

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

**FORM 10-Q**

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

**For the Quarterly Period Ended September 30, 2014**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

Commission file number 000-54957

**OWENS REALTY MORTGAGE, INC.**

(Exact Name of Registrant as Specified in Its Charter)

Maryland _____ (State or Other Jurisdiction of Incorporation or Organization)	46-0778087 _____ (I.R.S. Employer Identification No.)
2221 Olympic Boulevard Walnut Creek, California _____ (Address of Principal Executive Offices)	94595 _____ (Zip Code)

(925) 935-3840

Registrant's Telephone Number, Including Area Code

**NOT APPLICABLE**

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files). Yes  No



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**Part I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**OWENS REALTY MORTGAGE, INC.**  
Consolidated Balance Sheets  
September 30, 2014 and December 31, 2013  
(UNAUDITED)

	<u>September 30,</u> <u>2014</u>	<u>December 31,</u> <u>2013</u>
<b><u>ASSETS</u></b>		
Cash and cash equivalents	\$ 4,060,675	\$ 8,158,734
Restricted cash	5,580,485	4,095,435
Loans, net of allowance for losses of \$4,880,120 and \$4,739,088, respectively	57,353,092	54,057,205
Interest and other receivables	1,953,562	1,673,978
Other assets, net of accumulated depreciation and amortization of \$1,042,776 and \$976,090, respectively	1,104,797	1,102,683
Deferred financing costs, net of accumulated amortization of \$147,376	922,563	95,000
Investment in limited liability company	2,184,939	2,142,582
Real estate held for sale	15,403,511	5,890,131
Real estate held for investment, net of accumulated depreciation of \$5,992,168 and \$9,599,719, respectively	140,540,272	129,425,833
Total Assets	<u>\$ 229,103,896</u>	<u>\$ 206,641,581</u>
<b><u>LIABILITIES AND EQUITY</u></b>		
<b>LIABILITIES:</b>		
Dividends payable	\$ 538,400	\$ 180,000
Due to Manager	195,615	293,776
Accounts payable and accrued liabilities	3,350,699	2,710,745
Deferred gains	687,207	3,313,169
Lines of credit payable	20,852,700	—
Notes payable	14,579,543	13,917,585
Total Liabilities	<u>40,204,164</u>	<u>20,415,275</u>
Commitments and Contingencies (Note 13)		
<b>EQUITY:</b>		
<b>Stockholders' equity:</b>		
Preferred stock, \$.01 par value per share, 5,000,000 shares authorized, no shares issued and outstanding at September 30, 2014 and December 31, 2013	—	—
Common stock, \$.01 par value per share, 50,000,000 shares authorized, 11,198,119 shares issued, 10,768,001 and 10,794,209 shares outstanding at September 30, 2014 and December 31, 2013, respectively	111,981	111,981
Additional paid-in capital	182,437,522	182,437,522
Treasury stock, at cost – 430,118 and 403,910 shares at September 30, 2014 and December 31, 2013, respectively	(5,349,156)	(5,023,668)
Retained earnings	5,089,312	2,348,575
Total stockholders' equity	182,289,659	179,874,410
Noncontrolling interests	6,610,073	6,351,896
Total Equity	<u>188,899,732</u>	<u>186,226,306</u>
Total Liabilities and Equity	<u>\$ 229,103,896</u>	<u>\$ 206,641,581</u>

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

**OWENS REALTY MORTGAGE, INC.**  
Consolidated Statements of Income  
For the Three and Nine Months Ended September 30, 2014 and 2013  
(UNAUDITED)

	<u>For the Three Months Ended</u>		<u>For the Nine Months Ended</u>	
	<u>September 30,</u> <u>2014</u>	<u>September 30,</u> <u>2013</u>	<u>September 30,</u> <u>2014</u>	<u>September 30,</u> <u>2013</u>
<b>Revenues:</b>				
Interest income on loans	\$ 1,399,122	\$ 749,929	\$ 3,564,842	\$ 2,360,891
Gain on foreclosure of loan	—	—	257,020	952,357
Rental and other income from real estate properties	3,262,549	2,887,984	8,936,923	8,408,351
Income from investment in limited liability company	43,686	38,946	126,357	118,572
Other income	—	98	19	1,620
Total revenues	<u>4,705,357</u>	<u>3,676,957</u>	<u>12,885,161</u>	<u>11,841,791</u>
<b>Expenses:</b>				
Management fees to Manager	435,652	373,067	1,275,901	1,264,668
Servicing fees to Manager	39,605	33,915	115,991	115,333
General and administrative expense	285,669	496,088	1,090,876	1,193,954
Rental and other expenses on real estate properties	2,061,330	2,071,900	5,953,775	6,403,757
Depreciation and amortization	549,189	539,532	1,642,922	1,941,887
Interest expense	338,225	129,229	718,707	385,064
Provision for (reversal of) loan losses	117,680	(419,860)	141,032	(7,376,344)
Impairment losses on real estate properties	123,500	—	179,040	—
Total expenses	<u>3,950,850</u>	<u>3,223,871</u>	<u>11,118,244</u>	<u>3,928,319</u>
<b>Operating income</b>	754,507	453,086	1,766,917	7,913,472
Gain on sales of real estate, net	113,113	251,887	2,740,105	2,712,096
<b>Net income</b>	867,620	704,973	4,507,022	10,625,568
Less: Net income attributable to non-controlling interests	(83,797)	(3,899)	(151,752)	(2,063,545)
<b>Net income attributable to common stockholders</b>	<u>\$ 783,823</u>	<u>\$ 701,074</u>	<u>\$ 4,355,270</u>	<u>\$ 8,562,023</u>
 <b>Per common share data:</b>				
Basic and diluted earnings per common share	<u>\$ 0.07</u>	<u>\$ 0.06</u>	<u>\$ 0.40</u>	<u>\$ 0.76</u>
Basic and diluted weighted average number of common shares outstanding	<u>10,768,001</u>	<u>11,196,646</u>	<u>10,768,495</u>	<u>11,197,622</u>
Dividends declared per share of common stock	<u>\$ 0.05</u>	<u>\$ 0.05</u>	<u>\$ 0.15</u>	<u>\$ 0.20</u>

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

**OWENS REALTY MORTGAGE, INC.**  
Consolidated Statements of Stockholders' Equity  
For the Nine Months Ended September 30, 2014 and 2013  
(UNAUDITED)

	<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Treasury Stock</u>		<u>Retained Earnings (Accumulated Deficit)</u>	<u>Total Stockholders' Equity</u>	<u>Non- controlling Interests</u>	<u>Total Equity</u>
	<u>Shares</u>	<u>Amount</u>		<u>Shares</u>	<u>Amount</u>				
Balances, December 31, 2012 As Recast <sup>(1)</sup>	11,198,119	\$ 111,981	\$ 182,985,281	—	\$ —	(3,637,331)	\$ 179,459,931	\$ 8,049,300	\$ 187,509,231
Net income	—	—	—	—	—	8,562,023	8,562,023	2,063,545	10,625,568
Offering costs incurred	—	—	(527,785)	—	—	—	(527,785)	—	(527,785)
Distributions to stockholders for fractional shares upon conversion	—	—	(19,974)	—	—	—	(19,974)	—	(19,974)
Dividends declared	—	—	—	—	—	(2,210,028)	(2,210,028)	—	(2,210,028)
Purchase of treasury stock	—	—	—	(36,680)	(459,634)	—	(459,634)	—	(459,634)
Distributions to non- controlling interests	—	—	—	—	—	—	—	(4,143,304)	(4,143,304)
Balances, September 30, 2013	<u>11,198,119</u>	<u>\$ 111,981</u>	<u>\$ 182,437,522</u>	<u>(36,680)</u>	<u>\$ (459,634)</u>	<u>\$ 2,714,664</u>	<u>\$ 184,804,533</u>	<u>\$ 5,969,541</u>	<u>\$ 190,774,074</u>
Balances, December 31, 2013	11,198,119	\$ 111,981	\$ 182,437,522	(403,910)	(5,023,668)	2,348,575	\$ 179,874,410	\$ 6,351,896	\$ 186,226,306
Net income	—	—	—	—	—	4,355,270	4,355,270	151,752	4,507,022
Dividends declared	—	—	—	—	—	(1,614,533)	(1,614,533)	—	(1,614,533)
Purchase of treasury stock	—	—	—	(26,208)	(325,488)	—	(325,488)	—	(325,488)
Contribution from non- controlling interest	—	—	—	—	—	—	—	112,533	112,533
Distributions to non- controlling interests	—	—	—	—	—	—	—	(6,108)	(6,108)
Balances, September 30, 2014	<u>11,198,119</u>	<u>\$ 111,981</u>	<u>\$ 182,437,522</u>	<u>(430,118)</u>	<u>\$ (5,349,156)</u>	<u>\$ 5,089,312</u>	<u>\$ 182,289,659</u>	<u>\$ 6,610,073</u>	<u>\$ 188,899,732</u>

(1) As recast to reflect the balances of Owens Mortgage Investment Fund, LP combined with the balances of Owens Realty Mortgage, Inc. beginning January 1, 2013, as required under the accounting guidelines for a transfer of an entity under common control (refer to Note 1).

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

**OWENS REALTY MORTGAGE, INC.**  
Consolidated Statements of Cash Flows  
For the Nine Months Ended September 30, 2014 and 2013  
(UNAUDITED)

	<b>September 30,</b> <b>2014</b>	<b>September 30,</b> <b>2013</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 4,507,022	\$ 10,625,568
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Gain on sales of real estate and other assets, net	(2,740,105)	(2,712,096)
Gain on foreclosure of loan	(257,020)	(952,357)
Income from investment in limited liability company	(126,357)	(118,572)
Provision for (reversal of ) loan losses	141,032	(7,376,344)
Impairment losses on real estate properties	179,040	—
Depreciation and amortization of real estate and related assets	1,642,922	1,941,887
Amortization of deferred financing costs to interest expense	78,261	—
Accretion of discount on loan to interest income	(85,403)	—
Changes in operating assets and liabilities:		
Interest and other receivables	(561,304)	580,868
Other assets	(74,934)	(35,441)
Accounts payable and accrued liabilities	(198,465)	(2,213,885)
Due to Manager	(98,161)	(26,958)
Net cash provided by (used in) operating activities	2,406,528	(287,330)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Principal collected on loans	20,857,860	13,978,529
Investment in loans	(27,168,876)	(12,878,852)
Investment in real estate properties	(18,024,721)	(2,032,333)
Net proceeds from disposition of real estate properties and other assets	174,890	11,108,406
Purchases of vehicles and equipment	(7,212)	(13,482)
Transfer (to) from restricted cash	(1,485,050)	2,279,636
Distribution received from investment in limited liability company	84,000	80,000
Net cash (used in) provided by investing activities	(25,569,109)	12,521,904
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Repayments on notes payable	(330,905)	(224,337)
Advances on construction note payable	372,472	—
Advances on lines of credit	41,144,507	—
Repayments on lines of credit	(20,291,807)	—
Payment of deferred financing costs	(354,549)	—
Distributions to noncontrolling interests	(6,108)	(4,143,304)
Contributions from noncontrolling interest	112,533	—
Offering costs incurred and paid	—	(527,785)
Distributions to stockholders for fractional shares	—	(19,974)
Purchase of treasury stock	(325,488)	(459,634)
Dividends paid	(1,256,133)	(3,264,380)
Net cash provided by (used in) financing activities	19,064,522	(8,639,414)
Net (decrease) increase in cash and cash equivalents	(4,098,059)	3,595,160
Cash and cash equivalents at beginning of period	8,158,734	21,131,505
Cash and cash equivalents at end of period	\$ 4,060,675	\$ 24,726,665

Supplemental Disclosures of Cash Flow Information

Cash paid during the period for interest (including amounts capitalized)	\$ 705,238	\$ 469,510
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Supplemental Disclosures of Non-Cash Activity

Increase in real estate from loan foreclosures	\$ 3,241,220	\$ 18,650,121
Increase in accounts payable and accrued liabilities from loan foreclosure	—	(660,000)
Increase in notes payable from loan foreclosure	—	(1,000,000)
Decrease in loans, net of allowance for loan losses, from loan foreclosures	(2,959,500)	(15,609,812)
Decrease in interest and other receivables from adding balances to loans	—	(22,880)
Decrease in interest and other receivables from loan foreclosures	(281,720)	(1,380,309)
Increase in loans from sales of real estate	—	11,900,000
Increase in deferred gains from sales of real estate	—	(2,344,052)
Change in capital expenditures financed through accounts payable	(838,419)	(2,833,940)
Deferred financing costs paid from construction loan	620,391	—
Amortization of deferred financing costs capitalized to construction project	(69,116)	—

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



## OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements (Unaudited)

### **NOTE 1 – ORGANIZATION**

Owens Realty Mortgage, Inc. (the “Company”) was incorporated on August 9, 2012, under the laws of the State of Maryland and was authorized to issue 1,000,000 shares of \$0.01 par value common stock at the time of its incorporation. At the time of its incorporation, William C. Owens was issued 1,000 shares of common stock, \$0.01 par value per share, in exchange for cash consideration of \$1.00 per share (for total consideration of \$1,000). Per the Articles of Amendment and Restatement of the Company dated January 23, 2013, the authorized shares of common stock were increased to 50,000,000 shares, \$0.01 par value per share. In addition, the Company is now 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.

Upon effectiveness of the Merger, the outstanding 1,000 shares of common stock of the Company held by William C. Owens were cancelled in exchange for \$1,000, and every 25 limited partner units of OMIF were converted into one share of common stock of the Company. Additionally, the units representing the general partner interests of the Company’s manager, Owens Financial Group, Inc. (“OFG” or the “Manager”) were treated as follows: i) the 1,496,000 units representing the interest that was an expense of OMIF were cancelled, and ii) the 1,378,256 units representing the interest relating to cash contributions made by OFG to the capital of OMIF were converted into shares of common stock of the Company in the same manner limited partnership units were converted into shares of common stock. No fractional shares were issued in the Merger; instead, cash adjustments were paid in respect of shares otherwise issuable. 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 has been 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 is the carryover basis of OMIF. The consolidated financial statements included in this Form 10-Q 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. In addition, capitalized offering costs incurred during 2012 were reclassified from Other Assets to Additional Paid-in Capital in the accompanying consolidated financial statements.

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”), commencing with the Company’s taxable year ended December 31, 2012. As a REIT, the Company will be permitted to deduct distributions made to its stockholders, allowing its income and gain represented by such distributions to avoid taxation at the entity level and to be taxed generally only at the stockholder level. The Company intends to distribute substantially all of its income and gain. As a REIT, however, the Company will be 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 will be subject to full corporate income tax. Furthermore, the Company’s ability 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**

In the opinion of the management of the Company, the accompanying unaudited financial statements contain all adjustments, consisting of normal, recurring adjustments, necessary to present fairly the financial information included therein. Certain information and footnote disclosures presented in the annual consolidated financial statements are not included in these interim financial statements. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Form 10-K of the Company

## OWENS REALTY MORTGAGE, INC.

### Notes to Consolidated Financial Statements (Unaudited)

for the year ended December 31, 2013 filed with the Securities and Exchange Commission (“SEC”). The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the operating results to be expected for the full year ending December 31, 2014. The Company evaluates subsequent events up to the date it files its Form 10-Q with the SEC.

#### ***Basis of Presentation***

##### **Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly-owned taxable REIT subsidiary (TRS) and its majority- and wholly-owned limited liability companies (see notes 5 and 6). 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, not affecting previously reported net income or total stockholders’ equity, have been made to the previously issued consolidated financial statements to conform to the current period presentation.

##### **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 relate principally to the determination of the allowance for loan losses, including the valuation of impaired loans, the valuation of real estate held for sale and investment, and the estimate of the environmental remediation liability (see notes 4 and 13). Fair value estimates are derived from information available in the real estate markets including similar property and often require the experience and judgment of third parties such as real estate appraisers and brokers. The estimates figure materially in calculating the value of the property at acquisition, the level of charge to the allowance for loan losses and any subsequent valuation reserves or write-downs. Such estimates are inherently imprecise and actual results could differ significantly from such estimates.

##### **Recently Issued Accounting Standards**

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 is effective for the first interim or annual period beginning after December 15, 2016, and is to be applied prospectively. Early adoption is not permitted. The Company is currently evaluating the impact that ASU 2014-09 will have on its financial statements.

In August 2014, the FASB issued ASU 2014-15, “Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern,” or ASU 2014-15. ASU 2014-15 introduces an explicit requirement for management to assess and provide certain disclosures if there is substantial doubt about an entity’s ability to continue as a going concern. ASU 2014-15 is effective for the annual period ending after December 15, 2016. The Company is currently evaluating the impact that ASU 2014-15 will have on its financial statements.

#### ***Significant Accounting Policies***

##### **Cash and Cash Equivalents**

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

## OWENS REALTY MORTGAGE, INC.

### Notes to Consolidated Financial Statements (Unaudited)

#### **Restricted Cash**

Restricted cash includes contingency reserves required pursuant to the Company's charter, non-interest bearing deposits required pursuant to the Company's two lines of credit (see Note 8), the deposit required pursuant to the Company's construction loan payable (see Note 9) and escrow deposits for property taxes and insurance to be paid on certain Company real estate properties.

#### **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 stated at the principal amount outstanding. 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 by 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 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 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 7).

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 a 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 or when monthly payments are delinquent for more than 90 days on a loan. 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

## OWENS REALTY MORTGAGE, INC.

### Notes to Consolidated Financial Statements (Unaudited)

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

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 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 reserve 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.

