the impaired loan as nonrecurring Level 3. Unobservable market data included in appraisals often includes adjustments to comparable property sales for such items as location, size and quality to estimate fair values using a sales comparison approach. Unobservable market data also includes cash flow assumptions and capitalization rates used to estimate fair values under an income approach.

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Notes to Consolidated Financial Statements

Real Estate Held for Sale and Investment

Real estate held for sale and investment includes properties acquired through foreclosure of the related loans. When property is acquired, any excess of the Company's recorded investment in the loan and accrued interest income over the estimated fair market value of the property, net of estimated selling costs, is charged against the allowance for loan losses. Subsequently, real estate properties held for sale are carried at the lower of carrying value or fair value less costs to sell. The Company periodically compares the carrying value of real estate held for investment to expected future cash flows as determined by internally or third party generated valuations (including third party appraisals that primarily utilize an income or market approach or some combination of the two) for the purpose of assessing the recoverability of the recorded amounts. If the carrying value exceeds future undiscounted cash flows, the assets are reduced to fair value. As fair value is generally based upon an appraisal that may include observable data, unobservable data, or a combination thereof, the Company records these assets as nonrecurring Level 2 or Level 3 based on the same factors discussed in the impaired loans section above.

There were no assets or liabilities measured at fair value on a recurring basis, nor were there any liabilities measured at fair value on a nonrecurring bases at December 31, 2017 and 2016.

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The following table presents information about the Company's assets measured at fair value on a nonrecurring basis as of December 31, 2017 and 2016:

| | | Fair Value Measurements Using | | |
|---|---|---|---|---|
| | Carrying Value | Quoted Prices In Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| 2017 Nonrecurring: | | | | |
| Impaired loans: | | | | |
| Residential | $1,115,999 | $— | $— | $ 1,115,999 |
| Total | $1,115,999 | $— | $— | $ 1,115,999 |
| Real estate properties: | | | | |
| Commercial | $7,460,800 | $— | $— | $ 7,460,800 |
| Land | 1,914,870 | | | 1,914,870 |
| Total | $9,375,670 | $— | $— | $ 9,375,670 |
| 2016 Nonrecurring: | | | | |
| Impaired loans: | | | | |
| Residential | $4,413,000 | $— | $— | $ 4,413,000 |
| Total | $4,413,000 | $— | $— | $ 4,413,000 |
| Real estate properties: | | | | |
| Land | $139,498 | $— | $— | $ 139,498 |
| Commercial | 732,539 | | | 732,539 |
| Total | $872,037 | $— | $— | $ 872,037 |

The provision for loan losses (net) based on the fair value of loan collateral less estimated selling costs for the impaired loans above totaled approximately $0 and $733,000 during the years ended December 31, 2017 and 2016, respectively. There were charge-offs against the loan loss allowance totaling $546,000 during 2017 for the impaired loan above. Impairment losses of approximately $1,423,000 and $3,228,000 were recorded on real estate properties during the years ended December 31, 2017 and 2016, respectively. The impairment losses recorded for the years ended December 31, 2017 and 2016 included $145,000 and $2,110,000, respectively, in the Land class and $1,278,000 and $1,118,000, respectively, in the Commercial class.
During the years ended December 31, 2017 and 2016, there were no transfers into or out of Levels 1 and 2.
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Notes to Consolidated Financial Statements

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at December 31, 2017 and 2016:

December 31, 2017:

| Description | Fair Value | Valuation Technique | Significant Unobservable Inputs | Input/Range | Weighted Average |
|---|---|---|---|---|---|
| Impaired Loans: | | | | | |
| Residential | $ 1,115,999 | Comparable Sales | Comparable Sales Adjustment | (4.6)% to 4.2% | N/A |
| Real Estate Properties: | | | | | |
| Commercial | $ 7,460,800 | Appraisal | Comparable Sales Adjustment | (23.7)% to (11.6)% | (13.5)% |
| Land | 1,914,870 | Appraisal | Comparable Sales Adjustment | (50.8)% to 21.9% | N/A |
| | | | Estimate of Future Improvements | 32.5% | N/A |

December 31, 2016:

| Description | Fair Value | Valuation Technique | Significant Unobservable Inputs | Input/Range | Weighted Average |
|---|---|---|---|---|---|
| Impaired Loans: | | | | | |
| Residential | $ 4,413,000 | Comparable Sales | Comparable Sales Adjustment | (4.6)% to 4.2% | N/A |
| Real Estate Properties: | | | | | |
| Land | $139,498 | Appraisal | Comparable Sales Adjustment | (33.7)% | N/A |
| Commercial | 732,539 | Appraisal | Comparable Sales Adjustment | (5.0)% to 5.0% | N/A |
| | | | Capitalization Rate | 7.3% | N/A |

Where only one percentage is presented in the above table there was only one unobservable input of that type for one loan or property. Adjustments to comparable sales included items such as market conditions, location, size, condition, access/frontage and intended use. A weighted average of an unobservable input is presented in the table above only to the extent there were multiple impaired loans or real estate properties within that class measured at fair value on a nonrecurring basis.

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Notes to Consolidated Financial Statements

The approximate carrying amounts and estimated fair values of financial instruments at December 31, 2017 and 2016 are as follows:

| | | Fair Value Measurements at December 31, 2017 | | | |
|---|---|---|---|---|---|
| | Carrying Value | Level 1 | Level 2 | Level 3 | Total |
| Financial assets | | | | | |
| Cash and cash equivalents | $2,171,000 | $2,171,000 | $— | $— | $2,171,000 |
| Restricted cash | 3,500,000 | 3,500,000 | — | — | 3,500,000 |
| Loans, net | 144,344,000 | — | — | 144,255,000 | 144,255,000 |
| Investment in limited liability company | 2,141,000 | — | — | 4,819,000 | 4,819,000 |
| Accrued interest and advances receivable | 1,459,000 | — | — | 1,459,000 | 1,459,000 |
| Financial liabilities | | | | | |
| Accrued interest payable | $115,000 | — | 77,000 | 38,000 | $115,000 |
| Lines of credit payable | 1,555,000 | — | 1,555,000 | — | 1,555,000 |
| Notes payable | 30,419,000 | — | 17,176,000 | 13,233,000 | 30,409,000 |

| | | Fair Value Measurements at December 31, 2016 | | | |
|---|---|---|---|---|---|
| | Carrying Value | Level 1 | Level 2 | Level 3 | Total |
| Financial assets | | | | | |
| Cash and cash equivalents | $434,000 | $434,000 | $— | $— | $434,000 |
| Restricted cash | 6,500,000 | 6,500,000 | — | — | 6,500,000 |
| Loans, net | 126,975,000 | — | — | 126,652,000 | 126,652,000 |
| Investment in limited liability company | 2,140,000 | — | — | 2,650,000 | 2,650,000 |
| Accrued interest and advances receivable | 1,328,000 | — | — | 1,328,000 | 1,328,000 |
| Financial liabilities | | | | | |
| Accrued interest payable | $137,000 | — | 97,000 | 40,000 | $137,000 |
| Lines of credit payable | 4,976,000 | — | 4,976,000 | — | 4,976,000 |
| Notes payable | 33,386,000 | — | 20,213,000 | 13,499,000 | 33,712,000 |

The following methods and assumptions were used by the Company in estimating the fair value of each class of financial instruments:

Cash, cash equivalents and restricted cash: The carrying values of cash and cash equivalents and restricted cash approximate the fair values because of the relatively short maturity and/or liquid nature of these instruments and are classified as Level 1.

Loans, net: Except as it relates to impaired loans measured at fair value on a nonrecurring basis discussed previously, the fair value of loans is estimated using discounted cash flow methodology, using discount rates, which, in the opinion of management, best reflect current market interest rates that would be offered for loans with similar characteristics and credit quality but are often unobservable resulting in a Level 3 classification. Accrued interest and advances receivable relate to loans and are thus classified as Level 3.

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Investment in limited liability company: The fair value of the Company's investment in limited liability company is estimated based on an appraisal obtained and is classified as Level 3 because the appraisal itself and/or adjustments thereto include unobservable data similar to the unobservable data discussed in the disclosures related to assets measured at fair value on a nonrecurring basis.

Lines of credit payable: The fair value of the Company's lines of credit payable is estimated based upon a discounted cash flow model using comparable market indicators of current pricing for the same or similar issue or on the current rate offered to the Company for debt of the same remaining maturity and is generally observable resulting in a Level 2 classification. Accrued interest payable associated with the lines of credit is also classified as Level 2.

Notes and loans payable: The fair values of the Company's notes and loans payable and related accrued interest payable are estimated based upon a discounted cash flow model using comparable market indicators of current pricing for the same or similar issues or on the current rates offered to the Company for debt of the same remaining maturities resulting in either a Level 2 or Level 3 classification. Generally, Level 2 inputs are used for notes and loans payable with maturities of one year or less or that have been entered into in relatively close proximity to the balance sheet date and Level 3 inputs are used for other notes and loans payable. Accrued interest payable associated with the notes and loans payable is also classified as either Level 2 or Level 3.

## NOTE 15 - COMMITMENTS AND CONTINGENCIES

### Contractual Obligations

As of December 31, 2017, the Company has commitments to advance additional funds to borrowers of construction, rehabilitation and other loans in the total amount of approximately $30,495,000 (including approximately $3,883,000 in interest reserves).

### Legal Proceedings

The Company is involved in various legal actions arising in the normal course of business. In the opinion of management, such matters will not have a material effect upon the financial position of the Company.

## NOTE 16 – SUBSEQUENT EVENTS

As described above in Note 9, the Company purchased, pursuant to the Settlement Agreement between the Company and Freestone, 141,879 of the Freestone Shares in January 2018 at a total cost of approximately $2,731,000 ($2,271,000 treasury stock and $460,000 settlement expense). This amount was recorded as forward contract liability for shares repurchased in the accompanying consolidated balance sheets as of December 31, 2017.

The Company sold three condominium units at ZRV in January and February 2018 for net sales proceeds totaling approximately $3,725,000 (all proceeds used to repay the construction loan) and gains totaling approximately $539,000.