#### **Other Assets**

Other assets primarily include 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 are capitalized and amortized to interest expense under the straight-line method over the terms of the respective debt instruments. Deferred financing costs related to the construction loan in TOTB North, LLC are being 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. Recognition of gains on the sale of real estate is dependent upon the transaction meeting certain criteria related to the nature of the property and the terms of the sale including potential seller financing.

#### **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

## OWENS REALTY MORTGAGE, INC.

### Notes to Consolidated Financial Statements (Unaudited)

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. Recognition of a gain on the sale of real estate is dependent upon the transaction meeting certain criteria related to the nature of the property and the terms of the sale including potential seller financing.

#### **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 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.

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.

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.

#### **Environmental Remediation Liability**

Liabilities related to future environmental remediation costs are recorded when remediation or monitoring or both are probable and the costs can be reasonably estimated. The Company's environmental remediation liability related to the property located in Santa Clara, California (held within 1850 De La Cruz, LLC – see Notes 4 and 13) was recorded based on a third party consultant's estimate of the costs required to remediate and monitor the

## OWENS REALTY MORTGAGE, INC.

### Notes to Consolidated Financial Statements (Unaudited)

contamination.

#### **Earnings per Common Share**

The Company calculates basic earnings per common share by dividing net income allocable to common stockholders for the period by the weighted-average shares of common stock outstanding for that period. Diluted earnings per common share takes into effect any dilutive instruments, except if when doing so such instruments would be anti-dilutive. At the present time, the Company has not issued any restricted stock or restricted stock units.

#### **Income Taxes**

The Company has elected to be taxed as a REIT. As a result of the Company's REIT status 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 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 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. Lone Star Golf, Inc. is treated as a TRS of the Company.

ASC 740 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. ASC 740 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. 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.

As of September 30, 2014 and December 31, 2013, the Company has not recorded a reserve for any uncertain income tax positions. There has been no interest or penalties incurred to date.

**OWENS REALTY MORTGAGE, INC.**

Notes to Consolidated Financial Statements (Unaudited)

**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 three and nine months ended September 30, 2014 and 2013 and the allocation of the allowance for loan losses and loans as of September 30, 2014 and December 31, 2013 by portfolio segment and by impairment methodology:

<u>2014</u>	<u>Commercial</u>	<u>Residential</u>	<u>Land</u>	<u>Total</u>
<b>Allowance for loan losses:</b>				
<b><u>Three Months Ended September 30, 2014</u></b>				
Beginning balance	\$ 1,507,196	\$ 3,249,975	\$ 5,269	\$ 4,762,440
Charge-offs	—	—	—	—
Provision (reversal)	<u>46,937</u>	<u>70,742</u>	<u>1</u>	<u>117,680</u>
Ending Balance	<u>\$ 1,554,133</u>	<u>\$ 3,320,717</u>	<u>\$ 5,270</u>	<u>\$ 4,880,120</u>
<b><u>Nine Months Ended September 30, 2014</u></b>				
Beginning balance	\$ 932,651	\$ 3,798,203	\$ 8,234	\$ 4,739,088
Charge-offs	—	—	—	—
Provision (reversal)	<u>621,482</u>	<u>(477,486)</u>	<u>(2,964)</u>	<u>141,032</u>
Ending balance	<u>\$ 1,554,133</u>	<u>\$ 3,320,717</u>	<u>\$ 5,270</u>	<u>\$ 4,880,120</u>
<b><u>As of September 30, 2014</u></b>				
Ending balance: individually evaluated for impairment	<u>\$ 618,775</u>	<u>\$ 3,087,345</u>	<u>\$ —</u>	<u>\$ 3,706,120</u>
Ending balance: collectively evaluated for impairment	<u>\$ 935,358</u>	<u>\$ 233,372</u>	<u>\$ 5,270</u>	<u>\$ 1,174,000</u>
Ending balance	<u>\$ 1,554,133</u>	<u>\$ 3,320,717</u>	<u>\$ 5,270</u>	<u>\$ 4,880,120</u>
<b>Loans:</b>				
Ending balance	<u>\$ 43,965,785</u>	<u>\$ 16,257,359</u>	<u>\$ 2,010,068</u>	<u>\$ 62,233,212</u>
Ending balance: individually evaluated for impairment	<u>\$ 17,342,280</u>	<u>\$ 9,614,786</u>	<u>\$ 1,860,068</u>	<u>\$ 28,817,134</u>
Ending balance: collectively evaluated for impairment	<u>\$ 26,623,505</u>	<u>\$ 6,642,573</u>	<u>\$ 150,000</u>	<u>\$ 33,416,078</u>

**OWENS REALTY MORTGAGE, INC.**

Notes to Consolidated Financial Statements (Unaudited)

<u>2013</u>	<u>Commercial</u>	<u>Residential</u>	<u>Land</u>	<u>Total</u>
<b>Allowance for loan losses:</b>				
<b><u>Three Months Ended September 30, 2013</u></b>				
Beginning balance	\$ 1,216,857	\$ 4,378,847	\$ 9,012	\$ 5,604,716
Charge-offs	—	—	—	—
(Reversal) Provision	<u>(420,085)</u>	<u>222</u>	<u>3</u>	<u>(419,860)</u>
Ending Balance	\$ <u>796,772</u>	\$ <u>4,379,069</u>	\$ <u>9,015</u>	\$ <u>5,184,856</u>
<b><u>Nine Months Ended September 30, 2013</u></b>				
Beginning balance	\$ 1,606,925	\$ 4,288,108	\$ 18,522,864	\$ 24,417,897
Charge-offs	—	—	(11,856,697)	(11,856,697)
(Reversal) Provision	<u>(810,153)</u>	<u>90,961</u>	<u>(6,657,152)</u>	<u>(7,376,344)</u>
Ending balance	\$ <u>796,772</u>	\$ <u>4,379,069</u>	\$ <u>9,015</u>	\$ <u>5,184,856</u>
<b><u>As of December 31, 2013</u></b>				
Ending balance: individually evaluated for impairment	\$ <u>537,743</u>	\$ <u>3,087,345</u>	\$ <u>—</u>	\$ <u>3,625,088</u>
Ending balance: collectively evaluated for impairment	\$ <u>394,908</u>	\$ <u>710,858</u>	\$ <u>8,234</u>	\$ <u>1,114,000</u>
Ending balance	\$ <u>932,651</u>	\$ <u>3,798,203</u>	\$ <u>8,234</u>	\$ <u>4,739,088</u>
<b>Loans:</b>				
Ending balance	\$ <u>26,158,878</u>	\$ <u>27,461,913</u>	\$ <u>5,175,502</u>	\$ <u>58,796,293</u>
Ending balance: individually evaluated for impairment	\$ <u>16,566,878</u>	\$ <u>10,195,725</u>	\$ <u>4,975,502</u>	\$ <u>31,738,105</u>
Ending balance: collectively evaluated for impairment	\$ <u>9,592,000</u>	\$ <u>17,266,188</u>	\$ <u>200,000</u>	\$ <u>27,058,188</u>



**OWENS REALTY MORTGAGE, INC.**

Notes to Consolidated Financial Statements (Unaudited)

The following tables show an aging analysis of the loan portfolio by the time past due as of September 30, 2014 and December 31, 2013:

<u>September 30, 2014</u>	<u>Loans 30-59 Days Past Due</u>	<u>Loans 60-89 Days Past Due</u>	<u>Loans 90 or More Days Past Due</u>	<u>Total Past Due Loans</u>	<u>Current Loans</u>	<u>Total Loans</u>
Commercial	\$ —	\$ —	\$ 5,790,698	\$ 5,790,698	\$ 38,175,087	\$ 43,965,785
Residential	—	—	9,614,786	9,614,786	6,642,573	16,257,359
Land	—	—	1,860,068	1,860,068	150,000	2,010,068
	\$ —	\$ —	\$ 17,265,552	\$ 17,265,552	\$ 44,967,660	\$ 62,233,212

  

<u>December 31, 2013</u>	<u>Loans 30-59 Days Past Due</u>	<u>Loans 60-89 Days Past Due</u>	<u>Loans 90 or More Days Past Due</u>	<u>Total Past Due Loans</u>	<u>Current Loans</u>	<u>Total Loans</u>
Commercial	\$ —	\$ 690,000	\$ 5,100,699	\$ 5,790,699	\$ 20,368,179	\$ 26,158,878
Residential	—	—	10,195,725	10,195,725	17,266,188	27,461,913
Land	—	—	4,975,502	4,975,502	200,000	5,175,502
	\$ —	\$ 690,000	\$ 20,271,926	\$ 20,961,926	\$ 37,834,367	\$ 58,796,293

All of the loans that are 90 or more days past due as listed above are on non-accrual status as of September 30, 2014 and December 31, 2013. In addition, two commercial loans totaling \$11,466,179 that are considered impaired were also on non-accrual status as of December 31, 2013 (total of \$31,738,105). These two loans were restored to accrual status during the first quarter of 2014 because the Company had received consistent payments from the borrower over the previous six month period, and management expects that the borrower will continue to keep the loans current with respect to principal and interest payments. These two loans continue to be reported as impaired due to the previous modification of the borrower's terms in a troubled debt restructuring. There is an unamortized discount on one of these loans in the amount of approximately \$573,000 and \$659,000 as of September 30, 2014 and December 31, 2013, respectively.

**OWENS REALTY MORTGAGE, INC.**

Notes to Consolidated Financial Statements (Unaudited)

The following tables show information related to impaired loans as of and for the three and nine months ended September 30, 2014:

	<u>As of September 30, 2014</u>		
	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>
<i>With no related allowance recorded:</i>			
Commercial	\$ 16,432,058	\$ 15,573,528	\$ —
Residential	2,155,333	2,079,786	—
Land	1,860,216	1,860,068	—
<i>With an allowance recorded:</i>			
Commercial	1,913,681	1,768,752	618,775
Residential	7,983,345	7,535,000	3,087,345
Land	—	—	—
<i>Totals:</i>			
Commercial	\$ 18,345,739	\$ 17,342,280	\$ 618,775
Residential	\$ 10,138,678	\$ 9,614,786	\$ 3,087,345
Land	\$ 1,860,216	\$ 1,860,068	\$ —

**OWENS REALTY MORTGAGE, INC.**

Notes to Consolidated Financial Statements (Unaudited)

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<i>With no related allowance recorded:</i>				
Commercial	\$ 16,410,099	\$ 617,507	\$ 16,306,543	\$ 1,405,623
Residential	2,233,235	—	2,374,941	67,733
Land	1,860,216	38,276	2,633,298	132,916
<i>With an allowance recorded:</i>				
Commercial	1,910,269	13,484	1,867,315	39,956
Residential	7,983,345	22,000	7,983,373	96,000
Land	—	—	—	—
<i>Totals:</i>				
Commercial	\$ 18,320,368	\$ 630,991	\$ 18,173,858	\$ 1,445,579
Residential	\$ 10,216,580	\$ 22,000	\$ 10,358,314	\$ 163,733
Land	\$ 1,860,216	\$ 38,276	\$ 2,633,298	\$ 132,916

The following tables show information related to impaired loans as of December 31, 2013 and for the three and nine months ended September 30, 2013:

	As of December 31, 2013		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
<i>With no related allowance recorded:</i>			
Commercial	\$ 16,212,899	\$ 15,488,126	\$ —
Residential	2,734,228	2,660,725	—
Land	5,017,839	4,975,502	—
<i>With an allowance recorded:</i>			
Commercial	1,079,699	1,078,752	537,743
Residential	7,983,345	7,535,000	3,087,345
Land	—	—	—
<i>Totals:</i>			
Commercial	\$ 17,292,598	\$ 16,566,878	\$ 537,743
Residential	\$ 10,717,573	\$ 10,195,725	\$ 3,087,345
Land	\$ 5,017,839	\$ 4,975,502	\$ —

## OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements (Unaudited)

	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<i>With no related allowance recorded:</i>				
Commercial	\$ 13,706,182	\$ 219,319	\$ 9,380,952	\$ 541,670
Residential	2,834,509	33,913	2,865,277	102,754
Land	4,978,579	54,320	4,977,480	218,961
<i>With an allowance recorded:</i>				
Commercial	1,079,699	6,000	1,079,699	18,000
Residential	7,983,345	39,000	7,983,341	166,100
Land	—	—	11,682,004	—
<i>Totals:</i>				
Commercial	\$ 14,785,881	\$ 225,319	\$ 10,460,651	\$ 559,670
Residential	\$ 10,817,854	\$ 72,913	\$ 10,848,618	\$ 268,854
Land	\$ 4,978,579	\$ 54,320	\$ 16,659,484	\$ 218,961

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.

### ***Troubled Debt Restructurings***

The Company had allocated approximately \$3,631,000 and \$3,625,000 of specific reserves on loans totaling approximately \$22,130,000 and \$25,781,000 (recorded investments before reserves) to borrowers whose loan terms had been modified in troubled debt restructurings as of September 30, 2014 and December 31, 2013, respectively. The Company has not committed to lend additional amounts to any of these borrowers.

No loans were modified as troubled debt restructurings during the three and nine months ended September 30, 2014.

During the nine months ended September 30, 2013, the terms of two loans were modified as troubled debt restructurings. One loan was modified to combine all principal, delinquent interest and advances into principal and provide for amortizing payments at a reduced interest rate over an extended maturity of 15 years. The borrower is now delinquent in making payments on this modified loan. Another impaired loan was rewritten by the Company during the quarter ended September 30, 2013 whereby the Company repaid the first deed of trust on the subject property of approximately \$5,899,000 and refinanced its second deed of trust by combining them into one first deed of trust in the amount of \$9,625,000 with interest at 10% per annum due in five years. As part of the modification, approximately \$659,000 of past due interest on the Company's original note was paid from the proceeds of the rewritten loan, which was recorded as a discount against the principal balance of the new loan because the loan was

**OWENS REALTY MORTGAGE, INC.**

Notes to Consolidated Financial Statements (Unaudited)

impaired. Management believes that no specific loan loss allowance is needed on any of these modified loans given the estimated underlying collateral values.

The following tables show information related to loan modifications made by the Company during the three and nine months ended September 30, 2013:

	<b>Modifications During the Three Months Ended September 30, 2013</b>		
	<b>Number of Contracts</b>	<b>Pre-Modification Outstanding Recorded Investment</b>	<b>Post-Modification Outstanding Recorded Investment</b>
<i>Troubled Debt Restructurings That Occurred During the Three Months</i>			
Commercial	1	\$ 2,638,530	\$ 8,966,179

	<b>Modifications During the Nine Months Ended September 30, 2013</b>		
	<b>Number of Contracts</b>	<b>Pre-Modification Outstanding Recorded Investment</b>	<b>Post-Modification Outstanding Recorded Investment</b>
<i>Troubled Debt Restructurings That Occurred During the Nine Months</i>			
Commercial	1	\$ 2,638,530	\$ 8,966,179
Residential	1	272,028	272,028

	<b>Number of Contracts</b>	<b>Recorded Investment</b>
<i>Troubled Debt Restructurings That Subsequently Defaulted During the Nine Month Period</i>		
Residential	1	\$ 272,028

**NOTE 4 – INVESTMENT IN LIMITED LIABILITY COMPANY**

During 2008, the Company entered into an operating agreement (the “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. The property was subject to a Purchase and Sale Agreement dated July 24, 2007 (the “Sale Agreement”), as amended, between the Company, as seller, and Nanook, as buyer. During the course of due diligence under the Sale Agreement, it was discovered that the property was contaminated and that remediation and monitoring may be required. The parties agreed to enter into the Operating Agreement to restructure the arrangement as a joint venture. 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. (See Note 13 for further discussion of the Company’s environmental remediation obligation with respect to the properties owned by 1850.)

## OWENS REALTY MORTGAGE, INC.

### Notes to Consolidated Financial Statements (Unaudited)

The Company received no distributions from 1850 during the three months ended September 30, 2014 and 2013. The Company received distributions from 1850 of \$84,000 and \$80,000 during the nine months ended September 30, 2014 and 2013, respectively. The net income to the Company from its investment in 1850 De La Cruz was approximately \$44,000 and \$39,000 during the three months ended September 30, 2014 and 2013, respectively, and \$126,000 and \$119,000 during the nine months ended September 30, 2014 and 2013, respectively.

#### **NOTE 5 - REAL ESTATE HELD FOR SALE**

Real estate properties held for sale as of September 30, 2014 and December 31, 2013 consists of properties acquired through foreclosure classified by property type as follows:

	<u>September 30,</u> <u>2014</u>	<u>December 31,</u> <u>2013</u>
Residential	\$ 93,647	\$ 93,647
Land	1,527,360	3,427,200
Retail	11,534,319	—
Golf course	2,011,685	1,961,284
Marina	236,500	408,000
	<u>\$ 15,403,511</u>	<u>\$ 5,890,131</u>

During the quarter ended September 30, 2014, the Company transferred one retail property with a carrying value of approximately \$11,534,000 and one residential lot with a carrying value of approximately \$59,000 from “Held for investment” to “Held for sale” because the properties are now listed for sale and sales are expected within the next year.

During the nine months ended September 30, 2014, the Company transferred one parcel of land with a balance of approximately \$1,958,000 from “Held for sale” to “Held for investment” because the property is no longer listed for sale and a sale is not likely within the next year.

During the three and nine months ended September 30, 2014, the Company recorded impairment losses of \$124,000 and \$179,000, respectively, on the marina property located in Oakley, California due to a decrease in the listing price of the property and a reduction in the fair market value recently estimated by management.

During the nine months ended September 30, 2014, gains totaling approximately \$2,626,000 were recognized that had previously been deferred related to the sales of real estate properties in 2012 and 2013. The gains on the sales of the properties are being recognized under the installment method.

During the nine months ended September 30, 2013, the Company sold 45 residential and 2 commercial units located in Oakland, California and held within 1401 on Jackson, LLC via a land sales contract for \$11,000,000 (\$1,000,000 down with interest only payments at 4.5% interest due monthly with all remaining principal and interest due in one year), resulting in a gain to the Company of approximately \$207,000 and deferred gain of approximately \$2,073,000. The carryback loan was repaid by the borrower with partial payments in November 2013 and May 2014 resulting in the full recognition of the deferred gain as of September 30, 2014.

During the nine months ended September 30, 2013, the Company sold a retail complex located in Hilo, Hawaii for \$1,950,000 with a \$250,000 cash down payment and a \$1,700,000 carryback note due in three years with monthly payments of interest only at a starting rate of 5% per annum, resulting in a gain to the Company of approximately \$36,000 and deferred gain of approximately \$246,000. The note called for principal pay downs of \$125,000 each within 30 and 60 days of issuance of the title policy on the property (paid in July and August 2013).

## **OWENS REALTY MORTGAGE, INC.**

### Notes to Consolidated Financial Statements (Unaudited)

During the nine months ended September 30, 2013, the Company sold the remaining parcel of land held within Dation, LLC for \$300,000 with a \$100,000 down payment and a \$200,000 carryback note with interest only payments at 6% per annum due in one year, resulting in a gain to the Company of approximately \$13,000 and deferred gain of approximately \$25,000. The carryback loan was fully repaid by the borrower in May 2014 resulting in the full recognition of the deferred gain as of September 30, 2014.

During the nine months ended September 30, 2013, the Company sold four lots (one including a manufactured home) in a manufactured home subdivision development located in Ione, California for aggregate net sales proceeds of approximately \$73,000 resulting in a net gain to the Company of approximately \$30,000.

#### **720 University, LLC**

The Company has an investment in a limited liability company, 720 University, LLC (“720 University”), which owns a commercial retail property located in Greeley, Colorado. The Company receives 65% of the profits and losses in 720 University after priority return on partner contributions is allocated at the rate of 10% per annum. The assets, liabilities, income and expenses of 720 University have been consolidated into the accompanying consolidated balance sheet and statement of operations of the Company.

The net income to the Company from 720 University was approximately \$107,000 and \$31,000 (including depreciation and amortization of \$107,000 and \$108,000) for the three months ended September 30, 2014 and 2013, respectively, and \$145,000 and \$91,000 (including depreciation and amortization of \$322,000 and \$329,000) for the nine months ended September 30, 2014 and 2013, respectively. The noncontrolling interest of the joint venture partner of approximately \$0 and \$(15,000) as of September 30, 2014 and December 31, 2013, respectively, is reported in the accompanying consolidated balance sheets. The Company’s investment in 720 University real property and improvements was approximately \$11,534,000 and \$11,697,000 as of September 30, 2014 and December 31, 2013, respectively. The Company transferred the 720 University real property from “Held for investment” to “Held for sale” as of September 30, 2014 as the property is listed for sale and a sale is expected in the next year.

#### **1875 West Mission Blvd., LLC**

1875 West Mission Blvd., LLC (“1875”) was a California limited liability company formed for the purpose of owning 22.41 acres of industrial land located in Pomona, California which was acquired by the Company and PNL Company (who were co-lenders in the subject loan) via foreclosure in August 2011. Pursuant to the Operating Agreement, the Company had a 60% membership interest in 1875 and was entitled to collect approximately \$5,078,000 upon the sale of the property after PNL collected all unreimbursed LLC expenses it has paid and \$1,019,000 in its default interest at the time of foreclosure. The land was sold during the nine months ended September 30, 2013 for net sales proceeds of approximately \$9,489,000 resulting in gain on sale of \$2,174,000. As the Company received its basis in 1875 of \$5,078,000 upon sale, after noncontrolling interest expense, there was no net gain or loss attributable to common stockholders.

**OWENS REALTY MORTGAGE, INC.**

Notes to Consolidated Financial Statements (Unaudited)

**NOTE 6 - REAL ESTATE HELD FOR INVESTMENT**

Real estate held for investment as of September 30, 2014 and December 31, 2013 consists of properties acquired through foreclosure classified by property type as follows:

	<u>September 30,</u> <u>2014</u>	<u>December 31,</u> <u>2013</u>
Land (including land under development - see Tahoe Stateline Venture below)	\$ 68,407,529	\$ 46,873,135
Residential	47,466,560	47,037,370
Retail	3,890,967	15,588,452
Office	9,199,850	9,348,331
Industrial	4,516,541	4,605,910
Storage	3,871,858	3,943,780
Marina	<u>3,186,967</u>	<u>2,028,855</u>
	<u>\$ 140,540,272</u>	<u>\$ 129,425,833</u>

The balances of land and the major classes of depreciable property for real estate held for investment as of September 30, 2014 and December 31, 2013 are as follows:

	<u>September 30,</u> <u>2014</u>	<u>December 31,</u> <u>2013</u>
Land and land improvements	\$ 92,460,300	\$ 73,591,953
Buildings and improvements	<u>54,072,140</u>	<u>65,433,599</u>
	146,532,440	139,025,552
Less: Accumulated depreciation	<u>(5,992,168)</u>	<u>(9,599,719)</u>
	<u>\$ 140,540,272</u>	<u>\$ 129,425,833</u>

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

Depreciation expense was approximately \$523,000 and \$517,000 for the three months ended September 30, 2014 and 2013, respectively, and \$1,563,000 and \$1,867,000 for the nine months ended September 30, 2014 and 2013, respectively.

During the quarter ended September 30, 2014, the Company sold one of the improved, residential lots located in West Sacramento, California for \$175,000, resulting in a gain to the Company of approximately \$105,000. The remaining lot was then transferred to "Held for sale" as it is now listed for sale and a sale is expected within the next year.

***2014 Foreclosure Activity***

During the nine months ended September 30, 2014, Sandmound Marina, LLC ("Sandmound") (wholly owned by the Company) foreclosed on a first mortgage loan secured by unimproved land and a marina and campground located in Bethel Island, California with a principal balance of approximately \$2,960,000 and obtained the properties via the trustee's sale. In addition, advances made on the loan or incurred as part of the foreclosure (such as legal fees and delinquent property taxes) in the total amount of approximately \$282,000 were capitalized to the basis of the properties. The fair market values of the properties acquired were estimated to be higher than Sandmound's recorded investment in the subject loan, and, thus, a gain on foreclosure in the amount of approximately \$257,000 was recorded. The properties have been classified as held for investment as sales are not expected within one year.



## OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements (Unaudited)

### **2013 Foreclosure Activity**

During the nine months ended September 30, 2013, Brannan Island, LLC (“Brannan”) (wholly owned by the Company) foreclosed on two first mortgage loans secured by a marina with 179 boat slips located in Isleton, California with an aggregate principal balance of \$1,863,000 and obtained the property via the trustee’s sale. In addition, advances made on the loans or incurred as part of the foreclosures (such as legal fees and delinquent property taxes) in the total amount of approximately \$140,000 were capitalized to the basis of the property. Brannan’s recorded investment in the subject loans at the time of foreclosure approximated the net fair market value of the property so no charge-off or gain on foreclosure was recorded.

During the nine months ended September 30, 2013, Tahoe Stateline Venture, LLC (“TSV”) (wholly owned by the Company) foreclosed on a first mortgage loan secured by two undeveloped parcels of land located in South Lake Tahoe, California that was purchased at a discount during the same period with a principal balance of approximately \$1,401,000 and obtained the property via the trustee’s sale. In addition, advances made on the loan or incurred as part of the foreclosure (including delinquent property taxes) in the total amount of approximately \$335,000 were capitalized to the basis of the property. The fair market value of the land acquired was estimated to be higher than TSV’s recorded investment in the subject loan, and, thus, a gain on foreclosure in the amount of approximately \$952,000 was recorded. See below under “Tahoe Stateline Venture, LLC”.

During the nine months ended September 30, 2013, TSV also foreclosed on three mortgage loans secured by first, second and third deeds of trust secured by ten undeveloped parcels of land located in South Lake Tahoe, California with principal balances totaling approximately \$21,263,000 (total investment of \$23,381,000 including advances made on the loans) and obtained the property via the trustee’s sale. Based on a new appraisal dated June 30, 2013, it was determined that the fair value of the property was higher than the Company’s total investment in the loans (including a previously established loan loss allowance of \$18,333,000), and a reversal to the provision for loan losses of approximately \$6,476,000 was recorded at the time of foreclosure (for a net charge-off of \$11,857,000). See below under “Tahoe Stateline Venture, LLC”.

### **TOTB Miami, LLC**

During 2011, the Company 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 with the other two lenders (which included OFG, the manager of the Company, and PRC Treasures, LLC or “PRC”). The Company and the other lenders formed a Florida limited liability company, TOTB Miami, LLC (“TOTB Miami”), to own and operate the complex. The complex consists of three buildings and an undeveloped parcel of land. Two buildings in which TOTB Miami owns 169 unsold condominium units have been renovated. These units are being leased. A third building containing 160 vacant units is currently under renovation.

In March 2012, the Company made a priority capital contribution to TOTB Miami in the amount of \$7,200,000. TOTB Miami then purchased PRC’s member interest in TOTB Miami for \$7,200,000. Thus, the remaining members in TOTB Miami are now the Company and OFG. The change in capital as a result of the PRC buyout and the amended agreement resulted in an increase to the Company’s capital of approximately \$2,760,000, in addition to the \$7,200,000 paid to acquire PRC’s interest. On the same date, the Company and OFG executed an amendment to the TOTB Miami 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 the properties/TOTB Miami (excluding preferred capital). The preferred capital of \$2,583,000 was returned to the Company as of December 31, 2013 with the excess cash held by TOTB Miami and capital contributions of approximately \$1,520,000 and \$363,000 made by the Company and OFG, respectively.

During the nine months ended September 30, 2014, TOTB Miami contributed the vacant and unimproved 160 unit apartment building to a new wholly-owned entity, TOTB North, LLC (“TOTB North”). TOTB North then entered into a construction loan agreement which will provide up to \$21,304,000 for the purpose of renovating and improving the apartment building (see Note 9). As of September 30, 2014, approximately \$993,000 had been drawn

## OWENS REALTY MORTGAGE, INC.

### Notes to Consolidated Financial Statements (Unaudited)

from the construction loan to fund debt issuance costs and pre-construction costs to date. In addition, TOTB North has entered into various contracts for the design, engineering and first phase demolition and concrete remediation for the renovation project in the aggregate amount of approximately \$2,577,000 of which approximately \$1,079,000 had been incurred as of September 30, 2014. In addition, another \$375,000 in renovation-related costs, interest, property taxes, and amortization of deferred financing costs have been capitalized (total of \$1,454,000) as of September 30, 2014. The Company plans to negotiate and sign the final construction contract for the remainder of the work by the fourth quarter of 2014. During the nine months ended September 30, 2014, the Company and OFG contributed approximately \$453,000 and \$108,000, respectively, to TOTB Miami to fund the \$1,000,000 deposit required pursuant to the construction loan agreement.

The assets, liabilities, income and expenses of TOTB Miami have been consolidated into the accompanying consolidated balance sheets and statements of income of the Company. The noncontrolling interest of OFG totaled approximately \$6,610,000 and \$6,372,000 as of September 30, 2014 and December 31, 2013, respectively.

The net income to the Company from TOTB Miami was approximately \$336,000 and \$110,000 (including depreciation of \$150,000 and \$150,000, respectively) for the three months ended September 30, 2014 and 2013, respectively, and \$545,000 and \$20,000 (including depreciation of \$449,000 and \$748,000) for the nine months ended September 30, 2014 and 2013, respectively.

During the nine months ended September 30, 2013, the properties were moved from "Held for sale" to "Held for investment" as they were no longer being marketed and sales were not expected within the next year. The transfer resulted in the Company recording approximately \$598,000 of depreciation expense during the quarter ended June 30, 2013.

#### **Tahoe Stateline Venture, LLC**

The Company had made a series of loans with aggregate principal balances totaling approximately \$24,203,000. These loans were originally secured by first, second and third deeds of trust on 29 parcels of land with entitlements for a 502,267 square foot resort development located in South Lake Tahoe, California known as Chateau at Lake Tahoe, or the Project. Through multiple foreclosures, 16 of the parcels within the development were acquired by lenders who held senior positions to the Company. In December 2012, the Company acquired seven of those parcels for \$6,600,000, from the foreclosing lenders, that are contiguous to parcels securing the Company's loans. The parcel purchases were made through TSV which is a wholly-owned subsidiary of the Company. TSV paid approximately \$5,697,000 for the parcel purchases, including approximately \$81,000 in closing costs and \$1,691,000 in delinquent property taxes on the parcels. The sellers of the parcels also provided financing for the balance of the purchase prices which totaled \$3,300,000 at 5% interest with interest only, semi-annual payments and all principal due in December 2016 (see Note 9). While these parcels were originally part of the security for the Company's loans, management had chosen not to advance the funds to acquire the parcels at the foreclosure sales in 2010 and 2011 due to the uncertainty surrounding the Project.

In addition to the seven parcels purchased in 2012, in February 2013, TSV acquired the senior note for \$1,400,000 secured by two adjacent parcels on which they held junior loans. In March 2013, TSV acquired these two parcels via a trustee sale.

In February 2013, the Company's beneficial interest in the delinquent loans discussed above was transferred to TSV. In May 2013, TSV foreclosed on all of the remaining deeds of trust secured by ten parcels (not including one parcel where it held a third deed of trust - see below) and gained ownership of the related land.

In July 2013, TSV advanced \$660,000 to obtain a release of a second deed of trust that was senior to TSV's loan on a single parcel of land located on South Lake Tahoe Blvd. and adjacent to the parcels TSV acquired in the May 2013 foreclosure. In July 2013, TSV foreclosed on this parcel, subject to the existing first loan with a principal balance of \$1,000,000 plus accrued interest. In October 2013, the holders of this first loan agreed to restructure the note by waiving all accrued interest in exchange for a \$300,000 principal pay down from TSV. The restructured note (now with a principal balance of \$500,000 after another \$200,000 repayment made during the quarter ended June

## OWENS REALTY MORTGAGE, INC.

### Notes to Consolidated Financial Statements (Unaudited)

30, 2014) is due on August 1, 2017 and requires interest only payments from TSV on a quarterly basis at an interest rate of 5% (see Note 9). The holders of the restructured note also agreed to release from their security another parcel of land that TSV had acquired in the May 2013 foreclosure.

After the final trustee's sale, TSV owned all of the parcels necessary to complete the first retail phase of the Project and began construction in the summer of 2013. TSV signed a construction contract for the first phase of the Project in the amount of \$17,760,000 (including change orders to date) of which approximately \$15,922,000 has been incurred as of September 30, 2014. TSV has capitalized approximately \$21,500,000 in design, engineering, construction and other related development costs (including legal, consulting, property taxes and interest) related to the retail and residential phases of the Project as of September 30, 2014. It is possible that additional change orders will be submitted and construction costs may be higher than expected; however, management believes that the cash flows from operation and/or ultimate sale of the property will be sufficient to cover the Company's recorded investment. Construction on the retail phase is currently scheduled to be completed during the fourth quarter of 2014. The Company has executed lease agreements for approximately 75% of the currently available space as of the date of this filing. Management anticipates that tenant improvements will be completed and tenants will begin paying rent during the fourth quarter of 2014.

In April 2014, TSV finalized the purchase of nine additional parcels of land (and certain related assets) that constitute the balance of parcels in the second phase of the Project and that border the other parcels owned by TSV for \$6,000,000 in cash. As a result of the purchase, TSV now owns 24 parcels encompassing the entire Project (after combining six parcels into one for the retail development and purchase of nine parcels in 2014).

The approximate net income (loss) from Company real estate properties held within wholly-owned limited liability companies and other properties held for investment and sale with significant operating results (including gains/losses from sales and impairment losses) for the nine months ended September 30, 2014 and 2013 are included in the table below. The information presented includes only the revenues and expenses directly related to the properties and no allocations have been made for overhead and other expenses the Company incurs that are not directly related to an individual property.

	<u>September 30,</u> <u>2014</u>	<u>September 30,</u> <u>2013</u>
DarkHorse Golf Club, LLC (golf course sold in 2012)	\$ 1,000	\$ (166,000)
Lone Star Golf, Inc. (previously Lone Star Golf, LLC)	11,000	(62,000)
Baldwin Ranch Subdivision, LLC	(81,000)	(70,000)
The Last Resort and Marina, LLC	(195,000)	(17,000)
54 <sup>th</sup> Street Condos, LLC	24,000	(34,000)
Wolfe Central, LLC	298,000	298,000
AMFU, LLC	(8,000)	38,000
Phillips Road, LLC	85,000	73,000
Broadway & Commerce, LLC	36,000	38,000
Brannan Island, LLC (foreclosed in 2013)	(2,000)	(49,000)
Piper Point Marina- held in Sandmound Marina, LLC (foreclosed in 2014)	(36,000)	—
Light industrial building, Paso Robles, California	138,000	141,000
Undeveloped industrial land, San Jose, California	(92,000)	(84,000)
Office buildings, Roseville, California	4,000	1,000
Office condominium complex, Roseville, California	(23,000)	137,000
Storage facility/business, Stockton, California	231,000	224,000
Undeveloped land, Gypsum, Colorado	(159,000)	(205,000)

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### Notes to Consolidated Financial Statements (Unaudited)

Certain of 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 thirteen 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 September 30, 2014 and thereafter is as follows:

Twelve months ending September 30:	
2015	\$ 6,658,841
2016	3,704,530
2017	2,999,197
2018	2,639,494
2019	2,270,293
Thereafter (through 2026)	<u>3,692,228</u>
	<u>\$ 21,964,583</u>

#### **NOTE 7 - TRANSACTIONS WITH AFFILIATES**

In consideration of the management services rendered to the Company, OFG, the manager, is entitled to receive from the Company a management fee payable monthly, subject to a maximum of 2.75% per annum of the average unpaid balance of the Company's mortgage loans.