Effective February 28, 2018, the Company entered into First Note Revision Agreements with CB&T, First Bank and Umpqua Bank to extend the maturity date of the CB&T Credit Facility from March 1, 2018 to June 1, 2018, and to permit advances under the facility until that date. All other terms and conditions in the Credit Agreement and related agreements remained the same.

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

On March 12, 2018, the Board approved a quarterly dividend of $0.16 per share of Common Stock for the quarter ending March 31, 2018. The dividend will be paid on April 13, 2018 to stockholders of record at the close of business on March 31, 2018.

NOTE 17 – SUMMARY QUARTERLY CONSOLIDATED FINANCIAL INFORMATION (UNAUDITED)

The following tables represent unaudited summarized quarterly financial data of the Company for the years ended December 31, 2017, 2016 and 2015 which, in the opinion of management, reflects all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the Company's results of operations.

| | Three Months Ended | | | |
|---|---|---|---|---|
| | December 31, 2017 | September 30, 2017 | June 30, 2017 | March 31, 2017 |
| Total revenues | $3,850,940 | $4,277,493 | $3,867,290 | 3,537,405 |
| Total expenses | 3,964,664 | 3,427,969 | 4,164,895 | 3,355,582 |
| Operating (loss) income | (113,724) | 849,524 | (297,605) | 181,823 |
| Gain (loss) on sale of real estate, net | 268,891 | 582,496 | 13,877,715 | (181) |
| Settlement expense | (2,627,436) | — | — | — |
| Net (loss) income before income taxes | (2,472,269) | 1,432,020 | 13,580,110 | 181,642 |
| Income tax (expense) benefit | (1,951,828) | (1,275,700) | (824,163) | 10,036 |
| Net (loss) income attributable to common stockholders | $(4,424,097) | $156,320 | $12,755,947 | $191,678 |
| (Loss) earnings per common share (basic and diluted) | $(0.44) | $0.02 | $1.24 | $0.02 |
| Weighted average number of common shares outstanding (basic and diluted) | 9,984,352 | 10,173,448 | 10,247,477 | 10,247,477 |
| Dividends declared per share of Common Stock | $0.10 | $0.10 | $0.10 | $0.08 |

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

| | Three Months Ended | | | |
|---|---|---|---|---|
| | December 31, 2016 | September 30, 2016 | June 30, 2016 | March 31, 2016 |
| Total revenues | $3,667,283 | $4,493,977 | $4,692,114 | 4,225,617 |
| Total expenses | 3,942,004 | 5,587,213 | 6,999,063 | 4,316,678 |
| Operating loss | (274,721) | (1,093,236) | (2,306,949) | (91,061) |
| (Loss) gain on sale of real estate, net | (536,419) | 20,195,367 | — | 4,838,815 |
| Net (loss) income before income taxes | (811,140) | 19,102,131 | (2,306,949) | 4,747,754 |
| Income tax (expense) benefit | (380,706) | 260,848 | 7,368,835 | — |
| Net (loss) income | (1,191,846) | 19,362,979 | 5,061,886 | 4,747,754 |
| Less: Net loss (income) attributable to non-controlling interests | 15,960 | (3,630,318) | 56,847 | (13,492) |
| Net (loss) income attributable to common stockholders | $(1,175,886) | $15,732,661 | $5,118,733 | $4,734,262 |
| (Loss) earnings per common share (basic and diluted) | $(0.11) | $1.54 | $0.50 | $0.46 |
| Weighted average number of common shares outstanding (basic and diluted) | 10,247,477 | 10,247,477 | 10,247,477 | 10,247,477 |
| Dividends declared per share of Common Stock | $0.08 | $0.08 | $0.08 | $0.08 |

| | Three Months Ended | | | |
|---|---|---|---|---|
| | December 31, 2015 | September 30, 2015 | June 30, 2015 | March 31, 2015 |
| Total revenues | $4,432,455 | $4,414,217 | $5,987,048 | 6,409,831 |
| Total expenses | 2,817,184 | 3,998,225 | 4,463,246 | 5,453,674 |
| Operating income | 1,615,271 | 415,992 | 1,523,802 | 956,157 |
| Gain on sale of real estate, net | 6,787,254 | — | 14,825,858 | 205,441 |
| Gain on foreclosure of loans | — | — | — | — |
| Net income before income tax expense | 8,402,525 | 415,992 | 16,349,660 | 1,161,598 |
| Income tax expense | 93,335 | — | — | — |
| Net income | 8,309,190 | 415,992 | 16,349,660 | 1,161,598 |
| Less: Net income attributable to non-controlling interests | (36,891) | (31,671) | (2,588,884) | (9,878) |
| Net income attributable to common stockholders | $8,272,299 | $384,321 | $13,760,776 | $1,151,720 |
| Earnings per common share (basic and diluted) | $0.80 | $0.04 | $1.28 | $0.11 |
| Weighted average number of common shares outstanding (basic and diluted) | 10,310,149 | 10,538,735 | 10,768,001 | 10,768,001 |
| Dividends declared per share of Common Stock | $0.08 | $0.08 | $0.18 | $0.07 |

OWENS REALTY MORTGAGE, INC.
FINANCIAL STATEMENT SECHEDULE III - REAL ESTATE AND ACCUMULATED DEPRECIATION
DECEMBER 31, 2017

| Description | Encumbrances | Initial Cost | Capitalized Costs | Sales | Impairment Write-downs | Accumulated Depreciation | | Carrying Value | Date Acquired | De Li |
|---|---|---|---|---|---|---|---|---|---|---|
| Retail Complex (TSV), South Lake Tahoe, California | $13,242,514 Note Payable | 6,409,617 | 12,292,082 | $ (41,667) | — | $(2,036,794) | | $16,623,238 | Various | 5- |
| Retail Complex and 23 Residential Condominium Units (ZRV),South Lake Tahoe, California | $17,176,288 Construction Loan Payable | 5,016,443 | 36,825,438 | (9,581,278) | — | — | Note 4 | 32,260,603 | Various | N/ |
| Residential Land (ZRV II), South Lake Tahoe, California | None | 2,032,963 | 4,528,060 | — | — | — | Note 4 | 6,561,023 | Various | N/ |
| Assisted Living Facility, Bensalem, Pennsylvania | None | 4,454,867 | 1,265,436 | — | (467,178) | — | Note 5 | 5,253,125 | 12/12/2014 | N/ |
| Office Condominium Complex (13 units), Roseville, California | None | 8,569,286 | 321,923 | (1,632,971) | (3,712,707) | (680,529) | Note 6 | 2,865,002 | 9/26/2008 | 2- |
| 73 Residential Lots, Auburn, California | None | 13,746,625 | 376,746 | (96,678) | (9,904,826) | — | Note 7 | 4,121,867 | 9/27/2007 | N/ |
| 12 Condominium & 3 Commercial | None | 2,486,400 | 84,909 | — | — | (307,961) | | 2,263,348 | 7/8/2011 | 27 Ye |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Units,<br>Tacoma,<br>Washington | | | | | | | | | | |
| Marina & Boat Club with 179 Boat Slips, Isleton, California | None | 1,809,663 | 713,318 | — | (315,306) | — | Note 8 | 2,207,675 | 1/29/2013 | N/ |
| Undeveloped, Industrial Land, San Jose, California | None | 3,025,992 | 102,046 | — | (1,213,168) | — | Note 9 | 1,914,870 | 12/27/2002 | N/ |
| Golf Course, Auburn, California | None | 1,796,254 | 203,195 | — | — | | Note 10 | 1,999,449 | 6/20/2009 | N/ |
| Unimproved residential and commercial land, Bethel Island, California | None | 2,336,640 | 3,460 | (1,867) | — | — | | 2,338,233 | 3/11/2014 | N/ |
| Miscellaneous Real Estate | None | | | | | (291,469) | | 2,057,692 | Various | Va |
| TOTALS | | | | | | $(3,316,753) | | $80,466,125 | | |

NOTE 1: All real estate listed above was acquired through foreclosure or deed in lieu of foreclosure other than certain parcels of the commercial and residential land under development located in South Lake Tahoe, California that were purchased in 2012 and 2014 and one office condominium unit purchased in 2015.

NOTE 2: Changes in real estate held for sale and investment were as follows:

| | |
|---|---|
| Balance at beginning of period (1/1/15) | $163,016,805 |
| Additions during period: | |
| Acquisitions through foreclosure | — |
| Investments in real estate properties | 25,274,125 |
| Amortization of deferred financing costs capitalized to construction project | 207,347 |
| Subtotal | 188,498,277 |

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| | |
|---|---|
| Deductions during period: | |
| Cost of real estate properties sold | 31,099,086 |
| Impairment losses on real estate properties | 1,589,434 |
| Depreciation of properties held for investment | 1,971,345 |
| Balance at end of period (12/31/15) | $153,838,412 |
| | |
| Balance at beginning of period (1/1/16) | $153,838,412 |
| Additions during period: | |
| Acquisitions through foreclosure | 700,800 |
| Investments in real estate properties | 29,061,735 |
| Amortization of deferred financing costs capitalized to construction project | 119,471 |
| Subtotal | 183,720,418 |
| Deductions during period: | |
| Cost of real estate properties sold | 66,183,589 |
| Impairment losses on real estate properties | 3,227,807 |
| Depreciation of properties held for investment | 1,185,624 |
| Balance at end of period (12/31/16) | $113,123,398 |
| | |
| Balance at beginning of period (1/1/17) | 113,123,398 |
| Additions during period: | |
| Acquisitions through foreclosure | — |
| Investments in real estate properties | 11,274,904 |
| Amortization of deferred financing costs capitalized to construction project | 76,260 |
| Subtotal | 124,474,562 |
| Deductions during period: | |
| Cost of real estate properties sold | 41,505,148 |
| Impairment losses on real estate properties | 1,423,286 |
| Depreciation of properties held for investment | 1,080,003 |
| Balance at end of period (12/31/17) | $80,466,125 |