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 paid 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 management 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  $\frac{1}{12}$  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 \$436,000 and \$373,000 for the three months ended September 30, 2014 and 2013, respectively, and \$1,276,000 and \$1,265,000 for the nine months ended September 30, 2014 and 2013, respectively, and are included in the accompanying consolidated statements of income. Servicing fees amounted to approximately \$40,000 and \$34,000 for the three months ended September 30, 2014 and 2013, respectively, and \$116,000 and \$115,000 for the nine months ended September 30, 2014 and 2013, respectively, and are included in the accompanying consolidated statements of income. As of September 30, 2014 and December 31, 2013, the Company owed management and servicing fees to OFG in the amount of approximately \$157,000 and \$294,000, respectively.

The maximum servicing fees were paid to OFG during the three and nine months ended September 30, 2014 and 2013. The maximum management fees were paid to OFG during the three and nine months ended September 30, 2014. If the maximum management fees had been paid to OFG during the nine months ended September 30, 2013, the management fees would have been \$1,269,000 (increase of \$4,000), which would have decreased net income by approximately 0.05%.

In determining the management fees to pay to OFG, OFG may consider a number of factors, including current market yields, delinquency experience, un-invested cash and real estate activities. OFG expects that the management fees it receives from the Company will vary in amount and percentage from period to period. However, due to reduced levels of mortgage investments held by the Company, during 2013 and 2014, OFG has chosen to take close to the maximum compensation that it is able to take pursuant to the Management Agreement and will likely continue to take the maximum compensation for the foreseeable future.

Pursuant to the Management Agreement, OFG receives all late payment charges from borrowers on loans owned by the Company. The amounts paid to or collected by OFG for such charges totaled approximately \$2,000

## OWENS REALTY MORTGAGE, INC.

### Notes to Consolidated Financial Statements (Unaudited)

and \$1,000 for the three months ended September 30, 2014 and 2013, respectively, and \$4,000 and \$3,000 for the nine months ended September 30, 2014 and 2013, 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). The amounts paid to or collected by OFG for such fees totaled approximately \$1,000 and \$0 during the three months ended September 30, 2014 and 2013, respectively, and \$2,000 and \$1,000 during the nine months ended September 30, 2014 and 2013, respectively.

OFG originates all loans the Company invests in and receives loan origination and extension fees from borrowers. During the three and nine months ended September 30, 2014, OFG earned approximately \$186,000 and \$726,000, respectively, on loans originated or extended of approximately \$8,025,000 and \$30,226,000, respectively. During the three and nine months ended September 30, 2013, OFG earned approximately \$440,000 and \$464,000 in loan fees on loans originated of \$10,892,000 and \$12,137,000, respectively. Of such fees earned during 2013, \$55,000 was a back end fee that will not be collected by OFG until the subject loan is paid off.

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 (subject to certain limitations in the Management Agreement and the Company's charter). The total OFG reimbursements expensed by the Company for such services were \$167,000 and \$191,000 during the three months ended September 30, 2014 and 2013, respectively, and \$507,000 and \$560,000 during the nine months ended September 30, 2014 and 2013, respectively. As of September 30, 2014, there was approximately \$39,000 payable to OFG for reimbursable expenses and other fees owed and no amounts payable as of December 31, 2013. The Company also reimbursed certain of OFG's officers for allowed expenses in the total amount of \$0 and \$10,000 during the three months ended September 30, 2014 and 2013, respectively, and \$1,000 and \$11,000 during the nine months ended September 30, 2014 and 2013, respectively.

The Company paid Investor's Yield, Inc. (a wholly owned subsidiary of OFG) approximately \$30,000 and \$34,000 during the nine months ended September 30, 2014 and 2013, respectively, in fees primarily related to certain foreclosure proceedings on Company loans.

#### **NOTE 8 – LINES OF CREDIT PAYABLE**

The Company borrows funds under the California Bank & Trust ("CB&T") Line of Credit and the Opus Bank ("Opus") Line of Credit (collectively, the "Funding Agreements"). As of September 30, 2014, the outstanding balances and total commitments under the Funding Agreements consisted of the following:

	As of September 30, 2014		As of December 31, 2013	
	Outstanding Balance	Total Commitment	Outstanding Balance	Total Commitment
CB&T Line of Credit	\$ 17,355,000	\$ 17,355,000	\$ —	\$ —
Opus Bank Line of Credit	<u>3,497,700</u>	<u>11,511,000</u>	<u>—</u>	<u>—</u>
Total	<u>\$ 20,852,700</u>	<u>\$ 28,866,000</u>	<u>\$ —</u>	<u>\$ —</u>

The Funding Agreements are generally collateralized by assignments of specific loans or real estate properties owned by the Company.

#### ***CB&T Line of Credit***

On February 10, 2014, the Company entered into a Credit Agreement and Advance Formula Agreement with California Bank & Trust ("CB&T") as the lender and executed a related Master Revolving Note and Security Agreement, which agreements provide the Company with a new revolving line of credit facility (the "CB&T Credit Facility"). Subject to various conditions, borrowings under the CB&T Credit Facility will be used for general corporate purposes and to finance the origination of new commercial real estate loans.

## OWENS REALTY MORTGAGE, INC.

### Notes to Consolidated Financial Statements (Unaudited)

The maximum borrowings available (total commitment) under the revolving CB&T Credit Facility is the lesser of \$20,000,000, which is the face amount of the Master Revolving Note, or the amount determined pursuant to a borrowing base calculation described in the Advance Formula Agreement. At any time that the aggregate principal amount of the total borrowings under the CB&T Credit Facility exceeds the maximum permitted pursuant to the borrowing base calculation, the Company must promptly repay an amount equal to such excess.

Borrowings under the CB&T Credit Facility mature on February 5, 2016. Such borrowings will bear interest payable monthly, in arrears, on the first business day of each month, at the prime rate of interest established by CB&T from time-to-time plus one quarter percent (.25%) per annum (3.5% at September 30, 2014). Upon a default under the CB&T Credit Facility such interest rate increases by 2.00%. The CB&T Credit Facility required the payment of an origination fee of \$100,000 and other issuance costs and is subject to certain ongoing administrative fees and expenses. As of September 30, 2014, \$177,000 of these costs were paid and capitalized to deferred financing costs and are being amortized to interest expense using the straight-line method through the maturity date of the CB&T Credit Facility.

Interest expense on the CB&T Credit Facility was approximately \$171,000 and \$287,000 during the three and nine months ended September 30, 2014, respectively (including \$23,000 and \$46,000 in amortization of deferred financing costs).

Borrowings under the CB&T Credit Facility are secured by certain assets of the Company. These collateral assets will include the grant to CB&T of first-priority deeds of trust on certain real property assets and trust deeds of the Company to be identified 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 September 30, 2014, the carrying amount and classification of loans and real estate properties securing the CB&T Credit Facility were as follows:

	<b>September 30,</b>
	<b>2014</b>
<b>Loans:</b>	
Commercial	\$ <u>11,505,000</u>
<b>Real Estate:</b>	
Residential	6,824,260
Storage	3,871,858
Industrial	<u>3,049,999</u>
Total	\$ <u>13,746,117</u>

The borrowing base calculation outlined in the Advance Formula Agreement equals the sum of: (a) the lesser of (i) 75% of the outstanding principal balance of those mortgage loan promissory notes issued by the Company in the ordinary course of business that qualify as "Eligible Loan Notes" according to criteria outlined in the Advance Formula Agreement and (ii) 50% of the then-current appraised value of the real property securing such Eligible Loan Notes; plus (b) 50% of the then-current appraised value of the real property owned by the Company that qualifies as "Eligible Owned Real Property" according to criteria outlined in the Advance Formula Agreement.

The CB&T Credit Facility contains affirmative, negative, and financial covenants which are customary for loans of this type, including among others: approvals of new leases or lease renewals with respect to Collateral properties; maintaining the Company's principal bank accounts with CB&T and maintenance of \$2,000,000 of Unencumbered Liquid Assets (reported as part of restricted cash on the accompanying consolidated balance sheets); obligations to use best efforts to keep certain of the Company's properties fully leased; maintenance of minimum debt-to-tangible net worth and debt service coverage ratios; limitations on repurchasing or redeeming stock of the Company; limitations on incurrence of liens or additional indebtedness; restrictions against guarantying debt outside the ordinary course of business; restrictions on asset dispositions, capital or corporate restructuring or other transactions outside the ordinary course of business; and restrictions on making certain investments. Management is not aware of any breach of these covenants as of September 30, 2014.

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### Notes to Consolidated Financial Statements (Unaudited)

The Credit Agreement contains certain events of default (subject to specified thresholds and, in certain cases, cure periods), including among others: nonpayment of principal and other amounts when due; breach of covenants or inaccuracy of representations and warranties; maintenance of required insurance; change in the management, ownership or control of the Company which CB&T believes could have a Material Adverse Effect as defined in the Credit Agreement; cross-default and/or cross-acceleration to other indebtedness; certain bankruptcy or insolvency events; the dissolution, merger or consolidation of the Company or if the Company ceases to do business as a going concern; the issuance of a writ of attachment, seizure or similar process against any part of the Company's property; certain ERISA-related events; entry of non-appealable judgments against the Company that are not covered by insurance, or the entry of a levy or lien of attachment against any assets of the Company or entry by the Company into certain types of settlements; or if CB&T deems itself insecure with respect to the payment obligations of the Company or is of the opinion that a Material Adverse Effect has occurred or could occur. If an event of default occurs and is continuing under the Credit Agreement, CB&T may, among other things, terminate its obligations to lend under the CB&T Credit Facility and require the Company to repay all amounts owed thereunder.

#### ***Opus Bank Line of Credit***

On April 22, 2014, the Company entered into a Secured Revolving Credit Loan Agreement ("Opus Credit Agreement") with Opus as the lender and executed a Promissory Note in favor of Opus, which agreements provide the Company with a new revolving line of credit facility (the "Opus Credit Facility"). As a condition to providing the Opus Credit Facility to the Company, Opus also required the Company's Chairman of the Board, President and Chief Executive Officer, William C. Owens, to enter into a Carveout Payment Guaranty (the "Guaranty"), dated April 22, 2014, in favor of Opus. Mr. Owens' has delivered the Guaranty in his individual capacity and as sole trustee of Owens Trust, a California trust controlled by Mr. Owens, to guarantee performance by the Company of certain specified obligations under the Credit Facility. Subject to various conditions, borrowings under the Opus Credit Facility will be used by the Company for general corporate purposes and to finance the origination of new commercial real estate loans.

The maximum borrowings available (total commitment) under the revolving Opus Credit Facility is the lesser of \$20,000,000, which is the face amount of the Promissory Note, or the Maximum Allowed Advance amount determined pursuant to a borrowing base calculation described in the Opus Credit Agreement. At any time that the aggregate principal amount of the total borrowings under the Opus Credit Facility exceeds the Maximum Allowed Advance permitted pursuant to the borrowing base calculation, the Company must promptly repay an amount equal to such excess.

Advances under the Opus Credit Facility may be made by Opus until April 1, 2016. All borrowings under the Opus Credit Facility bear interest payable monthly, in arrears, on the first business day of each month, as follows: (i) continuing through October 1, 2014 the rate of interest will be 4.5%; (ii) commencing October 1, 2014, and on each successive six month anniversary during the term (the "Rate Change Date"), the rate of interest will be reset to the Six Month LIBOR rate of interest (.33% at September 30, 2014) as reported on such Rate Change Date plus four percent (4.0%) per annum but in no event will the interest rate be lower than 4.5% per annum. Upon a default under the Opus Credit Facility such interest rate increases by an additional 5.00%. Commencing on May 1, 2016, in addition to the required interest payments, the Company is also required to make mandatory monthly principal payments and all amounts under the Opus Credit Facility are to be repaid not later than April 1, 2017.

Borrowings under the Opus Credit Facility will be secured by certain of the Company's assets. These collateral assets will include the following types of assets to be identified by the parties and described in Borrowing Base Collateral Certificates to be entered into by the parties from time-to-time: (i) the grant to Opus of first-priority deeds of trust on certain of the Company's real property assets that meet related eligibility requirements set forth in the Opus Credit Agreement (as further defined in the Opus Credit Agreement, the "REO Collateral"); and (ii) the grant to Opus of a collateral interest in mortgage loan promissory notes issued by the Company in the ordinary course of business that meet related eligibility requirements set forth in the Opus Credit Agreement (as further defined in the Opus Credit Agreement, the "Note Collateral").

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The borrowing base calculation outlined in the Opus Credit Agreement equals the sum of: (a) the lesser of (i) 70% of the outstanding principal balance of the Note Collateral and (ii) 50% of the then-current Appraised Value of the real property securing such Note Collateral; plus (b) 60% of the then-current Appraised Value of the real property owned by the Company that qualifies as REO Collateral. As of September 30, 2014, the carrying amount and classification of loans and real estate properties securing the Opus Credit Facility were as follows:

	<b>September 30,</b>
<b>Loans:</b>	<b>2014</b>
Commercial	\$ <u>5,850,000</u>
<b>Real Estate:</b>	
Office	4,456,356
Industrial	<u>1,466,542</u>
Total	\$ <u>5,922,898</u>

The Opus Credit Facility contains affirmative, negative, and financial covenants which are customary for loans of this type, including among others: approvals of new leases or lease renewals with respect to collateral properties; maintaining a minimum of \$2,500,000 (which increased to \$4,000,000 in October 2014) in bank accounts maintained at Opus (reported as part of restricted cash in the accompanying consolidated balance sheets); compliance by Mr. Owens with all terms of the Guaranty obligations; maintenance of minimum debt-to-tangible net worth and debt service coverage ratios and limitations on making dividends or distributions that could cause a material adverse change in the Company's financial position or have other financial consequences as described in the agreements. Management is not aware of any breach of these covenants as of September 30, 2014.

The Opus Credit Facility required the payment of an origination fee of \$100,000 and other issuance costs and is subject to certain administrative fees and expenses. As of September 30, 2014, \$231,000 of these costs were paid and capitalized to deferred financing costs and are being amortized to interest expense using the straight-line method through the maturity date of the Opus Credit Facility.

Interest expense on the Opus Credit Facility was approximately \$40,000 and \$53,000 during the three and nine months ended September 30, 2014, respectively (including \$19,000 and \$32,000 in amortization of deferred financing costs).

#### **NOTE 9 - NOTES PAYABLE**

The Company had the following notes payable outstanding as of September 30, 2014 and December 31, 2013:

	<b>September 30,</b>	<b>December 31,</b>
	<b>2014</b>	<b>2013</b>
720 University, LLC Note Payable	\$ 9,786,680	\$ 9,917,585
Tahoe Stateline Venture, LLC Notes Payable	3,800,000	4,000,000
TOTB North, LLC Construction Loan Payable	<u>992,863</u>	<u>—</u>
	\$ <u>14,579,543</u>	\$ <u>13,917,585</u>

#### ***720 University, LLC Note Payable***

The Company has a note payable with a bank through its investment in 720 University (see Note 5), which is secured by the retail development located in Greeley, Colorado. The note requires amortized monthly payments of \$56,816 at a fixed rate of 5.07% per annum with the balance of unpaid principal due on March 1, 2015. Interest expense was approximately \$127,000 and \$129,000 for the three months ended September 30, 2014 and 2013, respectively, and \$378,000 and \$385,000 for the nine months ended September 30, 2014 and 2013, respectively.



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#### ***Tahoe Stateline Venture, LLC Notes Payable***

The Company also has three notes payable related to the foreclosure or purchase of nine parcels by TSV in 2013 and 2012. Two of the notes with principal balances totaling \$3,300,000 require semi-annual interest-only payments of 5% per annum and are due in December 2016, and one note with a remaining principal balance of \$500,000 as of September 30, 2014 requires quarterly interest-only payments of 5% per annum and is due in August 2017. The Company repaid \$200,000 of this note during the nine months ended September 30, 2014 to allow demolition of the buildings on the land for the overall development in Phase II of the project. The Company paid approximately \$107,000 and \$83,000 of interest on the notes during the nine months ended September 30, 2014 and 2013, respectively. As of September 30, 2014 and December 31, 2013, there was approximately \$61,000 and \$54,000 in accrued but unpaid interest on these notes. All interest paid/accrued has been capitalized to the basis of the land now under development.