NOTE 3: Changes in accumulated depreciation were as follows:

| | |
|---|---|
| Balance at beginning of period (1/1/15) | $6,075,287 |
| Additions during period: | |
| Depreciation expense | 1,971,345 |
| Subtotal | 8,046,632 |
| Deductions during period: | |
| Accumulated depreciation on real estate moved to held for sale | 5,131,036 |
| Balance at end of period (12/31/15) | $2,915,596 |
| | |
| Balance at beginning of period (1/1/16) | $2,915,596 |
| Additions during period: | |
| Depreciation expense | 1,185,624 |
| Subtotal | 4,101,220 |
| Deductions during period: | |
| Accumulated depreciation on real estate moved to held for sale | 949,793 |
| Balance at end of period (12/31/16) | $3,151,427 |

| | |
|---|---|
| Balance at beginning of period (1/1/17) | 3,151,427 |
| Additions during period: | |
| Depreciation expense | 1,080,003 |
| Subtotal | 4,231,430 |
| Deductions during period: | |
| Accumulated depreciation on real estate moved to held for sale | 914,677 |
| Balance at end of period (12/31/17) | $3,316,753 |

NOTE 4: During the year ended December 31, 2017 $518,960 book value of land and $2,571,536 of construction and related costs related to common areas in the ZRV project were transferred from ZRV to ZRV II pursuant to a cost sharing agreement between the two entities (reflected in capitalized costs column).
NOTE 5: Write-down of $467,178 recorded on this property during 2017 based on pending sale contract. Property was moved to Held for Sale during 2017 and accumulated depreciation up to that time of $563,299 is shown net with the Initial Cost above.
NOTE 6: Write-downs totaling $3,712,707 were recorded on this property during 2010 and 2011 based on third party appraisals and comparable sales.
NOTE 7: Write-downs totaling $9,904,826 were recorded on this property during 2009 through 2012 based on broker's opinions of value and third party appraisals.
NOTE 8: Write-downs totaling $315,306 were recorded on this property in 2017 based on management's estimate of value and third party appraisal. Property was moved to Held for Sale during 2017 and accumulated depreciation up to that time of $192,862 is shown net with the Initial Cost above.
NOTE 9: Write-downs totaling $1,213,168 were recorded on this property in 2010 through 2012 and 2017 based on third party appraisals and other valuation information.
NOTE 10: Property was moved to Held for Sale during 2016 and accumulated depreciation up to that time of $267,716 is shown net with the Initial Cost above.
NOTE 11: The aggregate cost of the above real estate properties for Federal income tax purposes is approximately $105,382,000.
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OWENS REALTY MORTGAGE, INC.
FINANCIAL STATEMENT SCHEDULE IV - MORTGAGE LOANS ON REAL ESTATE
DECEMBER 31, 2017

| Description | Interest Rate | Final Maturity date | Carrying Amount of Mortgages | Principal Amount of Loans Subject to Delinquent Principal | Principal Amount of Loans Subject to Delinquent Payments |
|---|---|---|---|---|---|
| TYPE OF PROPERTY | | | | | |
| Commercial | 6.99-10.00% | Current to November 2020 | $127,873,281 | $4,585,000 | $1,212,851 |
| Residential | 7.75-11.00% | Current to March 2028 | 13,170,795 | 10,107,398 | 7,321,359 |
| Land | 4.00-9.82% | October 2018 to October 2020 | 5,127,574 | — | — |
| TOTAL | | | $146,171,650 | $14,692,398 | $8,534,210 |
| AMOUNT OF LOAN | | | | | |
| $0-500,000 | 6.00-10.00% | Current to March 2028 | $2,631,611 | $1,039,157 | $771,057 |
| $500,001-1,000,000 | 7.75-11.00% | Current to January 2020 | 3,736,554 | 2,146,369 | 1,577,452 |
| $1,000,001-5,000,000 | 4.00-10.00% | Current to November 2020 | 75,562,318 | 11,506,872 | 6,185,701 |
| Over $5,000,000 | 6.99-8.00% | January 2018 to November 2019 | 64,241,167 | — | — |
| TOTAL | | | $146,171,650 | $14,692,398 | $8,534,210 |
| POSITION OF LOAN | | | | | |
| First | 4.00-11.00% | Current to March 2028 | $142,782,492 | $13,803,241 | $8,045,052 |
| Second | 8.00-9.82% | Current to October 2018 | 3,389,158 | 889,157 | 489,158 |
| TOTAL | | | $146,171,650 | $14,692,398 | $8,534,210 |

NOTE 1: All loans are arranged by or acquired from an affiliate of the Company, namely Owens Financial Group, Inc., the Manager.
NOTE 2:

| | |
|---|---|
| Balance at beginning of period (1/1/15) | $68,033,511 |
| Additions during period: | |
| New loans | 73,389,645 |
| Advances moved to principal of loans | 536,816 |
| Subtotal | 141,959,972 |
| Deductions during period: | |
| Collection of principal | 35,216,165 |
| Foreclosures | — |
| Balance at end of period (12/31/15) | $106,743,807 |

| | |
|---|---|
| Balance at beginning of period (1/1/16) | $106,743,807 |
| Additions during period: | |
| New loans, including from sale of real estate property | 79,867,140 |
| Discount accretion | — |
| Subtotal | 186,610,947 |
| Deductions during period: | |
| Collection of principal | 55,849,884 |
| Foreclosures | 1,078,752 |
| Balance at end of period (12/31/16) | $129,682,311 |
| | |
| Balance at beginning of period (1/1/17) | $129,682,311 |
| Additions during period: | |
| New loans, including from sale of real estate property | 86,274,680 |
| Subtotal | 215,956,991 |
| Deductions during period: | |
| Collection of principal | 69,785,341 |
| Foreclosures | — |
| Balance at end of period (12/31/17) | $146,171,650 |

NOTE 3: Included in the above loans are the following loans which exceed 3% of the total loans as of December 31, 2017:

| Description | Interest Rate | Final Maturity Date | Periodic Payment Terms | Prior Liens | Face Amount of Mortgages | Carrying Amount of Mortgages | Principal Amount of Loans Subject to Delinquent Principal or Interest |
|---|---|---|---|---|---|---|---|
| Apartment Building Oxnard, California | 7.25% | 4/1/18 | Interest only, balance due at maturity | 0 | 14,900,000 | 13,272,146 | 0 |
| Hotel Novi, Michigan | 7.75% | 12/31/18 | Interest only, balance due at maturity | 0 | 8,835,000 | 8,467,892 | 0 |
| Shopping Center Ontario, California | 6.99% | 1/1/18 | Interest only, balance due at maturity | 0 | 10,000,000 | 8,400,000 | 0 |
| Office Building Pleasanton, California | 7.50% | 11/1/19 | Interest only, balance due at maturity | 0 | 8,250,000 | 8,000,000 | 0 |
| Office Building Pleasanton, California | 7.50% | 11/1/19 | Interest only, balance due at maturity | 0 | 8,250,000 | 6,757,044 | 0 |
| Retail Building Antioch, California | 8.00% | 10/15/18 | Interest only, balance due at maturity | 0 | 7,000,000 | 6,741,605 | 0 |
| Storage Facility | 7.75% | 5/15/18 | Interest only, | 0 | 6,625,000 | 6,625,000 | 0 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Benbrook, Texas | | | balance due at maturity | | | | |
| Retail Building Folsom, California | 7.75% | 1/15/19 | Interest only, balance due at maturity | 0 | 8,006,000 | 5,977,480 | 0 |
| Office Building Chula Vista, California | 8.00% | 11/1/18 | Interest only, Balance due at maturity | 0 | 5,600,000 | 4,760,059 | 0 |
| TOTALS | | | | $ 0 | $ 77,466,000 | $ 69,001,226 | $0 |

NOTE 4: The aggregate cost of the Company's loans for Federal income tax purposes is approximately $146,718,000 as of December 31, 2017.

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## Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

## Item 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Management of the Company carried out an evaluation, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as that term is defined in Rule 13a-15(e) under the Exchange Act. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective as of December 31, 2017.

Changes in Internal Control over Financial Reporting

There have been no changes in the Company's internal control over financial reporting, as that term is defined in Rule 13a-15(f) under the Exchange Act, in the fiscal quarter ending December 31, 2017 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Management's Report on Internal Control over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting, as that term is defined in Rule 13a-15(f) under the Exchange Act, for the Company. Under the supervision and with the participation of our principal executive officer and principal financial officer, an evaluation of the effectiveness of the internal control over financial reporting was conducted based on the framework established in the 2013 Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). There are inherent limitations in any internal control system over financial reporting, which may not prevent or detect misstatements. The Company's internal control system over financial reporting is a process designed to provide reasonable assurance of achieving its objectives and management has concluded that the Company maintained effective internal control over financial reporting as of December 31, 2017.

Attestation Report of Independent Registered Public Accounting Firm

Crowe Horwath LLP, our independent registered public accounting firm, has audited our financial statements included in this Annual Report and has issued an attestation report on the effectiveness of our internal control over financial reporting, which is included in Item 8 of this Annual Report.

## Item 9B. OTHER INFORMATION

There is no information required to be disclosed in a report on Form 8-K during the fourth quarter of the year ended December 31, 2017 that has not been so reported.

# PART III

## Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Directors of the Company.

Our Board of Directors is comprised of five members divided into three classes serving staggered terms of three-years each, with a term of office of only one of these three classes of directors expiring each year. Gary C. Wallace is the Class I director, Bryan H. Draper and James M. Kessler are the Class II directors, and William C. Owens and Dennis G. Schmal are the Class III directors. Set forth below is certain information about each director of the Company as of the date of this Annual Report. The business address of each of the directors is c/o Owens Realty Mortgage, Inc., 2221 Olympic Boulevard, Walnut Creek, California 94595.

Class I Director (Term expires at the 2020 Annual Meeting):

Gary C. Wallace – Mr. Wallace, age 63, has been a member of our Board since July 22, 2016. Mr. Wallace has provided consulting services to various banks, private equity firms, venture capital firms and the Public Company Accounting Oversight Board since his retirement from KPMG in 2005. He has also served as a member of the Board and Chairman of the Audit Committee of Plaza Bancorp and Plaza Bank from June 26, 2015 until November 2017. From February 2014 until February 2017, Mr. Wallace served as a member of the Board and Chairman of the Audit Committee of Orient Bancorp and Bank of the Orient. From 2012 until June 26, 2015, Mr. Wallace served as a Director of Manhattan Bancorp and Bank of Manhattan, N.A. Mr. Wallace joined KPMG in 1975 and retired as a KPMG Audit Partner Specialist in Banking and Investment Services in 2005, having served as head of the Northern California Financial Institutions Practice. As a KPMG Audit Partner, Mr. Wallace served as engagement partner and associate SEC reviewing partner for banks, real estate, venture capital, private equity, hedge fund and investment companies ranging in size from startups to entities with over fifty billion dollars in assets. Mr. Wallace received a Bachelor of Science degree in Business Administration, Summa Cum Laude, from California State University – East Bay in 1975.

Mr. Wallace's extensive experience in audit, accounting and other financial matters, as well as deep familiarity with the financial services industry and corporate governance issues, make him well qualified to serve as a director of the Company and strengthens our Board's collective qualifications, skills, experience and viewpoints.

Class II Directors (Terms expire at the 2018 Annual Meeting):

Bryan H. Draper – Mr. Draper, age 60, has served as our President and CEO since January 2016 and as a member of our Board since the consummation of the Merger on May 20, 2013. Mr. Draper served as the Secretary and Treasurer of the Company from its inception in 2012 until January 2016, and as our Chief Financial Officer from January 2013 to January 2016. He has also been Chief Financial Officer and Corporate Secretary of our Manager since December 1987 and a member of the Board of Directors of the Manager since January 1997. Mr. Draper is also currently the Chief Financial Officer of Investors Yield, Inc. (a California Trust Company) which is owned 100% by the Manager. Mr. Draper is expected to continue as a director and Corporate Secretary and Chief Financial Officer of the Manager until he resigns or is replaced by a vote of the Manager's stockholders and board of directors, respectively. Mr. Draper is a certified public accountant and is responsible for all accounting, finance, and tax matters for the Manager. Mr. Draper received a Master's degree in business administration from the University of Southern California in 1981.

Mr. Draper's extensive experience in the mortgage financing and real estate industries, his deep knowledge of our business as our Chief Executive Officer, as our former Chief Financial Officer and as the Chief Financial Officer of our Manager, as well as his expertise in accounting and financial matters make him well qualified to serve a director of the Company and strengthens our Board's collective qualifications, skills, experience and viewpoints.

James M. Kessler – Mr. Kessler, age 65, has been a member of our Board since the consummation of the Merger on May 20, 2013. He has been the President of Stonehenge Property Group, a private real estate development and advisory services company, since its inception in August 2005. Mr. Kessler founded Stonehenge Property Group and is responsible for all of its operations including budgets, business plans, property acquisition and development, financing and leasing. From January 2004 to July 2005, he was the founder and principal of Highland Development Company, a retail acquisition and development company that was part of the Marcus & Millchap group of companies. From April 2002 to October 2003, Mr. Kessler served as the Chief Operating Officer of ScanlanKemperBard Companies, a private real estate investment firm. From July 1999 to February 2002, he served as the Chief Development Officer of Federal Realty Investment Trust, a publicly traded REIT. While at Federal Realty Investment Trust, Mr. Kessler was responsible for establishing and managing regional and satellite offices, development, redevelopment, construction, operations, asset management and leasing. From December 1989 to July 1999, Mr. Kessler was the Chief Development Officer of Burnham Pacific Properties/The Martin Group, a publically

traded REIT. From 1985 to December 1989, he served as the Director of Marketing of Transpacific Development, a private real estate development and management company. Mr. Kessler received his bachelor's degree in business administration and management from Golden Gate University in 1981.

Mr. Kessler's extensive experience in the real estate investment, development and management industries and his senior management positions in two publicly traded REITs make him well qualified to serve as a director of the Company and strengthens our Board's collective qualifications, skills, experience and viewpoints.

Class III Directors (Terms Expire at the 2019 Annual Meeting):

William C. Owens – Mr. Owens, age 67, has been our executive Chairman of the Board since ORM's inception in 2012. Mr. Owens also served as our President from our inception in 2012 until January 2016, and as our Chief Executive Officer from January 2013 until January 2016. He has been President of our Manager since April 1996, and is a member of the Board of Directors and the Loan Committee of the Manager and its Chief Executive Officer. Mr. Owens is expected to continue as a director and President and Chief Executive Officer of the Manager until he resigns or is replaced by a vote of the Manager's stockholders and board of directors, respectively. From 1979 until April 1996, he served as a Senior Vice President of the Manager. Mr. Owens is also currently the President of Investors Yield, Inc. (a California Trust Company) which is owned 100% by the Manager. Mr. Owens has been active in real estate construction, development, and mortgage financing since 1973. Prior to joining Owens Mortgage Company in 1979, Mr. Owens was involved in mortgage banking, property management and real estate development. As President of the Manager, Mr. Owens is responsible for the overall activities and operations of the Manager, including corporate investment, operating policy and planning. In addition, he is responsible for loan production, including the underwriting and review of potential loan investments. Mr. Owens graduated from Westmont College in 1973 and is a licensed real estate broker.

Mr. Owens' extensive experience in the mortgage financing and real estate industries, his deep knowledge of our business as our executive Chairman of the Board, as our former Chief Executive Officer and as the Chief Executive Officer of our Manager, and his prior leadership experience make him well qualified to serve as Chairman of our Board and strengthens our Board's collective qualifications, skills, experience and viewpoints.

Dennis G. Schmal – Mr. Schmal, age 71, has been a member of our Board since the consummation of the Merger on May 20, 2013. In May of 2015, Mr. Schmal began service as a director and as chair of the audit committee of a public technology company, Blue Calypso, Inc., which deregistered and became a private company in March 2017. Mr. Schmal currently serves as a director of Blue Calypso, Inc., however, he no longer serves on the audit committee. Mr. Schmal also serves as a director of the public investment funds overseen by the following three asset management complexes: the AssetMark GuideMark/GuidePath Funds, where he has served as a director since 2006 and is chairman of the audit committee; the Wells Fargo GAI Hedge Funds where he has served as a director since 2008 and is a member of the audit committee; and the Cambria ETF Series where he has served as a director since 2013 and is chairman of the audit committee. Mr. Schmal served as a director and a member of the audit (chairman), nominating, and compensation committees of Merriman Holdings, Inc., a securities and investment banking firm from August 2003 until July 2016. From May 2005 until July 2014, Mr. Schmal served as chairman of the board of directors of Pacific Metrics Corporation, a private company in the educational assessment/software field. Mr. Schmal served as chairman of the board of directors of a technology industry startup, Sitoa Global Inc., from January 2012 until April 2013. From August 2004 to November 2011, he served as a member of the board of directors, audit committee (chairman) and compensation committee of Varian Semiconductor, a semiconductor equipment manufacturer. From October 2008 to May 2011, he served as a director and chairman of the audit committee of Grail Advisors EFT Trust, an exchange traded fund complex. From September 2006 to May 2008, Mr. Schmal served as a director and chairman of the audit committee of North Bay Bancorp, a bank holding company. From February 1972 to April 1999, Mr. Schmal was employed by Arthur Andersen LLP, primarily as a partner overseeing the delivery of accounting and audit services. During his career with Arthur Andersen LLP, Mr. Schmal specialized in working with companies in the financial services sector, including the commercial banking, securities/investment banking and asset management industries. Mr. Schmal received a Bachelor of Science in Business Administration – Finance and Accounting Option from California State University, Fresno in 1972 and holds a CPA certificate (retired).

Mr. Schmal's extensive experience serving on boards and the audit and other key committees of multiple private and public companies, as well as his extensive expertise in accounting and financial matters, make him well qualified to serve as a director of the Company and strengthens our Board's collective qualifications, skills, experience and

viewpoints.

Executive Officers of the Company that are not Directors.

Set forth below is certain information about each executive officer that is not also a director of the Company as of the date of this Annual Report. The business address of each executive officer is c/o Owens Realty Mortgage, Inc., 2221 Olympic Blvd., Walnut Creek, CA 94595.

| Name | Age | Information about Executive Officers |
| --- | --- | --- |
| William E. Dutra | 55 | Mr. Dutra has served as an Executive Vice President of the Manager since March 2014 and member of the Board of Directors and the Loan Committee of the Manager since January 1997. Mr. Dutra previously served as a Senior Vice President of the Manager and has been one of its employees since February 1986. Mr. Dutra has responsibility for loan committee review, loan underwriting and loan production. |
| Melina A. Platt | 51 | Ms. Platt was appointed as the Company's Chief Financial Officer and Treasurer in January 2016 and has been the Controller of the Manager since May 1998. Ms. Platt is a certified public accountant and is responsible for all accounting, finance, and regulatory agency filings of the Company. Ms. Platt was previously a Senior Manager with KPMG LLP. |
| Daniel J. Worley | 46 | Mr. Worley has served as a Senior Vice President of the Manager since June 2013 and is responsible for capital markets, investor relations, regulatory compliance, and governance. Mr. Worley has served as Secretary of the Company since January 2016, and was Assistant Secretary of the Company from June 2013 until January 2016. In addition, he is a member of the senior management team and participates in executive management and strategy. Prior to joining the Company, from July 2012 to June 2013, he served as a consultant to OMIF. From July 2010 to October 2011, he was the Chief Strategy Officer at Mason-McDuffie Real Estate where his responsibilities included executive management, strategy, corporate development, governance, and legal matters. From May 2001 to October 2010, he co-founded and served as the Chief Operating Officer of NorthPoint Financial Group/SmartZip Analytics where his responsibilities included executive management, strategy and governance. From January 1998 to May 2001, he was the Managing Director of the Berkeley Center for Advanced Technology where his responsibilities included venture fund management, investment due diligence, investment oversight and investor relations. |
| Brian M. Haines | 40 | Mr. Haines has served as a Senior Vice President of the Manager since January 2014 and as a Loan Officer of the Manager since 2007. Mr. Haines' focus is on originating and structuring debt investments, developing and fostering broker relationships and asset management oversight. Prior to joining the Manager, Mr. Haines co-owned and operated a private lending firm headquartered in Northern California. He is a director of the Bay Area Mortgage Association (BAMA) and an active member of the Urban Land Institute (ULI) and California Mortgage Association (CMA). |

Audit Committee

Our Board of Directors has a standing Audit Committee, established in accordance with the requirements of the SEC and NYSE American rules. The Audit Committee's purpose and responsibilities are more fully set forth in the committee's charter, which was adopted by our Board of Directors on May 20, 2013, and is available on our web site at www.owensmortgage.com.