#### ***TOTB North, LLC Construction Loan Payable***

TOTB Miami, LLC contributed the unimproved “North” apartment building and the related 2.37 acre parcel of land to a new wholly owned limited liability company, TOTB North, LLC (“TOTB North” or “Borrower”) during the nine months ended September 30, 2014 and entered into a Construction Loan Agreement (the “Loan Agreement”) with Bank of the Ozarks (“Ozarks”) as the lender providing Borrower with a loan (the “Loan”) of up to \$21,304,000, subject to the terms and conditions of the Loan documents, for the purpose of renovating and improving the Apartments (the “Project”). The Loan is evidenced by the Loan Agreement, a related Promissory Note (the “Note”), a Mortgage, Security Agreement and Fixture Filing (the “Security Agreement”), an Assignment of Rents and Revenues (the “Assignment”), an Environmental Indemnity Agreement (the “Indemnity Agreement”) and a Post-Closing Agreement (the “Post-Closing Agreement”). As a condition to providing the Loan to the Borrower, Ozarks also required a joint and several completion guaranty from the Company and the Manager (the “Completion Guaranty”) with respect to completion of the Apartments, a joint and several repayment guaranty from the Company and the Manager (the “Repayment Guaranty”) that guarantees repayment of the Loan subject to certain limitations and a joint and several carve-out guaranty from the Company and the Manager (the “Carve-Out Guaranty”) and, together with the Completion Guaranty and the Repayment Guaranty, the “Guarantees”) that provides a guaranty with respect to standard “bad-boy” carve-out provisions. Capitalized terms used and not defined herein are further defined in the Loan Agreement and the Note.

The initial maturity date (the “Maturity Date”) of the Loan is June 12, 2017, which may be extended at the option of Borrower for two additional one year periods if a number of conditions are met including, among others, the conditions that there be no defaults, that the Property have a loan to value ratio calculated in accordance with the Loan Agreement at or below 60% at the time of each extension, that the debt service coverage ratio (“DSCR”) of the Property calculated in accordance with the Loan Agreement equals or exceeds 1.25:1 at the time of each extension, that there be no Material Adverse Change relating to Borrower or any Guarantor and that certain additional fees are paid to Ozarks at the time of the extension.

All outstanding borrowings under the Loan will bear interest equal to the floating daily Three Month LIBOR rate of interest plus four percent (4.0%) per annum (the “Note Rate”), but in no event will the Note Rate be lower than the floor rate of four and one-half percent (4.5%) per annum. The Note Rate as of September 30, 2014 was 4.5% per annum. Upon a default under the Loan documents the Note Rate increases by an additional eight percent (8.00%) per annum. Interest only payments are payable monthly, in arrears, on the first business day of each month (the “Payment Date”), until the “Amortization Commencement Date” which is the earlier to occur of (i) December 12, 2015 or (ii) the first Payment Date occurring after the Project is completed and the Property achieves a DSCR of greater than 1.25:1.

Commencing on the Amortization Commencement Date and continuing on each Payment Date thereafter until the Maturity Date, Borrower is required to make, in addition to the interest payment due on such date, a monthly principal payment. The principal payment is calculated monthly based on the principal component of a mortgage-style amortization schedule calculated using the principal balance and the Note Rate as of the corresponding

## OWENS REALTY MORTGAGE, INC.

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Payment Date and a period of 300 months (less the number of any such monthly principal payments made by Borrower prior to the applicable monthly calculation). The balance of the Loan is due on the Maturity Date.

Borrowings under the Loan documents are subject to customary conditions, and, additionally, Ozarks is not required to loan more than \$1.0 million to the Borrower until the Borrower satisfies certain additional conditions detailed in the Post-Closing Agreement (the "Post-Closing Conditions"), including, without limitation, delivery of various completed plans, permits and construction agreements relating to the Project. The Borrower is also required to deposit with Ozarks \$1.0 million, or such greater amount as is required (the "Bridge Equity"), to fund all Project costs incurred prior to the satisfaction of the Post-Closing Conditions. The required deposit of \$1.0 million was made during the quarter ended June 30, 2014 with a capital contribution by TOTB Miami (excess funds held and capital contributions of \$453,000 from the Company and \$108,000 from OFG). Upon satisfaction of the Post-Closing Conditions, Ozarks will reimburse as part of the Loan the amount of the Bridge Equity to Borrower to the extent the proceeds were expended in conformance with the approved Project budget. Management believes that the Post-Closing Conditions will be met sometime during the fourth quarter of 2014 and TOTB North will have access to the remaining balance of the Loan, but there can be no assurance that this will occur when planned.

Borrowings under the Loan Agreement will be secured by: (i) a first mortgage lien on the Property and all improvements, amenities and appurtenances to the Property, (ii) an assignment of all personal property, sales contracts, rents, leases, and ground leases associated with the Property and (iii) all design, development, service, management, leasing and construction contracts associated with the Property. In addition, the Bridge Equity and other reserves established by Ozarks are additional collateral for the Loan.

The Loan documents contain affirmative, negative and financial covenants of the Borrower and the Guarantors which are customary for loans of this type, including, among others, a requirement that the Company in its capacity as a Guarantor maintain: (i) a minimum of \$5,000,000 in unencumbered cash balances and (ii) a minimum Net Worth of \$35,000,000. Management is not aware of any breach of these covenants as of September 30, 2014.

As of September 30, 2014, the Borrower had paid customary closing fees, disbursements and expenses, including an origination fee to Ozarks, which totaled \$622,000. The majority of these costs were paid out of proceeds from the loan and capitalized to deferred financing costs and are being amortized to the construction project using the straight-line method through the Maturity Date. During the three and nine months ended September 30, 2014, approximately \$52,000 and \$69,000, respectively, of deferred financing costs were amortized to the Project. During the three and nine months ended September 30, 2014, approximately \$9,000 and \$10,000, respectively, of interest was incurred which was capitalized to the Project.

The Loan documents contain events of default (subject to specified thresholds and, in certain cases, cure periods) which are customary for loans of this type. If an event of default occurs and is continuing under the Loan documents, Ozarks may, among other things, terminate its obligations to lend and require the Company to repay all amounts owed thereunder, take possession of the Project and proceed to complete the Project at the cost of the Borrower and/or take certain actions against Guarantors pursuant to the Guarantees.

The following table shows maturities by year on these notes payable as of September 30, 2014:

Twelve months ending September 30:	
2015	\$ 9,786,680
2016	—
2017	4,792,863
	<u>\$ 14,579,543</u>

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#### **NOTE 10 – STOCKHOLDERS' EQUITY**

The Company was incorporated on August 9, 2012, under the laws of the State of Maryland and was authorized to issue 1,000,000 shares of \$0.01 par value common stock at the time of its incorporation. Per the Articles of Amendment and Restatement of the Company dated January 23, 2013, the authorized shares of common stock were increased to 50,000,000 shares (at \$0.01 par value per share). In addition, the Company was 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 was approved by a requisite vote of OMIF limited partners on April 16, 2013 and was completed on May 20, 2013.

Per resolutions of the Board of Directors of the Company on August 9, 2012, the Board of Directors authorized the issuance of 1,000 shares of \$0.01 par value common stock to William C. Owens in exchange for cash consideration of \$1.00 per share (for total consideration of \$1,000). Upon effectiveness of the Merger, the outstanding 1,000 shares of common stock of the Company held by William C. Owens were cancelled in exchange for \$1,000, and every 25 limited partner units of OMIF were converted into one share of common stock of the Company. Additionally, the units representing the general partner interests of OFG were treated as follows: i) the 1,496,000 units representing the interest that was an expense of OMIF were cancelled, and ii) the 1,378,256 units representing the interest relating to cash contributions made by OFG to the capital of OMIF were converted into shares of common stock of the Company in the same manner limited partnership units were converted into shares of common stock. No fractional shares were issued in the Merger; instead, cash adjustments were paid in respect of shares otherwise issuable.

On August 9, 2013, the Board of Directors authorized a Rule 10b5-1 stock repurchase plan (the "Repurchase Plan") which permitted the Company to repurchase up to the lesser of \$7 million of its common stock or five percent of the shares of common stock outstanding as of that date. As of September 30, 2014 and December 31, 2013, the Company had repurchased 430,118 and 403,910 shares of its common stock, respectively, for a total cost of approximately \$5,349,000 and \$5,024,000 (including commissions) and an average cost of \$12.44 per share. No further repurchases were made under the Repurchase Plan which expired on May 19, 2014.

#### **NOTE 11 – RESTRICTED CASH**

##### **Contingency Reserves**

In accordance with the charter, the Company is required to maintain cash, cash equivalents and marketable securities as contingency reserves in an aggregate amount of 1-1/2% 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 September 30, 2014 and December 31, 2013 were approximately \$3,896,000 and \$3,895,000, respectively, and are reported as part of restricted cash in the accompanying consolidated balance sheets. The \$4,500,000 required to be held in non-interest bearing accounts as of September 30, 2014 pursuant to the Company's two lines of credit agreements satisfy this contingency reserve requirement (see Note 8).

##### **Escrow Deposits**

Restricted cash includes deposits held in third party escrow accounts to pay property taxes and insurance on Company real estate in the amounts of approximately \$118,000 and \$200,000 as of September 30, 2014 and December 31, 2013, respectively.

##### **Bridge Equity Deposit**

Restricted cash includes the Bridge Equity deposit held by Ozarks to fund all Project costs incurred prior to the satisfaction of the Post-Closing Conditions (net of amounts disbursed for construction costs to date) in the amount of

## OWENS REALTY MORTGAGE, INC.

### Notes to Consolidated Financial Statements (Unaudited)

approximately \$963,000 as of September 30, 2014 (see Note 9).

#### **NOTE 12 – FAIR VALUE**

The Company accounts for 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. Our 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 a specific 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. The fair value of impaired loans is estimated by either an 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 (by licensed appraisers), broker price opinions, comparable properties 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 September 30, 2014 and December 31, 2013, the majority of impaired loans were evaluated based on the fair value of the collateral by obtaining third party appraisals that valued

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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 are disclosed as measured at fair value on a nonrecurring basis. 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 management determines the fair value of the collateral is further impaired below the appraised value or when the current appraisal includes unobservable market data, 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.

#### **Real Estate Held for Sale and Investment**

Real estate held for sale and investment include 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 held for sale properties 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 the future undiscounted cash flows, the Company records the impairment on real estate properties 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 (Unaudited)

The following tables present information about the Company's assets and liabilities measured at fair value on a nonrecurring basis as of September 30, 2014 and December 31, 2013:

	<b>Fair Value Measurements Using</b>			
	<b>Fair Value</b>	<b>Quoted Prices In Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
<b><u>September 30, 2014</u></b>				
<b><u>Nonrecurring:</u></b>				
<b>Impaired loans:</b>				
Commercial	\$ 1,294,906	—	—	\$ 1,294,906
Residential	4,896,000	—	—	4,896,000
<b>Total</b>	<b>\$ 6,190,906</b>	<b>—</b>	<b>—</b>	<b>\$ 6,190,906</b>
<b>Real estate properties:</b>				
Marina	\$ 236,500	—	—	\$ 236,500
Land	2,710,133	—	—	2,710,133
<b>Total</b>	<b>\$ 2,946,633</b>	<b>—</b>	<b>—</b>	<b>\$ 2,946,633</b>
<b><u>December 31, 2013</u></b>				
<b><u>Nonrecurring:</u></b>				
<b>Impaired loans:</b>				
Commercial	\$ 541,956	—	—	\$ 541,956
Residential	4,896,000	—	—	4,896,000
<b>Total</b>	<b>\$ 5,437,956</b>	<b>—</b>	<b>—</b>	<b>\$ 5,437,956</b>
<b>Real estate properties:</b>				
Marina	\$ 408,000	—	—	\$ 408,000
Land	433,920	—	—	433,920
<b>Total</b>	<b>\$ 841,920</b>	<b>—</b>	<b>—</b>	<b>\$ 841,920</b>

The provision for (reversal of) loan losses based on the fair value of loan collateral less estimated selling costs for the impaired loans above totaled approximately \$8,000 and \$(11,000) during the three months ended September 30, 2014 and 2013, respectively, and \$81,000 during the nine months ended September 30, 2014, all of which was from commercial loans. There were no such provisions or reversals on impaired loans above for the nine months ended September 30, 2013. Impairment losses were recorded on real estate properties in the amounts of approximately \$124,000 and \$179,000 during the three and nine months ended September 30, 2014, respectively, all of which related to the marina property included in the table above. No impairment losses were recorded during the three and nine months ended September 30, 2013.

During the nine months ended September 30, 2014 and 2013, there were no transfers in or out of Levels 1 and 2.

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Notes to Consolidated Financial Statements (Unaudited)

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 September 30, 2014 and December 31, 2013:

At September 30, 2014:

<u>Description</u>	<u>Fair Value</u>	<u>Valuation Technique</u>	<u>Significant Unobservable Inputs</u>	<u>Input/Range</u>	<u>Weighted Average</u>
<b>Impaired Loans:</b>					
Commercial	\$ 1,294,906	Appraisal	Estimate of Future Improvements	13.6%	
			Capitalization Rate	5.0 to 6.5%	5.6%
			Comparable Sales Adjustment	(59)% to 32%	(8.9)%
Residential	\$ 4,896,000	Appraisal	Capitalization Rate	5.5%	
			Comparable Sales Adjustment	(19.1)% to 39%	
<b>Real Estate Properties:</b>					
Marina	\$ 236,500	Appraisal	Comparable Sales Adjustment	(186.2)% to (27.1)%	
			Capitalization Rate	8.2%	
			Estimate of Future Improvements	15.8%	
Land	\$ 2,710,133	Appraisal	Comparable Sales Adjustment	(33.3)% to 62.8%	29.8%
			Estimate of Future Improvements	54.1%	
			Discount Rate	8.0%	

At December 31, 2013:

<u>Description</u>	<u>Fair Value</u>	<u>Valuation Technique</u>	<u>Significant Unobservable Inputs</u>	<u>Input/Range</u>	<u>Weighted Average</u>
<b>Impaired Loans:</b>					
Commercial	\$ 541,956	Appraisal	Estimate of Future Improvements	13.6%	
			Capitalization Rate	6.5%	
			Comparable Sales Adjustment	(59)% to (2.3)%	
Residential	\$ 4,896,000	Appraisal	Capitalization Rate	5.5%	
			Comparable Sales Adjustment	(19.1)% to 39%	
<b>Real Estate Properties:</b>					
Marina	\$ 408,000	Appraisal	Comparable Sales Adjustment	(186.2)% to (27.1)%	
			Capitalization Rate	8.2%	
			Estimate of Future Improvements	15.8%	
Land	\$ 433,920	Appraisal	Comparable Sales Adjustment	(33.3)% to 35.5%	7.5%
			Estimate of Future Improvements	54.1%	

**OWENS REALTY MORTGAGE, INC.**

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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.

The approximate carrying amounts and estimated fair values of financial instruments at September 30, 2014 and December 31, 2013 are as follows:

	<u>Carrying Value</u>	<u>Fair Value Measurements at September 30, 2014</u>			
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Financial assets					
Cash and cash equivalents	\$ 4,061,000	\$ 4,061,000	\$ —	\$ —	\$ 4,061,000
Restricted cash	5,580,000	5,580,000	—	—	5,580,000
Loans, net	57,353,000	—	—	58,226,000	58,226,000
Investment in limited liability company	2,185,000	—	—	2,185,000	2,185,000
Interest and other receivables	1,954,000	—	114,000	1,840,000	1,954,000
Financial liabilities					
Due to Manager	\$ 196,000	\$ —	\$ 196,000	\$ —	\$ 196,000
Accrued interest payable	169,000	—	169,000	—	169,000
Lines of credit payable	20,853,000	—	20,853,000	—	20,853,000
Notes payable	14,580,000	—	—	14,607,000	14,607,000

	<u>Carrying Value</u>	<u>Fair Value Measurements at December 31, 2013</u>			
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Financial assets					
Cash and cash equivalents	\$ 8,159,000	\$ 8,159,000	\$ —	\$ —	\$ 8,159,000
Restricted cash	4,095,000	4,095,000	—	—	4,095,000
Loans, net	54,057,000	—	—	54,602,000	54,602,000
Investment in limited liability company	2,143,000	—	—	2,352,000	2,352,000
Interest and other receivables	1,674,000	—	238,000	1,436,000	1,674,000
Financial liabilities					
Due to Manager	\$ 294,000	\$ —	\$ 294,000	\$ —	\$ 294,000
Accrued interest payable	64,000	—	64,000	—	64,000
Notes payable	13,918,000	—	—	13,960,000	13,960,000

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 value of cash and cash equivalents and restricted cash approximates the fair value because of the liquidity and/or relatively short maturity of these instruments and are classified as Level 1.



## OWENS REALTY MORTGAGE, INC.

### Notes to Consolidated Financial Statements (Unaudited)

**Loans, net:** The fair value of loans that are not impaired are 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. The fair values of loans that are impaired are estimated by the Company primarily through the use of third party appraisals of the underlying collateral. Such appraisals often include unobservable market data including adjustments to comparable property sales for such items as location, size and quality to estimate fair values using a sales comparison approach and include cash flow assumptions and capitalization rates used to estimate fair values under an income approach resulting in a Level 3 classification.

**Investment in limited liability company:** The fair value of the Company's investment in limited liability company is estimated based on an appraisal obtained which used unobservable inputs and is classified as Level 3.

**Line of credit payable:** The fair value of the Company's line of credit payable is estimated based upon 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.

**Notes payable:** The fair values of the Company's notes payable are estimated based upon 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 but may be unobservable resulting in a Level 3 classification.

**Other:** The carrying values of interest and other receivables, due to Manager and accrued interest payable are estimated to approximate fair values due to the short term nature of these instruments and are classified as Level 2 (except for accrued interest and advances related to loans which are classified as Level 3).

### **NOTE 13 - COMMITMENTS AND CONTINGENCIES**

#### **Environmental Remediation Obligations**

The Company has an obligation to pay all required costs to remediate and monitor contamination of the real properties owned by 1850 (Note 4). As part of the Operating Agreement executed by the Company and its joint venture partner in 1850, Nanook, the Company has indemnified Nanook against all obligations related to the expected costs to monitor and remediate the contamination. In 2008, the Company had accrued an amount that a third party consultant had estimated will need to be paid to monitor and remediate the site. The majority of clean-up activities were completed during 2012 as part of the tenant's construction of a new building on the site. Thus, approximately \$460,000 was paid by the Company from the previously established liability, and an additional \$100,000 was accrued during the year ended December 31, 2012 as a result of an updated estimate of future costs to be incurred. If additional amounts are required, it will be an obligation of the Company. As of September 30, 2014 and December 31, 2013, approximately \$61,000 and \$63,000 of this obligation remains accrued on the Company's books. All costs for this remediation will be paid from cash reserves.

During the course of due diligence performed by a potential buyer of TOTB Miami in 2012, a low level of arsenic was found in the ground water of a monitoring well located on the property owned by TOTB Miami. While the level of arsenic exceeds the minimum level acceptable for drinking water standards, the water under this property is subject to tidal influence and is not used for domestic consumption. TOTB Miami has retained an environmental consultant to perform additional testing and analysis with the goal of petitioning the appropriate governmental agency to issue a no further action letter for this property due to the low level of contamination and the low quality of the ground water under the property. At this time, the costs of any potential remediation and/or monitoring are unknown and cannot be estimated. As of September 30, 2014 and December 31, 2013, approximately \$78,000 and \$65,000 has been accrued and/or paid for testing and analysis.

## **OWENS REALTY MORTGAGE, INC.**

Notes to Consolidated Financial Statements (Unaudited)

### **Contractual Obligations**

The Company has entered into various contracts related to construction of the retail portion of the land owned by TSV. The aggregate amount of these contracts is approximately \$20,043,000 as of the date of this filing, of which approximately \$18,144,000 was incurred as of September 30, 2014. All costs for this project will be paid from cash reserves, from the recently obtained lines of credit, and/or financing to be obtained in the future. It is possible that additional change orders will be submitted and construction costs may be higher than expected.

The Company has also entered into contracts for the initial demolition and concrete remediation, design, architectural and engineering services related to the renovation of the vacant apartment building owned by TOTB North (see Notes 6 and 9) in the aggregate amount of approximately \$2,577,000 of which approximately \$1,079,000 has been incurred to September 30, 2014 in addition to other capitalized costs related to the construction project of \$375,000 (total of \$1,454,000). All costs for this project will be paid from cash reserves or the recently obtained construction loan.

As of September 30, 2014, the Company has commitments to advance additional funds to borrowers of construction, rehabilitation and other loans in the total amount of approximately \$3,058,000 (including approximately \$781,000 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.

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

### **Forward Looking Statements**

The following discussion provides information to assist you in understanding our financial condition and results of operations. This discussion and analysis contains forward-looking statements. These forward-looking statements include information about possible or assumed future results of our business, financial condition, liquidity, results of operations, plans and objectives. When we use the words "may," "believe," "expect," "anticipate," "estimate," "plan," "continue," "intend," "should," "project" or similar expressions, it intends to identify forward-looking statements. These forward-looking statements are subject to risks and uncertainties, as more particularly set forth in our filings with the Securities and Exchange Commission, including those described in the "Forward Looking Statements" and "Risk Factors" sections of our Annual Report on Form 10-K for the year ended December 31, 2013, that could cause actual results to differ materially from those projected 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 Owens Financial Group, Inc. ("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. Owens Mortgage Investment Fund ("OMIF") was a California Limited Partnership registered with the Securities and Exchange Commission ("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 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 MKT 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 between May and December 2013, the Company originated \$30.2 million of commercial real estate loans (including \$11.9 million in carryback financing from the sales of real estate properties). We originated an additional \$27.2 million in loans during the first nine months of 2014, including the rewrite of two loans in the aggregate amount of \$1.65 million. While we believe the Company is well positioned to capitalize on lending opportunities as the economy continues to recover, 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.

Over the past seven years, we have experienced increased delinquent loans and foreclosures which have created substantial losses. In addition, we now own significantly more real estate than in the past, which has reduced cash flow and net income. As of September 30, 2014, approximately 46% of our loans are impaired and/or past maturity. As of September 30, 2014, we own approximately \$156 million of real estate held for sale or investment, which is approximately 68% of total assets. During the nine month period ended September 30, 2014, we foreclosed on one loan and obtained the two securing properties in the trustee's sale (land and a marina/campground located in Bethel Island, California) with an estimated net fair market value of \$3,498,000. We sold one improved, residential lot for net sales proceeds of \$163,000 and gain of \$105,000 during the nine months ended September 30, 2014. We also recognized an additional \$2,626,000 in deferred gain under the installment method due to full and partial repayments received on carryback loans from the sale of three real estate properties in late 2012 and 2013. We will continue to attempt to sell certain of our properties but may need to sell them for losses or wait until market values recover. 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 order to fit within a REIT "safe harbor" and avoid prohibited transaction tax, we expect to wait to sell any property that would result in tax gain until we have held such property for at least two years after the conversion (May 2015). 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 believes that only three of our delinquent loans will result in loss to the Company (and has caused the Company to record specific allowances for loan losses on such loans), real estate values could decrease further. Management continues to perform frequent evaluations of such collateral values 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 change in the near term, and such changes could be material.

Our website can be found at [www.owensmortgage.com](http://www.owensmortgage.com). We make available through the website, access to our annual and quarterly financial statements, current reports on Form 8-K, and amendments to those reports, as well as proxy statements and other periodic reports and filings submitted to the SEC. We also provide access to our Company presentations, fact sheets, press releases and corporate governance information.

### ***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 and funds from operations, or FFO, through active portfolio management and execution of our business plan which is outlined below:

- Capitalize on market lending opportunity by leveraging our 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.

### ***Current Market Conditions, Risks and Recent Trends***

During 2013 and 2014, the global capital and credit markets continued to slowly recover from the economic downturn which began in 2007. Real estate markets also continued to recover, slowly on a national basis and more significantly in major metropolitan areas, and we expect this trend to continue through 2014 and beyond. 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 embedded 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 and these embedded gains could be substantial. However, despite these improvements, the overall market recovery remains uncertain. Should the economy regress, the commercial real estate sector may experience additional losses and operating challenges.

### **Critical Accounting Policies**

Please refer to the section of the Company's Annual Report on Form 10-K for the year ended December 31, 2013 entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies" for a discussion of our critical accounting policies. During the nine months ended September 30, 2014, there were no material changes to these policies.

In preparing the consolidated financial statements, management is required to make estimates based on the information available that 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 including the accrued interest and advances that are estimated to be unrecoverable based on estimates of amounts to be collected plus estimates of the value of the property as collateral; (2) the valuation of real estate held for sale and investment (at acquisition and subsequently); and (3) the estimate of environmental remediation liabilities. While we believe that these accounting policies and estimates are based on sound measurement criteria, actual future events can and often do result in outcomes that can be materially different from these estimates and forecasts.

### **Results of Operations**

Net income attributable to our common stockholders increased approximately \$83,000 during the three months ended September 30, 2014, as compared to the same period in 2013. The increase was primarily a result of an increase in interest income on loans and rental and other income on real estate totaling approximately \$1,024,000 net of an increase in provision for loan losses, impairment losses on real estate and interest expense totaling approximately \$870,000 and a decrease in gain on sale of real estate of \$139,000 during 2014 as compared to 2013.

Net income attributable to our common stockholders decreased approximately \$4,207,000 during the nine months ended September 30, 2014, as compared to the same period in 2013. The decrease was primarily a result of the 2013 reversal of the provision for loan losses in the amount of approximately \$6,476,000 related to three delinquent loans securing the same property (the Chateau at Lake Tahoe project) that were foreclosed on by TSV during the nine months ended September 30, 2013 based on a new appraisal obtained, which reflected a significant increase in value from the previous appraisal and decreases in the general loan loss allowance during 2013. The impact of this loan loss allowance reversal on the change in net income between 2014 and 2013 was offset by the following:

- An increase in interest income on loans of \$1,204,000 during the nine months ended September 30, 2014, as compared to the same period in 2013, due to an increase in the average balance of performing loans in our portfolio;
- An increase in operating income from real estate properties (excluding amounts from our investment in 1850) of \$1,098,000 during the nine months ended September 30, 2014, as compared to the same period in 2013, as a result of increased rental rates and/or occupancy and decreased operating expenses on certain of our real estate properties held for investment and the sale of certain operating properties during 2013 which

had operating losses during the nine months ended September 30, 2013; and

- A net increase in gain on sale of real estate (after the net effect of gain attributable to noncontrolling interests during 2013) of \$2,202,000 during the nine months ended September 30, 2014, as compared to the same period in 2013, as a result of deferred gains recognized on three properties sold in 2012 or 2013 due to full or partial principal repayments received on the carry back loans during the nine months ended September 30, 2014.

### *Summary of Financial Results*

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2014</u>	<u>2013</u>	<u>2014</u>	<u>2013</u>
Total revenues	\$ 4,705,357	\$ 3,676,957	\$ 12,885,161	\$ 11,841,791
Total expenses	<u>3,950,850</u>	<u>3,223,871</u>	<u>11,118,244</u>	<u>3,928,319</u>
Operating income	754,507	453,086	1,766,917	7,913,472
Gain on sale of real estate	<u>113,113</u>	<u>251,887</u>	<u>2,740,105</u>	<u>2,712,096</u>
Net income	867,620	704,973	4,507,022	10,625,568
Less: Net income attributable to noncontrolling interests	<u>(83,797)</u>	<u>(3,899)</u>	<u>(151,752)</u>	<u>(2,063,545)</u>
Net income attributable to common stockholders	<u>\$ 783,823</u>	<u>\$ 701,074</u>	<u>\$ 4,355,270</u>	<u>\$ 8,562,023</u>
Net income per common share (basic and diluted)	<u>\$ 0.07</u>	<u>\$ 0.06</u>	<u>\$ 0.40</u>	<u>\$ 0.76</u>
Weighted average number of common shares outstanding	<u>10,768,001</u>	<u>11,196,646</u>	<u>10,768,495</u>	<u>11,197,622</u>
Dividends declared per share of common stock	<u>\$ 0.05</u>	<u>\$ 0.05</u>	<u>\$ 0.15</u>	<u>\$ 0.20</u>

### *Three and Nine Months Ended September 30, 2014 Compared to Three and Nine Months Ended September 30, 2013*

#### Total Revenues

Interest income on loans increased \$649,000 (86.6% increase) and \$1,204,000 (51.0% increase) during the three and nine months ended September 30, 2014, as compared to the same periods in 2013. The increases were primarily due to an increase in the average balance of performing loans of approximately 23% and 22%, respectively, and an increase in interest income collected on delinquent/impaired loans of approximately \$350,000 and \$510,000, respectively, during the three and nine months ended September 30, 2014, as compared to the same periods in 2013.

Rental and other income from real estate properties increased \$375,000 (13.0% increase) and \$529,000 (6.3% increase) during the three and nine months ended September 30, 2014, as compared to the same periods in 2013, primarily due to increased rental rates and/or occupancy on certain of our properties during the latter part of 2013 and 2014 and increased income from properties obtained via foreclosure in 2013 and 2014, net of reduced revenue as a result of the sale of three operating properties during 2013.

#### Total Expenses

Management fees amounted to approximately \$436,000 and \$373,000 for the three months ended September 30, 2014 and 2013, respectively, and \$1,276,000 and \$1,265,000 for the nine months ended September 30, 2014 and 2013, respectively. Servicing fees amounted to approximately \$40,000 and \$34,000 for the three months ended September 30, 2014 and 2013, respectively, and \$116,000 and \$115,000 for the nine months ended September 30, 2014 and 2013, respectively.

The maximum management and servicing fees were paid to the Manager during the three and nine months ended September 30, 2014. The maximum servicing fees were paid to the Manager during the three and nine months ended September 30, 2013. If the maximum management fees had been paid to the Manager during the nine months ended September 30, 2013, the management fees would have been \$1,269,000 (increase of \$4,000), which would have decreased net income by approximately 0.05%.

The maximum management fee permitted under our charter is 2.75% per year of the average unpaid balance of mortgage loans. For the years 2011, 2012 and 2013 and the nine months ended September 30, 2014 (annualized), the management fees were 2.19%, 2.67%, 2.74% and 2.75% of the average unpaid balance of mortgage loans, respectively. Although management fees as a percentage of mortgage loans have increased between 2011 and 2014, the total dollar amount of management fees paid to the Manager has decreased because the weighted balance of the loan portfolio has decreased by approximately 42% between 2011 and 2014.

In determining the management fees, the Manager may consider a number of factors, including current market yields, delinquency experience, un-invested cash and real estate activities. The Manager expects that the management fees it receives from us will vary in amount and percentage from period to period. However, due to reduced levels of mortgage investments held by us during the three and nine months ended September 30, 2014, the Manager chose to take close to the maximum compensation that it is able to take pursuant to the charter and will likely continue to take the maximum compensation for the foreseeable future.

General and administrative expense decreased \$210,000 (42.4% decrease) and \$103,000 (8.6% decrease) during the three and nine months ended September 30, 2014, as compared to the same periods in 2013. The decreases were due primarily to additional expenses incurred as a result of the Merger during 2013 including consulting fees and organization costs that were not incurred in the same periods in 2014. In addition, there was a decrease in salary reimbursements to the Manager and tax preparation fees in 2014 as compared to 2013.

Rental and other expenses on real estate properties decreased \$11,000 (0.5% decrease) and \$450,000 (7.0% decrease) during the three and nine months ended September 30, 2014, as compared to the same periods in 2013, primarily due to reduced operating costs on certain of our rental properties during the three and nine month periods and the sales of three operating properties during 2013.

Depreciation and amortization expense increased \$10,000 (1.8% increase) and decreased \$299,000 (15.4% decrease) during the three and nine months ended September 30, 2014 as compared to the same periods in 2013. The decrease during the nine months ended September 30, 2014 was primarily due to the recording of approximately \$598,000 of depreciation on the property held within TOTB Miami, LLC in June 2013 when the property was transferred from "Held for sale" to "Held for investment".

Interest expense increased \$209,000 (161.7% increase) and \$334,000 (86.7% increase) during the three and nine months ended September 30, 2014 as compared to the same periods in 2013, due to interest incurred on our new lines of credit and the amortization of deferred financing costs on the lines of credit to interest expense during the three and nine months ended September 30, 2014.

The provision for loan losses of \$118,000 and \$141,000 during the three and nine months ended September 30, 2014 was the result of an analysis performed on the loan portfolio. The general loan loss allowance increased \$110,000 and \$60,000 during the three and nine months ended September 30, 2014 primarily due to an increase in the balance of non-delinquent loans as a result of new loan originations during 2014 (net of payoffs). There was also an adjustment to the historical loss factor at the beginning of 2014. The specific loan loss allowance increased \$81,000 during the nine months ended September 30, 2014, primarily because a reserve was established during 2014 on a newly impaired loan with a principal balance of \$690,000.

The reversal of the provision for loan losses of \$(420,000) and \$(7,376,000) during the three and nine months ended September 30, 2013 was the result of an analysis performed on the loan portfolio. The general loan loss allowance decreased \$409,000 and \$710,000 during the three and nine month periods in 2013 due to a decrease in the historical loss rate utilized during the second quarter of 2013 and a decrease in the balance of non-delinquent loans during the nine month period. The loss rate applied to non-delinquent loans was lowered as a supplemental loss factor utilized over the past five years for the concentration of loans was no longer applicable given the

Company's loan portfolio and favorable economic and market conditions. The specific loan loss allowance decreased \$11,000 and \$6,666,000 during the three and nine month periods ended September 30, 2013, as reserves were adjusted on five impaired loans, the largest of which was adjusted during the second quarter of 2013 due to a new appraisal obtained near the time of foreclosure.

The impairment losses on real estate properties of \$124,000 and \$179,000 during the three and nine months ended September 30, 2014, respectively, were the result of a decrease in the listing price and a reduction in the fair market value of the marina property located in Oakley, California recently estimated by management.

#### Gain on Sales of Real Estate

Gain on sales of real estate (net of gain attributable to a noncontrolling interest in 2013) decreased \$139,000 and increased \$2,202,000 during the three and nine months ended September 30, 2014, as compared to the same periods in 2013. The increase during the nine months ended September 30, 2014 was a result of the recording of deferred gains under the installment method in the total amount of \$2,626,000 related to the sale of the condominiums located in Santa Barbara, California in 2012 (and held within Anacapa Villas, LLC), the condominiums located in Oakland, California in 2013 (and held within 1401 on Jackson, LLC) and the parcel of land located in Lake Charles, Louisiana in 2013 (and held within Dation, LLC) due to full or partial principal repayments received on the carry back loans during 2014. During the three months ended September 30, 2014, we also sold one of the improved, residential lots located in West Sacramento, California for \$175,000, resulting in a gain of approximately \$105,000. During the nine months ended September 30, 2013, we sold five real estate properties and recognized gains of \$2,712,000. The gain from the sale of one of these properties was offset by net income attributable to a noncontrolling interest of approximately \$2,174,000, as the gain on sale of the property held within 1875 was all attributable to the noncontrolling interest.

#### **Financial Condition**

##### ***September 30, 2014 and December 31, 2013***

#### **Loan Portfolio**

During the quarter ended September 30, 2014, we originated eight new loans with aggregate principal balances totaling \$6,961,000 (one loan in the amount of \$1,036,000 was a rewrite of an existing loan). Four of these new loans are incrementally funded for construction, renovation and/or interest and together with all incrementally funded loans there is \$3,058,000 available to be funded in the future. We also advanced an additional \$276,000 on incrementally funded loans and received full or partial payoffs on five loans totaling \$4,491,000 during the quarter.