The members of the Audit Committee are the independent directors, Messrs. Wallace, Kessler and Schmal. Our Board of Directors has determined that Mr. Wallace (the Chairman of the Audit Committee) qualifies as an "audit committee financial expert" for purposes of, and as defined by, applicable SEC rules and has the requisite accounting or related financial management expertise required by the NYSE American rules. In addition, our Board has determined that all of the members of the Audit Committee are financially literate as required by the NYSE American rules.

Code of Business Conduct and Ethics

We have adopted a Code of Business Conduct and Ethics, which requires our directors, employees (if any), officers (including our Chief Executive Officer and Chief Financial Officer), and the personnel of our Manager, to abide by high standards of business conduct and ethics. The Code of Business Conduct and Ethics covers a variety of topics, including those required by the SEC and the NYSE American rules. Topics covered include, but are not limited to, conflicts of interest, confidentiality of information, and compliance with laws and regulations. The Code of Business Conduct and Ethics is available for viewing on our web site at www.owensmortgage.com, and a copy may also be obtained by stockholders, free of charge, by writing to us at Owens Realty Mortgage, Inc., 2221 Olympic Boulevard, Walnut Creek, CA 94595, Attention: Daniel Worley, Secretary. The Code of Business Conduct and Ethics was adopted by our Board of Directors on May 20, 2013 and amended and restated on February 3, 2016.

Procedures for Recommending Director Nominees

There have been no material changes to the procedures described in the Company's proxy statement relating to the 2017 Annual Meeting of Stockholders by which stockholders may recommend director nominees to the Company.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires our directors, executive officers and holders of more than 10% of the outstanding shares of Common Stock ("10% Holders") to file with the SEC and the NYSE initial reports of ownership and reports of changes in ownership of Common Stock and other equity securities of ORM. Directors, executive officers and 10% Holders are required by the SEC's regulations to furnish us with copies of all Section 16(a) forms and amendments thereto filed during any given year.

Based on the review of copies of the Section 16(a) reports and amendments thereto furnished to us and/or written representations from our directors, executive officers and 10% Holders, we believe that for the year ended December 31, 2017 our directors, executive officers and 10% Holders complied with all Section 16(a) filing requirements applicable to them.

## Item 11. EXECUTIVE COMPENSATION

Compensation Committee Interlocks and Insider Participation

Our Compensation Committee members are Messrs. Wallace, Schmal and Kessler and each of them served as members of the Compensation Committee throughout 2017, None of the foregoing persons served as an officer, former officer or employee of ours or had a relationship disclosable under Item 404 of Regulation SK. Further, during 2017, none of our executive officers served as a member of the board of directors or compensation committee (or equivalent) of any other entity, one of whose executive officers served as one of our directors or on our Compensation Committee.

Compensation Discussion and Analysis

We are managed by our Manager pursuant to the terms of our charter and the Management Agreement between the Company and our Manager. In August 2017, the Board and the Manager agreed to adjust the Existing Management Fee paid to the Manager pursuant to the charter on an interim basis to the Interim Management Fee, which is a monthly management fee that equals 1/12th of 1.50% of the Company's Stockholders' Equity, subject to the additional details of the calculation as described in "Related Party Transactions – Management Fees and Expenses – Interim Fee Reduction and Amendment Proposal to Permanently Reduce Management Fees and Expenses" in Item 13 of this Annual Report. The Interim Management Fee is payable during the Interim Adjustment Period, which is the period commencing July 1, 2017 and ending on March 31, 2018. Effective April 1, 2018, the Interim Management Fee adjustment will become permanent along with an additional adjustment such that the monthly management fee payable will equal (i) one-twelfth (1/12) multiplied by (ii) (a) 1.50% of the first $300,000,000 of the Company's Stockholders' Equity and (b) 1.25% of the Company's Stockholders' Equity that is greater than $300,000,000. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Significant Developments During 2017 and Subsequent Events" in Item 7 of this Annual Report and "Related Party Transactions – Management Fees and Expenses" in Item 13 of this Annual Report for additional details of the revised management fee calculation and for a description of certain relevant terms of the charter and the Management Agreement, including a description of certain additional proposed changes to the fees and expenses payable to our Manager.

We have no employees other than two full-time and one part-time employee(s) (none of whom is an officer) that work for one of our subsidiaries. We do not have agreements with any of our executive officers or any employees of our

Manager with respect to their compensation. Our executive officers are employees of our Manager and do not receive cash, equity or other compensation from us for serving as our executive officers. We did not pay any compensation to our executive officers nor did we make any grants of equity or other plan-based awards of any kind to them during 2017 or through the date of this Annual Report. None of our executive officers received any options or stock directly from us prior to the date of this Annual Report. We do not provide any of our executive officers with pension benefits or nonqualified deferred compensation plans. We do not have any employment agreements with any persons and are not obligated to make any payments to any of our executive officers upon termination of employment or a change in control of us.

We estimate that the median annual compensation for our two full-time and one part-time employees was $27,000 for 2017. The Company does not, however, pay salary, bonus or other compensation to its principal executive officer (or any of its officers) and the pay ratio required by Item 402(u) of Regulation SK is not calculable without salary and bonus information for our principal executive officer, which information will not become available unless we elect in the future to pay salary, bonus and/or other compensation to our principal executive officer.

Compensation Committee Report

Our Compensation Committee reviewed and discussed with our management the "Compensation Discussion and Analysis" contained in this Annual Report. Based on that review and discussions, our Compensation Committee recommends to our Board of Directors that the "Compensation Discussion and Analysis" be included in this Annual Report.

By the Compensation Committee:
Dennis George Schmal, Chair
James Matthew Kessler
Gary C. Wallace

The foregoing Compensation Committee Report shall not be deemed under the Securities Act or the Exchange Act to be (i) "soliciting material" or "filed" or (ii) incorporated by reference by any general statement into any filing made by us with the SEC, except to the extent that we specifically incorporate such report by reference.

Compensation of Independent Directors

Our independent directors are Messrs. Kessler, Schmal and Wallace and each of them serves as a member of our Audit, Nomination and Corporate Governance and Compensation committees. Mr. Schmal is our Lead Director and the Chairman of the Nomination and Corporate Governance and Compensation Committees and Mr. Wallace serves as Chairman of our Audit Committee.

From January 1 through June 30, 2017, each independent director was paid a cash retainer at an annual rate of $35,000 and, commencing July 1, 2017, the cash retainer paid to the independent directors was increased to an annual rate of $50,000, payable quarterly in advance. In addition, during 2017 the chair of our Audit Committee (Mr. Wallace) was paid a retainer at an annual rate of $7,500, the chair of our Compensation Committee (Mr. Schmal) was paid a retainer at an annual rate of $7,500, the chair of our Nominating and Corporate Governance Committee (Mr. Schmal) was paid a retainer at an annual rate of $5,000, and our lead independent director (Mr. Schmal) was paid a retainer at an annual rate of $2,500, each payable quarterly in advance.

We also reimburse all members of our Board for their travel expenses incurred in connection with their attendance at our Board, committee and stockholder meetings. We pay directors' fees only to those directors who are independent under the NYSE American rules.

The following table summarizes the compensation received by our independent directors for the fiscal year ended December 31, 2017.

| Name | Fees Earned or Paid in Cash($) |
|---|---|
| James M. Kessler | $42,500 |
| Dennis G. Schmal | $57,500 |
| Gary C. Wallace | $50,000 |

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Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table sets forth certain information regarding the beneficial ownership of the Common Stock as of March 9, 2018 (unless otherwise indicated), of each current director and director nominee, each of our executive officers, our executive officers and directors as a group and each stockholder known to management to own beneficially more than 5% of the outstanding shares of our Common Stock. Unless otherwise indicated, we believe that the beneficial owner set forth in the table has sole voting and investment power.

| Name and Address of Beneficial Owner[1] | Number of Shares Beneficially Owned | Percentage of Common Stock Beneficially Owned[2] |
| --- | --- | --- |
| Beneficial owners of more than 5%: | | |
| Nantahala Capital Management, LLC[3] 19 Old Kings Highway South, Suite 200 Darien, CT 06820 | 628,697 | 6.92% |
| BlackRock, Inc.[4] 55 East 52nd Street New York, NY 10055 | 497,967 | 5.48% |
| Executive officers and directors: | | |
| William C. Owens [5][6] | 185,985 | 2.05% |
| Bryan H. Draper[7] | 93,017 | * |
| James M. Kessler[8] | 29,074 | * |
| Dennis G. Schmal | 3,000 | * |
| Gary C. Wallace | 1,500 | * |
| Daniel J. Worley | 2,325 | * |
| William E. Dutra[9] | 25,589 | * |
| Melina A. Platt | 3,910 | * |
| Brian M. Haines[10] | 7,908 | * |
| All executive officers and directors as a group (9 persons) | 352,308 | 3.88% |

*Less than one percent.

(1) The address of each of the executive officers and directors listed above is c/o Owens Realty Mortgage, Inc., 2221 Olympic Boulevard, Walnut Creek, California 94595.

(2) The percentage reported in this column has been calculated based upon 9,091,454 shares of Common Stock outstanding on March 9, 2018.

(3) This information, other than the percentage ownership calculation which was calculated based upon 9,091,454 shares of Common Stock outstanding on March 9, 2018, is based on a Schedule 13G/A filed with the SEC on February 14, 2018, by Nantahala Capital Management, LLC, a Massachusetts limited liability company

("Nantahala"), Wilmot Harkey and Daniel Mack (collectively the "Reporting Persons"). The Reporting Persons report that Nantahala may be deemed to be beneficial owner of 628,697 shares of Common Stock held by funds and separately managed accounts under its control that, each of Messrs. Harkey and Mack may also be deemed the beneficial owner of those shares and that each of the Reporting Persons has shared voting and dispositive power over all 628,697 shares.

(4) This information, other than the percentage ownership calculation which was calculated based upon 9,091,454 shares of Common Stock outstanding on March 9, 2018, is based on a Schedule 13G/A filed with the SEC on February 9 , 2018, by BlackRock, Inc., a Delaware corporation ("BlackRock"). BlackRock discloses that it may be deemed to be beneficial owner of 497,967 shares of Common Stock held by certain of its subsidiaries and affiliates that constitute a group, that it has sole voting power over 492,095 of the shares and sole dispositive power over all 497,967 shares .

(5) Mr. Owens owns 62.5% of Owens Financial Group, Inc., our Manager and shares voting power at the Manager with Mr. Draper, Mr. Dutra and Mr. Haines, each of whom owns the following percentage of the Manager: Draper – 16.305%; Dutra – 16.305%; and Haines – 4.89%. Mr. Owens' is reporting beneficial ownership of 83,049 shares of Common Stock held by the Manager directly and 13,736 shares of Common Stock held by Investors Yield. Inc. (a wholly-owned subsidiary of the Manager), with respect to which he has shared voting and investment power. Mr. Owens disclaims beneficial ownership of these securities except to the extent of his pecuniary interest therein.

(6) Includes 360 shares of Common Stock held by Owens Trust dated February 24, 1998, the trustee of which is Mr. Owens. Also includes 4,637 shares of Common Stock held by Belmar, a California limited partnership of which Mr. Owens owns 49.22%. Mr. Owens disclaims beneficial ownership of these securities except to the extent of his pecuniary interest therein. Also includes: (i) 6,361 shares of Common Stock held indirectly by Mr. Owens spouse; (ii) 11,572 shares of Common Stock held in an Individual Retirement Account of which Mr. Owens is sole beneficiary; and (iii) 63,460 shares of Common Stock owned indirectly through the Owens Financial Group 401(k) Plan.

(7) Includes 4,543 shares of Common Stock held by Draper Family Partnership of which Mr. Draper is a 50% owner. Mr. Draper disclaims beneficial ownership of these securities except to the extent of his pecuniary interest therein. Also includes: (i) 32,713 shares of Common Stock held by Draper Family Trust dated May 16, 2000 of which Mr. Draper is co-trustee; (ii) 3,275 shares of Common Stock indirectly by Mr. Draper's spouse; (iii) 52,186 shares of Common Stock held in Individual Retirement Accounts of which Mr. Draper is sole beneficiary; and (iv) 300 shares of Common Stock owned by Mr. Draper's child. Does not include 83,049 shares of Common Stock held by the Manager directly and 13,736 shares of Common Stock held by Investors Yield, Inc.

(8) Mr. Kessler owns 29,074 shares of Common Stock through two trusts. Mr. Kessler has sole voting and investment power over 17,836 shares of Common Stock held in one of those trusts and shared voting and investment power over shares of Common Stock held in the other trust.

(9) Includes 2,689 shares of Common Stock held by The Dutra Trust of which Mr. Dutra is a co-trustee and 22,900 shares of Common Stock owned indirectly through the Owens Financial Group 401(k) Plan. Does not include 83,049 shares of Common Stock held by the Manager directly and 13,736 shares of Common Stock held by Investors Yield. Inc.

(10) Includes 1,248 shares of Common Stock held in an Individual Retirement Account and 3,973 shares of Common Stock owned indirectly through the Owens Financial Group 401(k) Plan. Does not include 83,049 shares of Common Stock held by the Manager directly and 13,736 shares of Common Stock held by Investors Yield. Inc.

## Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Related Party Transaction Policy and Procedures

The Company has adopted a written policy for approval of transactions and arrangements between the Company and the Company's current and recent former directors, director nominees, current and recent former executive officers, greater than five percent stockholders and their immediate family members, and entities where any of the foregoing persons is employed or serves as a general partner, principal or in a similar position (each, a "Related Party").

The policy provides that the Audit Committee reviews certain transactions subject to the policy and determines whether or not to approve or ratify those transactions. In doing so, the Audit Committee takes into account, among other things, whether the transaction is on terms comparable to those that could be obtained in arm's length dealings with an unrelated third party under similar circumstances, the extent of the Related Party's interest in the transaction, and the conflicts of interest provisions and corporate opportunity provisions of the Company's Code of Business Conduct and Ethics. The Related Party transaction must be approved or ratified by the Audit Committee in accordance with the provisions of the policy and in accordance with relevant provisions of the Company's charter, bylaws and applicable provisions of the MGCL.

The Audit Committee has considered and adopted standing pre-approvals under the policy for certain limited transactions with Related Parties that meet specific criteria. Information on transactions subject to pre-approval is to be provided to the Audit Committee at its next regularly scheduled meeting. Pre-approved transactions are limited to:

- compensation to an executive officer or director of the Company if (a) the related compensation is required to be reported in the Company's proxy statement under the SEC's compensation disclosure requirements or (b) the executive officer is not an immediate family member of another executive officer or director of the Company, the related compensation would be reported in the Company's proxy statement under the SEC's compensation disclosure requirements if the executive officer was a "named executive officer," and the Compensation Committee approved (or recommended that our Board approve and the Board has approved) such compensation;

- certain transactions in the Company's ordinary course of business where the Related Party's interest arises only from: (a) the Related Party's position as a director of another entity that is a party to the transaction; (b) from direct or indirect ownership by such Related Party and all other Related Parties, in the aggregate, of less than a 5% equity interest in another person (other than a partnership) that is a party to the transaction; (c) from both such position described in (a) and ownership described in (b); or (d) from the Related Party's position as a limited partner in a partnership in which all Related Parties in the aggregate have an interest of less than 5% and the Related Party is not a general partner of and does not have another position in such partnership;

- certain transactions in the Company's ordinary course of business where the Related Party's interest arises solely from the ownership of the Company's Common Stock and holders of the Company's Common Stock received the same benefit on a pro rata basis; and

- certain transactions involving a Related Party where the rates or charges involved are determined by competitive bids, or transactions involving the rendering of services as a common or contract carrier, or as a public utility, at rates or charges fixed in conformity with law or a governmental authority.

Related Party Transactions

Ownership of the Manager

The voting common stock of our Manager, Owens Financial Group, Inc., is owned as follows: 62.5% by William C. Owens, 16.305% by Bryan H. Draper, 16.305% by William E. Dutra and 4.89% by Brian M. Haines.

Management Fees and Expenses

We have entered into a Management Agreement with our Manager, Owens Financial Group, Inc., which describes the services to be provided by our Manager. The compensation payable to the Manager for those services and certain other important provisions relating to the Manager are described in our charter, provided, however that the Board and Manager have agreed to adjust the Existing Management Fee and pay the Interim Management Fee during the Interim Adjustment Period and to make certain permanent changes to reduce the management fee payable as described below in "Interim Fee Reduction and Amendment Proposal to Permanently Reduce Management Fees and Expenses". The Manager manages our day-to-day operations and business, subject to the supervision and oversight of our Board of Directors. The Manager is required to act in accordance with policies and restrictions contained in the Company's charter and such additional investment policies as may be adopted by our Board of Directors.

The Management Agreement continues in effect for the duration of the existence of the Company, unless earlier terminated by the affirmative vote of the holders of a majority of the outstanding shares of Common Stock, by the Manager in response to an amendment to its compensation that it does not consent to, automatically in certain circumstances relating to the assignment of the Management Agreement, or by either party for cause as defined therein.

The Management Agreement provides that the fees payable to the Manager as described in the charter may not be changed without the approval of the Board (including a majority of the independent members of the Board), the holders of a majority of the outstanding shares of Common Stock and the Manager; provided that stockholder approval is not required to adjust the Manager's compensation so long as such adjustment will not have a significant adverse impact on the stockholders of the Company. The charter provides for the payment of the following fees by the Company and by borrowers:

Fees paid by the Company. The Manager is entitled to receive the following fees from the Company:

- Management Fee. Up until July 1, 2017, the Existing Management Fee has been paid by the Company to the Manager monthly not to exceed 2.75% annually of the average unpaid balance of our loans at the end of each of the 12 months in the calendar year. Since this fee was paid monthly, it could exceed 2.75% in one or more months, but the total fee in any one year was limited to a maximum of 2.75%, and any amount paid above this had to be repaid by the Manager to the Company. The Manager was entitled to receive a management fee on all loans, including those that were delinquent. In August 2017, the Board and the Manager agreed to adjust the Existing Management Fee on an interim basis to the Interim Management Fee which is a monthly management fee that equals $1/12^{th}$ of 1.50% of the Company's Stockholders' Equity, subject to the additional details of the calculation as described below in "Interim Fee Reduction and Amendment Proposal to Permanently Reduce Management Fees and Expenses".

The Interim Management Fee is payable during the Interim Adjustment Period commencing July 1, 2017 and ending on March 31, 2018, and is intended to reduce the management fees that would otherwise be payable by the Company. Effective April 1, 2018, the Interim Management Fee adjustment will become permanent along with an additional adjustment such that the monthly management fee payable will equal (i) one-twelfth (1/12) multiplied by (ii) (a) 1.50% of the first $300,000,000 of the Company's Stockholders' Equity and (b) 1.25% of the Company's Stockholders' Equity that is greater than $300,000,000. See "Interim Fee Reduction and Amendment Proposal to Permanently Reduce Management Fees and Expenses" below for additional details of the revised management fee calculation, and for a description of certain additional proposed changes to the fees and expenses payable to our Manager. Management fees amounted to approximately $3,546,000 and $3,286,000 for the years ended December 31, 2017 and 2016, respectively.