The number of loans in our portfolio increased from 22 to 34, and the average loan balance decreased from \$2,673,000 to \$1,830,000, between December 31, 2013 and September 30, 2014.

As of September 30, 2014 and December 31, 2013, we had ten loans that were impaired totaling approximately \$28,817,000 (46%) and \$31,738,000 (54%), respectively. This included seven and five past maturity loans totaling \$17,000,000 (27%) and \$16,908,000 (29%), respectively. In addition, three loans totaling approximately \$1,290,000 (2%) were past maturity but current in monthly payments as of December 31, 2013, (combined total of impaired and past maturity loans of \$28,817,000 (46%) and \$33,028,000 (56%), respectively). Of the impaired and past maturity loans, approximately \$4,978,000 (8%) and \$6,981,000 (12%), respectively, were in the process of foreclosure and no loans involved borrowers who were in bankruptcy as of September 30, 2014 and December 31, 2013.

As of September 30, 2014 and December 31, 2013, approximately \$59,343,000 (95.4%) and \$58,527,000 (99.5%) of our loans are interest-only and 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 mortgage 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 interest 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 is due and payable, but the borrower has failed to make such payment of principal, are referred to as “past maturity loans”. As of September 30, 2014 and December 31, 2013, we had seven and eight past maturity loans totaling approximately \$17,000,000 and \$18,198,000, respectively.

We foreclosed on one and six loans during the nine months ended September 30, 2014 and 2013, respectively, with aggregate principal balances totaling approximately \$2,960,000 and \$26,187,000, respectively, and obtained the properties via the trustee’s sales.

As of September 30, 2014 and December 31, 2013, we held the following types of loans:

	<u>September 30, 2014</u>	<u>December 31, 2013</u>
<u>By Property Type:</u>		
Commercial	\$ 43,965,785	\$ 26,158,878
Residential	16,257,359	27,461,913
Land	2,010,068	5,175,502
	<u>\$ 62,233,212</u>	<u>\$ 58,796,293</u>
<u>By Position:</u>		
Senior loans	\$ 56,313,212	\$ 52,876,293
Junior loans*	5,920,000	5,920,000
	<u>\$ 62,233,212</u>	<u>\$ 58,796,293</u>

\* The junior loans in our portfolio at September 30, 2014 and December 31, 2013 are junior to existing senior loans held by us and are secured by the same collateral.

The types of property securing our commercial real estate loans are as follows as of September 30, 2014 and December 31, 2013:

	<u>September 30, 2014</u>	<u>December 31, 2013</u>
<u>Commercial Real Estate Loans:</u>		
Retail	\$ 4,156,000	\$ 4,140,000
Assisted care	4,021,946	4,021,946
Office	19,405,335	15,484,932
Industrial	3,070,000	1,245,000
Marina	3,200,000	—
Apartment	8,038,800	—
Restaurant	1,037,679	—
Golf course	1,036,025	1,267,000
	<u>\$ 43,965,785</u>	<u>\$ 26,158,878</u>

Scheduled maturities of loans secured by trust deeds as of September 30, 2014 and the interest rate sensitivity of such loans are as follows:

	<u>Fixed Interest Rate</u>	<u>Variable Interest Rate</u>	<u>Total</u>
Year ending September 30:			
2014 (past maturity)	\$ 16,999,648	\$ —	\$ 16,999,648
2015	2,436,025	2,698,183	5,134,208
2016	19,615,947	1,450,000	21,065,947
2017	5,895,923	—	5,895,923
2018	9,051,582	—	9,051,582
2019	2,500,000	—	2,500,000
Thereafter (through Mar. 2028)	265,904	1,320,000	1,585,904
	<u>\$ 56,765,029</u>	<u>\$ 5,468,183</u>	<u>\$ 62,233,212</u>

Variable rate loans may use as indices the one-year, five-year and 10-year Treasury Constant Maturity Index (0.13%, 1.78% and 2.52%, respectively, as of September 30, 2014), the prime rate (3.25% as of September 30, 2014) or the weighted average cost of funds index for Eleventh District savings institutions (0.67% as of September 30, 2014) or include terms whereby the interest rate is adjusted at a specific later date. Premiums over these indices have varied from 2.0% to 6.5% depending upon market conditions at the time the loan is made.

The following is a schedule by geographic location of loans secured by trust deeds as of September 30, 2014 and December 31, 2013:

	<u>September 30, 2014</u>	<u>Portfolio</u>	<u>December 31, 2013</u>	<u>Portfolio</u>
	<u>Balance</u>	<u>Percentage</u>	<u>Balance</u>	<u>Percentage</u>
Arizona	\$ 7,535,000	12.11%	\$ 7,535,000	12.81%
California	42,982,316	69.07%	39,862,058	67.80%
Hawaii	1,450,000	2.33%	1,450,000	2.47%
Louisiana	1,320,000	2.12%	1,520,000	2.58%
Oregon	1,250,000	2.01%	—	—%
Pennsylvania	4,021,946	6.46%	4,021,946	6.84%
Utah	1,813,882	2.91%	2,391,286	4.07%
Washington	1,860,068	2.99%	2,016,003	3.43%
	<u>\$ 62,233,312</u>	<u>100.00%</u>	<u>\$ 58,796,293</u>	<u>100.00%</u>

As of September 30, 2014 and December 31, 2013, our loans secured by real property collateral located in Northern California totaled approximately 65% (\$40,284,000) and 55% (\$32,362,000), 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. In addition, as of September 30, 2014 approximately 81% of our loans were secured by real estate located in the states of California and Arizona, which, up until recently, have experienced dramatic reductions in real estate values over the past seven years.

The allowance for loan losses increased by \$141,000 and decreased by \$19,233,000 (reversal of provision and charge-offs) during the nine months ended September 30, 2014 and 2013, respectively. The Manager believes that the allowance 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 the allowance for loan losses, but there can be no absolute assurance that the allowance is sufficient. Because any decision regarding 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 our 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 nine months ended September 30, 2014 and 2013 were as follows:

	<u>September 30, 2014</u>	<u>September 30, 2013</u>
Balance, beginning of period	\$ 4,739,088	\$ 24,417,897
Provision for (reversal of) loan losses	141,032	(7,376,344)
Charge-offs	<u>—</u>	<u>(11,856,697)</u>
Balance, end of period	<u>\$ 4,880,120</u>	<u>\$ 5,184,856</u>

As of September 30, 2014 and December 31, 2013, there was a general allowance for loan losses of \$1,174,000 and \$1,114,000, respectively, and a specific allowance for loan losses on three and two loans in the total amount of \$3,706,120 and \$3,625,088, respectively.

### Real Estate Properties Held for Sale and Investment

As of September 30, 2014, we held title to twenty-nine properties that were acquired through foreclosure with a total carrying amount of approximately \$155,944,000 (including properties held in one corporation and twelve limited liability companies), net of accumulated depreciation on real estate held for investment of \$5,992,000. As of September 30, 2014, properties held for sale total \$15,404,000 and properties held for investment total \$140,540,000. When we acquire property by foreclosure, we typically earn less income on those properties than could be earned on loans and may not be able to sell the properties in a timely manner.

Real estate properties held for sale as of September 30, 2014 and December 31, 2013 consists of the following properties acquired through foreclosure:

	<u>September 30, 2014</u>	<u>December 31, 2013</u>
Retail complex, Greeley, Colorado (held within 720 University, LLC) – transferred from held for investment as of September 30, 2014	\$ 11,534,319	\$ —
Undeveloped, industrial land, San Jose, California - transferred to held for investment as of June 30, 2014	—	1,958,400
Undeveloped, commercial land, Half Moon Bay, California	1,468,800	1,468,800
One improved residential lot, West Sacramento, California – transferred from held for investment as of September 30, 2014	58,560	—
Marina with 30 boat slips and 11 RV spaces, Oakley, California (held within The Last Resort and Marina, LLC)	236,500	408,000
Golf course, Auburn, California (held within Lone Star Golf, Inc.)	2,011,685	1,961,284
1/7 <sup>th</sup> interest in single family home, Lincoln City, Oregon	<u>93,647</u>	<u>93,647</u>
	<u>\$ 15,403,511</u>	<u>\$ 5,890,131</u>

Real estate held for investment is comprised of the following properties as of September 30, 2014 and December 31, 2013:

	<u>September 30,</u> <u>2014</u>	<u>December 31,</u> <u>2013</u>
Light industrial building, Paso Robles, California	\$ 1,466,542	\$ 1,489,120
Office buildings, Roseville, California	740,698	767,077
Undeveloped, industrial land, San Jose, California – transferred from held for sale as of June 30, 2014	1,958,400	—
Retail complex, Greeley, Colorado (held within 720 University, LLC) – transferred to held for sale as of September 30, 2014	—	11,697,485
Undeveloped, residential land, Madera County, California	726,580	726,580
Undeveloped, residential land, Marysville, California	403,200	403,200
Undeveloped land, Auburn, California (held within DarkHorse Golf Club, LLC)	103,198	103,198
75 improved, residential lots, Auburn, California (held within Baldwin Ranch Subdivision, LLC)	3,878,544	3,878,544
Storage facility/business, Stockton, California	3,871,858	3,943,780
Two improved residential lots, West Sacramento, California – one lot sold and one transferred to held for sale as of September 30, 2014	—	117,120
Undeveloped, residential land, Coolidge, Arizona	1,017,600	1,017,600
Office condominium complex (15 units), Roseville, California	3,715,657	3,810,020
Industrial building, Sunnyvale, California (held within Wolfe Central, LLC)	3,049,999	3,116,791
133 condominium units, Phoenix, Arizona (held within 54 <sup>th</sup> Street Condos, LLC)	6,824,260	7,097,056
Medical office condominium complex, Gilbert, Arizona (held within AMFU, LLC)	4,743,494	4,771,234
61 condominium units, Lakewood, Washington (held within Phillips Road, LLC)	4,401,014	4,509,828
Commercial buildings, Sacramento, California	3,890,968	3,890,968
169 condominium units and 160 unit unoccupied apartment building, Miami, Florida (held within TOTB Miami, LLC)	33,820,494	33,017,315
12 condominium and 3 commercial units, Tacoma, Washington (held within Broadway & Commerce, LLC)	2,420,792	2,413,170
6 improved residential lots, Coeur D’Alene, Idaho	316,800	316,800
Unimproved, residential and commercial land, Gypsum, Colorado	5,813,434	5,814,418
Commercial land under development, South Lake Tahoe, California (held within Tahoe Stateline Venture, LLC)	51,855,000	34,495,674
Marina and yacht club with 179 boat slips, Isleton, California (held within Brannan Island, LLC)	2,035,036	2,028,855
Unimproved, residential and commercial land, Bethel Island, California (held within Sandmound Marina, LLC)	2,334,773	—
Marina with 52 boat slips and campground, Bethel Island, California (held within Sandmound Marina, LLC)	1,151,931	—
	<u>\$ 140,540,272</u>	<u>\$ 129,425,833</u>

Changes in real estate held for sale and investment during the nine months ended September 30, 2014 and 2013 were as follows:

	<u>September 30,</u> <u>2014</u>	<u>September 30,</u> <u>2013</u>
Balance, beginning of period	\$ 135,315,964	\$ 127,773,349
Real estate acquired through foreclosure, net of specific loan loss allowance	3,498,240	19,602,478
Investments in real estate properties	18,932,256	4,916,273
Sales of real estate properties	(60,427)	(17,988,406)
Impairment losses on real estate properties	(179,040)	—
Depreciation of properties held for investment	<u>(1,563,210)</u>	<u>(1,866,767)</u>
Balance, end of period	<u>\$ 155,943,783</u>	<u>\$ 132,436,927</u>

Fourteen of our twenty-nine properties do not currently generate revenue. Expenses from real estate properties (not including depreciation) have decreased from approximately \$6,404,000 to \$5,954,000 (7.0% decrease) for the nine months ended September 30, 2013 and 2014, respectively, and revenues associated with these properties have increased from approximately \$8,408,000 to \$8,937,000 (6.3% increase), thus generating net income from real estate properties of \$2,983,000 during the nine months ended September 30, 2014 (compared to \$2,005,000 for the same period in 2013).

During the quarter ended September 30, 2014, we transferred one retail property with a carrying value of approximately \$11,534,000 and one residential lot with a carrying value of approximately \$59,000 from “Held for investment” to “Held for sale” because the properties are now listed for sale and sales are expected within the next year.

During the nine months ended September 30, 2014, we transferred one parcel of land with a balance of approximately \$1,958,000 from “Held for sale” to “Held for investment” because the property is no longer listed for sale and a sale is not likely within the next year.

During the three and nine months ended September 30, 2014, we recorded impairment losses of \$124,000 and \$179,000, respectively, on the marina property located in Oakley, California due to a decrease in the listing price of the property and a reduction in the fair market value recently estimated by management.

### ***Sales Activity***

During the quarter ended September 30, 2014, we sold one of the improved, residential lots located in West Sacramento, California for \$175,000, resulting in a gain of approximately \$105,000. The remaining lot was then transferred to “Held for sale” as it is now listed for sale and a sale is expected within the next year.

We recognized gains of approximately \$2,626,000 during the nine months ended September 30, 2014 that had previously been deferred related to the sales of real estate properties in 2012 and 2013. The gains on the sales of those properties were being accounted for under the installment method.

During the nine months ended September 30, 2013, we sold 45 residential and 2 commercial units located in Oakland, California and held within 1401 on Jackson, LLC via a land sales contract for \$11,000,000 (\$1,000,000 down with interest only payments of 4.5% interest due monthly with all remaining principal and interest due in one year), resulting in a gain of approximately \$207,000 and deferred gain of approximately \$2,073,000. The carry back loan was repaid by the borrower with partial payments in November 2013 and May 2014 resulting in the full recognition of the deferred gain as of September 30, 2014.

During the nine months ended September 30, 2013, we sold a retail complex located in Hilo, Hawaii for \$1,950,000 with a \$250,000 cash down payment and a \$1,700,000 carryback note due in three years with monthly payments of interest only at a starting rate of 5% per annum, resulting in a gain of approximately \$36,000 and

deferred gain of approximately \$246,000. The note called for principal pay downs of \$125,000 each within 30 and 60 days of issuance of the title policy on the property (paid in July and August 2013).

During the nine months ended September 30, 2013, we sold the remaining parcel of land held within Dation, LLC for \$300,000 with a \$100,000 down payment and a \$200,000 carryback note with interest only payments at 6% per annum due in one year, resulting in a gain of approximately \$13,000 and deferred gain of approximately \$25,000. The carryback loan was fully repaid by the borrower in May 2014 resulting in the full recognition of the deferred gain as of September 30, 2014.

During the nine months ended September 30, 2013, we sold four lots (one including a manufactured home) in the manufactured home subdivision development located in Ione, California for aggregate net sales proceeds of approximately \$73,000 resulting in a net gain of approximately \$30,000.

1875 West Mission Blvd., LLC ("1875") was a California limited liability company formed for the purpose of owning 22.41 acres of industrial land located in Pomona, California which was acquired by the Company and PNL (who were co-lenders in the subject loan) via foreclosure in August 2011. Pursuant to the Operating Agreement, the Company had a 60% membership interest in 1875 and was entitled to collect approximately \$5,078,000 upon the sale of the property after PNL collects any unreimbursed LLC expenses it has paid and \$1,019,000 in its default interest at the time of foreclosure. The land was sold during the nine months ended September 30, 2013 for net sales proceeds of approximately \$9,489,000 resulting in gain on sale of \$2,174,000. As we received our basis in 1875 of \$5,078,000 upon sale, after noncontrolling interest, there was no net gain or loss attributable to common stockholders.

#### ***Foreclosure Activity***

During the nine months ended September 30, 2014, Sandmound foreclosed on a first mortgage loan secured by unimproved land and a marina and campground located in Bethel Island, California with a principal balance of \$2,960,000 and obtained the properties via the trustee's sale. In addition, advances made on the loan or incurred as part of the foreclosure (such as legal fees and delinquent property taxes) in the total amount of approximately \$282,000 were capitalized to the basis of the properties. The fair market values of the properties acquired were estimated to be higher than Sandmound's recorded investment in the subject loan, and, thus, a gain on foreclosure in the amount of approximately \$257,000 was recorded. The properties have been classified as held for investment as sales are not expected within one year.

During the nine months ended September 30, 2013, Brannan Island, LLC (wholly owned by the Company) foreclosed on two first mortgage loans secured by a marina with 179 boat slips located in Isleton, California with an aggregate principal balance of \$1,863,000 and obtained the property via the trustee's sale. In addition, advances made on the loans or incurred as part of the foreclosures (such as legal fees and delinquent property taxes) in the total amount of approximately \$140,000 were capitalized to the basis of the property. The amount capitalized at the time of foreclosure approximated the net fair market value of the property.

During the nine months ended September 30, 2013, TSV (wholly owned by the Company) foreclosed on a first mortgage loan secured by two undeveloped parcels of land located in South Lake Tahoe, California that was purchased at a discount during the same period with a principal balance of approximately \$1,401,000 and obtained the property via the trustee's sale. In addition, advances made on the loan or incurred as part of the foreclosure (including delinquent property taxes) in the total amount of approximately \$335,000 were capitalized to the basis of the property. The fair market value of the land acquired was estimated to be higher than TSV's recorded investment in the subject loan, and, thus, a gain on foreclosure in the amount of approximately \$952,000 was recorded.