- Loan Servicing Fee. The Manager may act as servicing agent with respect to the Company's mortgage loans, in consideration for which it will be entitled to receive from ORM a monthly fee, which, when added to all other fees paid in connection with the servicing of a particular loan, does not exceed the lesser of the customary, competitive fee in the community where the loan is placed for the provision of such mortgage services on that type of loan, or up to 0.25% per year of the unpaid balance of ORM's mortgage loans at the end of each month. Servicing fees amounted to approximately $362,000 and $299,000 for the years ended December 31, 2017 and 2016, respectively.

Fees paid by borrowers. The Manager is entitled to receive directly from borrowers the following fees:

- Acquisition and Origination Fees. The Manager or its affiliates is entitled to receive and retain all fees and commissions paid or payable to it by any party other than ORM and any subsidiary in connection with ORM making or investing in mortgage loans. Included in the computation of such fees or commission is any selection fee, mortgage placement fee, nonrecurring management fee and any origination fee, loan fee or points paid by borrowers to the Manager or any fee of a similar nature, however designated. Such fees earned by the Manager amounted to approximately $2,492,000 and $2,514,000 on loans originated or extended of approximately $122,240,000 and $101,594,000 for the years ended December 31, 2017 and 2016, respectively.

- Late Payment Charges. The Manager is entitled to receive and retain all additional charges paid by borrowers on delinquent loans and loans past maturity held by ORM, including additional interest and late payment fees. The amounts paid to or collected by the Manager for late payment charges totaled approximately $83,000 and $83,000 for the years ended December 31, 2017 and 2016, respectively.

- Other Miscellaneous Fees. ORM remits other miscellaneous fees to the Manager, which are collected from loan payments, loan payoffs or advances from loan principal (i.e. funding, demand and partial release fees). Such fees remitted to the Manager totaled approximately $23,000 and $20,000 for the years ended December 31, 2017 and 2016, respectively.

The Manager is entitled to be reimbursed by ORM for any expenses (subject to certain exceptions outlined in the charter and the Management Agreement) paid by the Manager, including, without limitation, legal and accounting expenses, filing fees, printing costs, and goods, services and materials used by or for ORM. Additionally, the Manager is entitled to reimbursements for salaries for non-management and non-supervisory services. For the years ended December 31, 2017 and 2016, ORM recorded expenses totaling approximately $381,000 and $440,000, respectively, related to expense reimbursements to the Manager. ORM also reimbursed certain of the Manager's officers for allowed expenses in the total amount of $2,000 and $0 during the years ended December 31, 2017 and 2016, respectively.

ORM paid Investor's Yield, Inc. (a wholly owned subsidiary of the Manager) approximately $1,000 and $9,000 in trustee's fees related to certain foreclosure proceedings on ORM loans during the years ended December 31, 2017 and 2016, respectively.

Interim Fee Reduction and Amendment Proposal to Permanently Reduce Management Fees and Expenses

Interim Management Fee Reduction. In August 2017 the Manager and the Board agreed that, commencing July 1, 2017, the Existing Management Fee to be paid monthly is to be reduced (but not increased) during the Interim Adjustment Period to the amount of the "Interim Management Fee" calculated as follows:

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1. The "Interim Management Fee" is equal to (i) one-twelfth (1/12) multiplied by (ii) 1.50% of the "Opening Stockholders' Equity Balance" (defined below), with such Opening Stockholders' Equity Balance to be adjusted by the Manager in the following manner:

(A) at the end of a calendar month to reflect any changes that result from any of the events specified in clause (A) in the definition of "Stockholders' Equity" (defined below) during such calendar month from the Opening Stockholders' Equity Balance; and

(B) at the end of a calendar quarter to reflect any changes that result from the components specified in clauses (B), (C) or (D) in the definition of "Stockholders' Equity" (defined below) for such calendar quarter from the Opening Stockholders' Equity Balance.

Since the Management Fee is to be paid monthly during the Interim Adjustment Period, and the components of Stockholders' Equity specified in clauses (B), (C) and (D) in the definition of "Stockholders' Equity" will not be known until the end of the quarter in question, the Manager shall use the prior quarter's value as an estimate for each monthly payment and will effect a reconciliation at the end of the quarter, so that the actual aggregate Management Fee paid for each quarter will be based on the values of the components specified in clauses (B), (C) and (D) in the definition of "Stockholders' Equity" at the end of that particular quarter as if the components specified in clauses (B), (C) and (D) were known at each month end.

2. As used in the calculation of the Interim Management Fee, "Stockholders' Equity" means:

(A) the sum of the net proceeds from any issuances of the Company's equity securities since inception (including the book value of the Company's Common Stock and Additional Paid-in Capital at inception of the Company) less any amount that the Company pays for repurchases of its equity securities (determined as of the most recent month end), plus

(B) the Company's consolidated retained earnings at the end of the most recently completed calendar quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less

(C) any unrealized gains, losses or other items that do not affect realized net income as of the most recently completed calendar quarter as adjusted to exclude

(D) one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between the Manager and the Company's Independent Directors and after approval by a majority of the Company's Independent Directors.

3. As used in the calculation of the Interim Management Fee, "Opening Stockholders' Equity Balance" means Stockholders' Equity at the end of the most recently completed calendar quarter. "Independent Directors" means the members of the Company's Board of Directors who are not officers, employees or directors of the Manager or any person directly or indirectly controlling or controlled by the Manager, and who are otherwise "independent" in accordance with the applicable rules of the NYSE American.
4. The Manager shall compute each installment of the Interim Management Fee reasonably promptly at the end of each calendar month during the Interim Adjustment Period. A copy of the computations, including a comparison of the Interim Management Fee to the Existing Management Fee, made by the Manager to calculate such installment shall thereafter promptly be delivered to the Board of Directors.
5. The agreement of the parties in August 2017 did not include any change to the loan servicing fees or expense reimbursements payable by the Company to the Manager, and the Manager would also continue to receive the fees paid by our borrowers to the Manager.

This adjustment resulted in a reduced management fee of approximately $440,000 during the last six months of 2017.

Amendment Proposal to Permanently Reduce Management Fees and Expenses. On March 13, 2018, we announced that our Board and the Manager have reached a non-binding agreement in with respect to certain changes to be made to the Manager's compensation structure. The non-binding agreement contemplates that the Management Agreement will be amended (the "Amendment Proposal") as follows:

- Reduced Management Fee: The Amendment Proposal will reduce the management fee by making permanent the recent "Interim Management Fee" adjustment described above along with an additional adjustment such that the "Management Fee" will equal (i) one-twelfth (1/12) multiplied by (ii) (a) 1.50% of the first $300,000,000 of Opening Stockholders' Equity Balance (as defined above), and (b) 1.25% of the Opening Stockholders' Equity Balance that is greater than $300,000,000, subject to certain monthly and quarterly adjustments.

- Company to Receive 30% of All Loan Fees: The Company will become entitled to receive thirty-percent (30%) of all fees and commissions paid to the Manager in connection with the Company making or investing in mortgage loans, including thirty-percent (30%) of all gross fees paid in connection with the extension or modification of any loans, with the remaining seventy-percent (70%) to be paid to the Manager.

- Company to Receive 30% of All Late Payment Charges: The Company will become entitled to receive thirty-percent (30%) of all late payment charges from borrowers on loans owned by the Company, with the remaining seventy-percent (70%) to be paid to the Manager.

- Elimination of Service Fees: The Company will no longer pay the Manager any servicing fees for the Manager's services as servicing agent with respect to any mortgage loans.

- Elimination of Certain Expense Reimbursements: The Company will no longer reimburse the Manager for certain expenses, including the salary and related salary expense of the Manager's non-management and non-supervisory personnel.

No binding or definitive agreement has been entered into with respect to the Amendment Proposal. Any such definitive agreement to amend the Management Agreement must be reviewed and approved by the compensation committee of the Company before the Company could enter into such agreement. While the Company and the Manager caution that no assurances can be made regarding the timing or certainty of entering a definitive agreement, the Company and the Manager will work expeditiously to finalize and execute the Amendment Proposal. In the event the Amendment Proposal is not executed by March 31, 2018, the Manager has agreed that the Company will only be obligated to pay, and the Manager will only be entitled to receive, the reduced management fee contemplated under the Amendment Proposal from and after April 1, 2018.

Repurchase of Freestone Shares

On December 29, 2017, the Company entered into the Settlement Agreement with Freestone Capital Management, LLC and certain of its affiliates (collectively, "Freestone"), a shareholder group that beneficially owned more than 5% of our outstanding Common Stock, pursuant to which the Company agreed to purchase the 810,937 shares of Common Stock held by Freestone in a privately negotiated transaction for $19.25 per share, resulting in an aggregate purchase price of approximately $15.6 million . Pursuant to the terms of the Settlement Agreement, for a period of five years following the date of the Settlement Agreement, Freestone agreed to customary standstill restrictions relating to share purchases, support of proxy contests and other activist campaigns, calling of special meetings, and related matters. For a period of two years following the date of the Agreement, the Company and Freestone also agreed to abide by customary covenants not to sue and non-disparagement provisions. In addition, the Company and Freestone each released the other from all claims that the releasing party has, had or may have against the released

party that relate to the investment by Freestone in the Company.

Office Lease

ORM does not have any separate offices. The Manager operates from its executive offices at 2221 Olympic Boulevard, Walnut Creek, California 94595, or the Executive Office. The lessor of the Executive Office is Olympic Blvd. Partners, a California General Partnership ("OBP"), of which the Manager is a 50% general partner. The Executive Office is the sole asset of OBP. The lease agreement, or the Office Lease, between OBP and the Manager for the Executive Office has a term extending until December 31, 2019. The Manager pays rent in the amount of $15,975 per month to OBP under the Office Lease. For each of the years ended December 31, 2017 and 2016, Owens Financial Group paid $191,700 to OBP for use of the Executive Office. The Executive Office is subject to a deed of trust in the amount of $616,780 as of December 31, 2017 with monthly payments of interest and principal of $3,988 and the remaining principal balance of $583,332 due on December 31, 2019.

Director Independence

The Company's corporate governance guidelines provide that a majority of the directors serving on our Board must be "independent" as defined by the NYSE American rules. Based upon its review of all relevant facts and circumstances, our Board has affirmatively determined that three of our five current directors, Gary C. Wallace, Dennis G. Schmal and James M. Kessler qualify as independent directors under applicable SEC and NYSE American rules. In addition, our Board's three standing committees, the Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee, are each composed entirely of independent directors as required by the charters of those committees.

Item 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The following table summarizes the aggregate fees (including related expenses) billed to us for professional services provided by Crowe Horwath LLP for the fiscal years ended December 31, 2017 and 2016:

| | Fiscal Year Ended December 31, 2017 | Fiscal Year Ended December 31, 2016 |
|---|---|---|
| Audit Fees | $ 255,000 | $ 229,000 |
| Audit-Related Fees | 1,200 | 13,200 |
| Tax Fees | 107,068 | 119,483 |
| All Other Fees | 17,780 | 2,696 |
| Total | $ 381,048 | $ 364,379 |

Audit Fees. Audit fees consist of fees and expenses billed by Crowe Horwath LLP related to the audit of our consolidated financial statements included in Form 10-K, the audit of our internal control over financial reporting and the reviews of the interim consolidated financial statements included in the Form 10-Q's, including services normally provided by an accountant in connection with statutory and regulatory filings or engagements.

Audit Related Fees. Audit-related fees are fees and expenses billed for assurance and related services that are reasonably related to the performance of the audit or review of the Company's financial statements and are not reported under "Audit Fees."

Tax Fees. Tax fees billed to us by Crowe Horwath LLP are for tax compliance and consulting fees, which typically consist of fees billed for professional services for tax return preparation and other tax compliance.

All Other Fees. All other fees consist of fees for products and services other than the services reported above, including consulting fees paid for a cost segregation study and accounting guidance subscriptions paid.

All services rendered by Crowe Horwath LLP were pre-approved by the Audit Committee for 2017 in accordance with its pre-approval policy, and the Audit Committee concluded that the provision of such services by Crowe Horwath LLP was compatible with the maintenance of that firm's independence in the conduct of its audit functions. The Audit Committee charter requires that the committee review and pre-approve each audit or permissible non-audit engagement or accounting project involving the independent public accountant, and the related fees or ranges of fees, prior to commencement of the engagement or project subject to certain exceptions if the services meet pre-approval policies that may be established under the charter. The Audit Committee may delegate its pre-approval authority to one or more of its members and, if such delegation occurs, then such member(s) are required to report any pre-approval decisions to the Audit Committee at its next-scheduled meeting.

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PART IV

Item 15. EXHIBITS, CONSOLIDATED FINANCIAL STATEMENT SCHEDULES

(a)

(1) List of Financial Statements filed as part of Item 8 in this Annual Report:


| | |
|---|---|
| Report of Independent Registered Public Accounting Firm | 66 |
| Consolidated Balance Sheets - December 31, 2017 and 2016 | 68 |
| Consolidated Statements of Income - December 31, 2017, 2016 and 2015 | 69 |
| Consolidated Statements of Stockholders' Equity - December 31, 2017, 2016 and 2015 | 70 |
| Consolidated Statements of Cash Flows - December 31, 2017, 2016 and 2015 | 71 |
| Notes to Consolidated Financial Statements | 73 |


(2) List of Financial Statement Schedules filed as part of Item 8 in this Annual Report:


| | |
|---|---|
| Schedule III - Real Estate and Accumulated Depreciation – December 31, 2017 | 108 |
| Schedule IV - Mortgage Loans on Real Estate – December 31, 2017 | 111 |


(3) List of Exhibits:

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|---|---|
| * 3.1 | Articles of Amendment and Restatement of Owens Realty Mortgage, Inc., dated January 23, 2013, and related Certificate of Correction, dated September 17, 2013 incorporated by reference to exhibit 3.1 of the Annual Report on Form 10-K for the year ended December 31, 2014 filed with the SEC on March 16, 2015 |
| * 3.2 | Bylaws of Owens Realty Mortgage, Inc., incorporated herein by reference to Annex C to the Proxy Statement/Prospectus on Form S-4 filed with the SEC on February 13, 2013 |
| * 3.3 | Amendment No. 1 to the Bylaws of Owens Realty Mortgage, Inc., dated December 29, 2017, incorporated by reference to exhibit 3.1 of the current report on Form 8-K/A filed with the SEC on January 4, 2018 |
| * 3.4 | Articles Supplementary, dated November 12, 2013, relating to the election to be subject to Subtitle 8 of Title 3 of the Maryland General Corporation Law, incorporated by reference to exhibit 3.1 of the current report on Form 8-K filed with the SEC on November 13, 2013 |
| * 4.1 | Form of Common Stock Certificate, incorporated by reference to exhibit 4.1 to the Proxy Statement/Prospectus on Form S-4 filed with the SEC on January 25, 2013 |
| * 10.1 | Form of Management Agreement, dated May 20, 2013, by and between Owens Financial Group, Inc. and Owens Realty Mortgage, Inc., incorporated by reference to exhibit 10.1 of the current report on Form 8-K filed with the SEC on May 20, 2013 |
| * 10.2 | Credit Agreement, dated as of December 15, 2014, between Tahoe Stateline Venture, LLC and RaboBank, N.A., together with related Real Estate Term Loan Note, Deed of Trust, Assignment of Rents, Security Agreement and Fixture Filing, Environmental Certificate and Indemnity Agreement, and Guaranty, incorporated by reference to exhibits 10.1 through 10.5 of the current report on Form 8-K filed with the SEC on December 30, 2014 and amended on Form 8-K/A filed with the SEC on January 8, 2015 |
| * 10.3 | Amended and Restated Credit Agreement, dated as of April 16, 2015, by and among California Bank & Trust as Administrative Agent and a Lender, First Bank as a Lender and Owens Realty Mortgage, Inc. as Borrower, together with related Master Revolving Notes, Amended and Restated Advance Formula Agreement, Security Agreement, and Addendum to Credit Agreement (Agency Provisions) incorporated by reference to exhibits 10.1 through 10.6, respectively, to the current report on Form 8-K filed with the SEC on April 24, 2015 |
| * 10.4 | First Amendment to Amended and Restated Credit Agreement and Loan Documents, dated as of March 1, 2016, by and among California Bank & Trust, a division of ZB, N.A., as Administrative Agent and a Lender, |

First Bank as a Lender and Owens Realty Mortgage, Inc. as Borrower., together with the related Master Revolving Notes, incorporated by reference to exhibits 10.1 through 10.3, respectively, to the current report on Form 8-K filed with the SEC on March 7, 2016

| | |
|---|---|
| * 10.5 | Seventh Amendment to Amended and Restated Credit Agreement, dated as of June 5, 2017, by and among ZB, N.A. dba California Bank & Trust, as Administrative Agent and a Lender, First Bank as a Lender, Umpqua Bank as a Lender, and Owens Realty Mortgage, Inc. as Borrower, together with the related Sixth Amendment to Addendum to Credit Agreement, dated as of June 5, 2017 and Master Notes, incorporated by reference to exhibits 10.1 through 10.5, respectively, to the current report on Form 8-K filed with the SEC on June 9, 2017 |
| * 10.6 | Construction Loan Agreement and Exhibits, dated as of August 3, 2016, between Zalanta Resort at the Village, LLC, Zalanta Resort at the Village – Phase II, LLC and Western Alliance Bank, together with related Secured Promissory Note, Construction Deed of Trust, Deed of Trust, Security Agreement, Omnibus Assignment of Agreements, Environmental Indemnity, Completion Guaranty and Repayment Guaranty, incorporated by reference to exhibits 10.1 through 10.9 of the current report on Form 8-K filed with the SEC on August 8, 2016 |
| * 10.7 | Settlement Agreement, dated December 29, 2017, by and among Owens Realty Mortgage, Inc., Freestone Opportunity Partners LP, Freestone Opportunity Qualified Partners LP, Freestone Investments LLC, Freestone Capital Management, LLC, Freestone Capital Holdings, LLC, Erik Morgan and Gary I. Furukawa, incorporated by reference to exhibit 10.1 of the current report on Form 8-K/A filed with the SEC on January 4, 2018 |
| ** 21.1 | List of Subsidiaries of the Registrant |
| ** 23.1 | Consent of Crowe Horwath LLP |
| ** 24.1 | Power of Attorney |
| ** 31.1 | Certification of CEO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| ** 31.2 | Certification of CFO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| ** 32.1 | Certification of CEO and CFO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| ***101.INS | XBRL Instance Document |
| ***101.SCH | XBRL Taxonomy Extension Schema Document |
| ***101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| ***101.LAB | XBRL Taxonomy Extension Labels Linkbase Document |
| ***101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |
| ***101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |

*Previously filed.
** Filed herewith.
***This exhibit is being furnished rather than filed, and shall not be deemed incorporated by reference into any filing, in accordance with Item 601 of Regulation S-K.

Item 16. FORM 10-K SUMMARY

Not applicable.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

OWENS REALTY MORTGAGE, INC.

Dated: March 13, 2018 By: /s/ Bryan H. Draper
Bryan H. Draper, Chief Executive Officer and President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| | | |
|---|---|---|
| Dated: March 13, 2018 | By: | /s/ William C. Owens<br>William C. Owens, Director and Chairman of the Board |
| Dated: March 13, 2018 | By: | /s/ Bryan H. Draper<br>Bryan H. Draper, Director, Chief Executive Officer and President (Principal Executive Officer) |
| Dated: March 13, 2018 | By: | /s/ Melina A. Platt<br>Melina A. Platt, Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer) |
| Dated: March 13, 2018 | By: | * Dennis G. Schmal<br>Dennis G. Schmal, Director |
| Dated: March 13, 2018 | By: | * Gary C. Wallace<br>Gary C. Wallace, Director |
| Dated: March 13, 2018 | By: | * James M. Kessler<br>James M. Kessler, Director |
| | *By: | /s/ Bryan H. Draper<br>Bryan H. Draper, Attorney-in-fact |

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