During the nine months ended September 30, 2013, TSV also foreclosed on three mortgage loans secured by first, second and third deeds of trust secured by ten undeveloped parcels of land located in South Lake Tahoe, California with principal balances totaling approximately \$21,263,000 (total investment of \$23,381,000 including advances made on the loans) and obtained the property via the trustee's sale. Based on an appraisal dated June 30, 2013, it was determined that the fair value of the property was higher than the Company's total investment in the loans (including a previously established loan loss allowance of \$18,333,000), and a reversal to the provision for loan losses of approximately \$6,476,000 was recorded at the time of foreclosure (for a net charge-off of

\$11,857,000). TSV foreclosed on its remaining deed of trust secured by one parcel of land located in South Lake Tahoe, California in July 2013.

### **Cash and Cash Equivalents**

Cash and cash equivalents decreased from approximately \$8,159,000 as of December 31, 2013 to \$4,061,000 as of September 30, 2014 (\$4,098,000 or 50.2% decrease) due primarily to continued construction costs on the retail project owned by TSV and investments in new loans totaling approximately \$45,194,000, net of repayments of loans and net advances from the line of credit totaling approximately \$41,711,000 during the nine month period. In addition, approximately \$3,752,000 of cash was used for the payment of deferred financing costs, repayment of notes payable, purchase of treasury stock, payment of dividends and transfer to restricted cash during the period.

### **Interest and Other Receivables**

Interest and other receivables increased from approximately \$1,674,000 as of December 31, 2013 to \$1,954,000 as of September 30, 2014 (\$280,000 or 16.7% increase) due primarily to an increase in interest income receivable on loans as the balance of performing loans in the portfolio increased between December 31, 2013 and September 30, 2014 and increased advances related to impaired loans.

### **Deferred Financing Costs**

Deferred financing costs increased from approximately \$95,000 as of December 31, 2013 to \$923,000 as of September 30, 2014 (\$828,000 increase) due primarily to additional debt issuance costs paid or incurred related to our new lines of credit executed during 2014, for a new construction loan executed by TOTB North (wholly owned by TOTB Miami) to finance the renovation of the vacant apartment building in Miami, Florida and paid as deposits for two new potential loans securing our real estate assets in the aggregate amount of \$975,000, net of amortization of deferred financing costs of approximately \$147,000 during the period.

### **Dividends Payable**

Dividends payable increased from approximately \$180,000 as of December 31, 2013 to \$538,000 as of September 30, 2014 because the Board of Directors approved the payment of dividends on a quarterly basis rather than on a monthly basis in their January 2014 meeting. The Board of Directors declared a quarterly dividend on September 20, 2014 of \$0.05 per share or approximately \$538,000 that was paid on October 14, 2014 to stockholders of record at the close of business on September 30, 2014.

### **Accounts Payable and Accrued Liabilities**

Accounts payable and accrued liabilities increased from approximately \$2,711,000 as of December 31, 2013 to approximately \$3,351,000 as of September 30, 2014 (\$640,000 or 23.6% increase) due primarily to increased payables related to the renovation activities on the property owned by TOTB North and accrued property taxes payable on our real estate properties as of September 30, 2014.

### **Deferred Gains**

Deferred gains decreased from approximately \$3,313,000 as of December 31, 2013 to approximately \$687,000 as of September 30, 2014 (\$2,626,000 or 79.3% decrease) due to partial and full principal repayments received on three carryback loans during the nine months ended September 30, 2014, resulting in the recognition of additional gain under the installment method of \$2,626,000.

### **Lines of Credit Payable**

Lines of credit payable increased from \$0 as of December 31, 2013 to \$20,853,000 as of September 30, 2014. We executed two new line of credit agreements with two banks during 2014 and began to borrow from the lines during the nine month period.

## **Notes Payable**

Notes payable increased from \$13,918,000 as of December 31, 2013 to \$14,580,000 (\$662,000 or 4.8% increase) due primarily to the new construction loan obtained by TOTB North (wholly owned by TOTB Miami) and advances from the loan totaling \$993,000 to fund deferred financing and pre-construction costs. This increase was partially offset by a \$200,000 partial principal repayment made on one of the TSV notes and \$131,000 in amortization payments made on the 720 University note during the nine months ended September 30, 2014.

## **Noncontrolling Interests**

Noncontrolling interests increased from approximately \$6,352,000 as of December 31, 2013 to approximately \$6,610,000 as of September 30, 2014 (\$258,000 or 4.1% increase), due primarily to a contribution made by OFG to TOTB Miami to fund the deposit required pursuant to the new construction loan executed by TOTB North.

## **Non-GAAP Financial Measures**

### ***Funds from Operations***

We utilize supplemental non-GAAP measures of operating performance, including funds from operations ("FFO"), an industry-wide standard measure of REIT operating performance. We believe FFO provides investors with additional information concerning our operating performance and a basis to compare our performance with that of other REITs. We determine FFO in accordance with the standards established by the National Association of Real Estate Investment Trusts ("NAREIT"), as net income (loss) attributable to common stockholders (computed in accordance with GAAP), plus depreciation and amortization of real estate and other assets, amortization of deferred financing costs, impairments of real estate assets, provisions for loan losses and losses from sales of real estate, reduced by gains from sales of real estate and foreclosures of loans, accretion of discounts on loans and extraordinary items, and after adjustments for unconsolidated ventures.

Our calculation of FFO may not be comparable to similar measures reported by other REITs. This non-GAAP financial measure should not be considered as an alternative to net income as a measure of our operating performance or to cash flows computed in accordance with GAAP as a measure of liquidity, nor is it indicative of cash flows from operating and financial activities.

We urge investors to carefully review the GAAP financial information included as part of our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and quarterly earnings releases.



The following table reconciles FFO to comparable GAAP financial measures:

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2014	September 30, 2013	September 30, 2014	September 30, 2013
<b>Funds from Operations</b>				
Net income attributable to common stockholders	\$ 783,823	\$ 701,074	\$ 4,355,270	\$ 8,562,023
Adjustments:				
Depreciation and amortization of real estate and other assets	549,189	539,532	1,642,922	1,941,887
Amortization of deferred financing costs	42,335	—	78,261	—
Depreciation allocated to non-controlling interests	(32,241)	(31,404)	(96,806)	(151,919)
Accretion of discount on loan to interest income	(36,600)	—	(85,403)	—
Provisions for impairment of real estate assets	123,500	—	179,040	—
Provision for (reversal of) loan losses	117,680	(419,860)	141,032	(7,376,344)
Gain on sales of real estate assets	(113,113)	(251,887)	(2,740,105)	(2,712,096)
Gain on foreclosure of loan	—	—	(257,020)	(952,357)
Adjustments for unconsolidated ventures	(43,686)	(38,946)	(42,357)	(38,572)
FFO attributable to common stockholders	<u>\$ 1,390,887</u>	<u>\$ 498,509</u>	<u>\$ 3,174,834</u>	<u>\$ (727,378)</u>
Basic and diluted FFO per common share	<u>\$ 0.13</u>	<u>\$ 0.04</u>	<u>\$ 0.29</u>	<u>\$ (0.06)</u>

### 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 our control. 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 institutional 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 the Company's loan portfolio and current economic conditions. Such evaluation, which includes a review of all loans on which the management determines that full collectability may not be reasonably assured, considers among other matters the following:

- 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 losses. 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 September 30, 2014, management believes that the allowance for loan losses of approximately \$4,880,000 is adequate in amount to cover probable incurred losses. Because of the number of variables involved, the magnitude of 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 September 30, 2014, ten loans totaling \$28,817,000 were impaired. This includes seven past maturity loans totaling \$17,000,000. After management's evaluation of the loan portfolio, we recorded an increase in the allowance for loan losses of approximately \$141,000 during the nine months ended September 30, 2014 (increase in specific loan loss allowance of \$81,000 and increase in general allowance of \$60,000). Management believes that the specific allowance for loan losses is sufficient given the estimated fair values of the underlying collateral of impaired and past maturity loans.

### **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.

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 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; and
- to distribute 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.

We intend to meet these liquidity requirements primarily through the following:

- the use of our cash and cash equivalent balances of \$4,061,000 as of September 30, 2014;
- 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 new revolving lines of credit;
- proceeds from the new construction loan obtained by TOTB North;
- proceeds from future borrowings, including potential temporary and/or permanent financing on the TSV property; and
- proceeds from potential future offerings of our equity securities.

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

	<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
Net cash provided by (used in) operating activities	\$ 2,406,528	\$ (287,330)
Net cash (used in) provided by investing activities	(25,569,109)	12,521,904
Net cash provided by (used in) financing activities	19,064,522	(8,639,414)

During the nine months ended September 30, 2014, our cash and cash equivalents decreased approximately \$4,098,000 primarily due to investments in new loans and capitalized costs related to construction on the retail portion of the land owned by TSV. Although cash has decreased, we now have two new lines of credit, which together may provide an additional \$40,000,000 available to us if fully collateralized (of which \$20,853,000 had been drawn as of September 30, 2014). These lines of credit will require us to potentially maintain up to \$7,000,000 of restricted cash with the applicable banks, which is approximately \$2,500,000 more than our current restricted cash balance.

#### *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 nine months ended September 30, 2014, cash flows from operating activities increased \$2,694,000, compared to the nine months ended September 30, 2013. The increase reflects increased cash flow from rental properties as a result of increased occupancy and rental rates and increased interest income collected on loans during the period.

#### *Investing Activities*

Net cash provided by investing activities for both periods presented reflect our investing activity. For the nine months ended September 30, 2014, cash flows from investing activities decreased \$38,091,000. Approximately \$25,569,000 was used in investing activities during the period as \$46,679,000 was used for investments in loans, improvements to real estate properties and transfers to restricted cash, which was partially offset by approximately \$21,117,000 received from the payoff of loans, proceeds from the sale of a real estate property and distribution from an equity method investment during the period.

#### *Financing Activities*

Net cash provided by financing activities for the nine months ended September 30, 2014 reflects net advances on our new lines of credit from CB&T and Opus Bank of \$20,853,000 (advances net of repayments), \$372,000 in advances from the new TOTB North construction loan and a \$113,000 contribution from noncontrolling interest, net of dividends paid to stockholders of approximately \$1,256,000, purchase of treasury stock pursuant to the Repurchase Program of \$325,000, payment of deferred financing costs of \$355,000 and repayments of notes payable of \$331,000.

#### *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 net taxable income in any taxable year, and 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 net taxable income, 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 net

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.

### ***Company Debt***

#### **Notes Payable**

##### ***720 University, LLC Note Payable***

We have a note payable with a bank through our investment in 720 University, LLC with a balance of \$9,787,000 and \$9,918,000 as of September 30, 2014 and December 31, 2013, respectively. The note requires amortized monthly payments of \$56,816 at a fixed rate of 5.07% per annum with the balance of unpaid principal due on March 1, 2015. We anticipate that this note will be repaid through refinancing prior to the sale of the property during 2015.

##### ***Tahoe Stateline Venture, LLC Notes Payable***

We also have three notes payable in the aggregate amount of \$3,800,000 and \$4,000,000 as of September 30, 2014 and December 31, 2013 related to the foreclosure or purchase of nine parcels by TSV in 2013 and 2012. Two of the notes with principal balances totaling \$3,300,000 as of September 30, 2014 require semi-annual interest-only payments of 5% per annum and are due in December 2016 and one note with a principal balance of \$500,000 at September 30, 2014 requires quarterly interest-only payments of 5% per annum and is due in August 2017. We anticipate that the notes will be repaid from the proceeds of the eventual sale of the property currently under development, from line of credit advances or from cash reserves.

##### ***TOTB North, LLC Construction Loan Payable***

TOTB Miami contributed the unimproved “North” apartment building and a related parcel of land to a new wholly owned limited liability company, TOTB North, during the quarter ended June 30, 2014 and entered into a Construction Loan Agreement (the “Loan Agreement”) with Bank of the Ozarks (“Ozarks”) as the lender providing Borrower with a loan (the “Loan”) of up to \$21,304,000, subject to the terms and conditions of the Loan documents, for the purpose of renovating and improving the Apartments (the “Project”). The Loan is evidenced by the Loan Agreement, a related Promissory Note (the “Note”), a Mortgage, Security Agreement and Fixture Filing (the “Security Agreement”), an Assignment of Rents and Revenues (the “Assignment”), an Environmental Indemnity Agreement (the “Indemnity Agreement”) and a Post-Closing Agreement (the “Post-Closing Agreement”). As a condition to providing the Loan to the Borrower, Ozarks also required a joint and several completion guaranty from the Company and the Manager (the “Completion Guaranty”) with respect to completion of the Apartments, a joint and several repayment guaranty from the Company and the Manager (the “Repayment Guaranty”) that guarantees repayment of the Loan subject to certain limitations and a joint and several carve-out guaranty from the Company and the Manager (the “Carve-Out Guaranty” and, together with the Completion Guaranty and the Repayment Guaranty, the “Guarantees”) that provides a guaranty with respect to standard “bad-boy” carve-out provisions.

The initial maturity date (the “Maturity Date”) of the Loan is June 12, 2017, and the Maturity Date may be extended at the option of Borrower for two additional one year periods if a number of conditions are met including, among others, the conditions that there be no defaults, that the Property have a loan to value ratio calculated in accordance with the Loan Agreement at or below 60% at the time of each extension, that the debt service coverage ratio (“DSCR”) of the Property calculated in accordance with the Loan Agreement equals or exceeds 1.25:1 at the

time of each extension, that there be no Material Adverse Change relating to Borrower or any Guarantor and that certain additional fees are paid to Ozarks at the time of the extension.

The balance of the loan was \$993,000 as of September 30, 2014. All outstanding borrowings under the Loan will bear interest equal to the floating daily Three Month LIBOR rate of interest plus four percent (4.0%) per annum (the "Note Rate"), but in no event will the Note Rate be lower than the floor rate of four and one-half percent (4.5%) per annum. The Note Rate as of September 30, 2014 was 4.5% per annum. Upon a default under the Loan documents the Note Rate increases by an additional eight percent (8.00%) per annum. Interest only payments are payable monthly, in arrears, on the first business day of each month (the "Payment Date"), until the "Amortization Commencement Date" which is the earlier to occur of (i) December 12, 2015 or (ii) the first Payment Date occurring after the Project is completed and the Property achieves a DSCR of greater than 1.25:1.

Commencing on the Amortization Commencement Date and continuing on each Payment Date thereafter until the Maturity Date, Borrower is required to make, in addition to the interest payment due on such date, a monthly principal payment. The principal payment is calculated monthly based on the principal component of a mortgage-style amortization schedule calculated using the principal balance and the Note Rate as of the corresponding Payment Date and a period of 300 months (less the number of any such monthly principal payments made by Borrower prior to the applicable monthly calculation). The balance of the Loan is due on the Maturity Date.

Borrowings under the Loan documents are subject to customary conditions, and, additionally, the Ozarks is not required to loan more than \$1.0 million to the Borrower until the Borrower satisfies certain additional conditions detailed in the Post-Closing Agreement (the "Post-Closing Conditions"), including, without limitation, delivery of various completed plans, permits and construction agreements relating to the Project. The Borrower is also required to deposit with Ozarks \$1.0 million, or such greater amount as is required (the "Bridge Equity"), to fund all Project costs incurred prior to the satisfaction of the Post-Closing Conditions. Upon satisfaction of the Post-Closing Conditions, Ozarks will reimburse as part of the Loan the amount of the Bridge Equity to Borrower to the extent the proceeds were expended in conformance with the approved Project budget.

Borrowings will be secured by: (i) a first mortgage lien on the Property and all improvements, amenities and appurtenances to the Property, (ii) an assignment of all personal property, sales contracts, rents, leases, and ground leases associated with the Property and (iii) all design, development, service, management, leasing and construction contracts associated with the Property. In addition, the Bridge Equity and other reserves established by Ozarks are additional collateral for the Loan.

The Loan documents contain affirmative, negative and financial covenants of the Borrower and the Guarantors which are customary for loans of this type, including, among others, a requirement that the Company in its capacity as a Guarantor maintain: (i) a minimum of \$5,000,000 in unencumbered cash balances and (ii) a minimum Net Worth of \$35,000,000. The Borrower is obligated to pay customary closing fees, disbursements and expenses, including an origination fee to the Ozarks, which totaled \$620,000 as of September 30, 2014.

The Loan documents contain events of default (subject to specified thresholds and, in certain cases, cure periods) which are customary for loans of this type. If an event of default occurs and is continuing under the Loan documents, Ozarks may, among other things, terminate its obligations to lend and require the Company to repay all amounts owed thereunder, take possession of the Project and proceed to complete the Project at the cost of the Borrower and/or take certain actions against Guarantors pursuant to the Guarantees.

### **Lines of Credit Payable**

#### **California Bank & Trust**

In February 2014, we entered into the CB&T Credit Facility which provides us with a new revolving line of credit. Subject to various conditions, borrowings under the CB&T Credit Facility will be used for general corporate purposes and to finance the origination of new commercial real estate loans. The maximum borrowings under the revolving CB&T Credit Facility is the lesser of \$20,000,000 or the amount determined pursuant to a borrowing base calculation described in the related Advance Formula Agreement. At any time that the aggregate principal amount of

the total borrowings under the CB&T Credit Facility exceeds the maximum permitted pursuant to the borrowing base calculation, we must promptly repay an amount equal to such excess.

Borrowings under the CB&T Credit Facility mature on February 5, 2016. Such borrowings will bear interest payable monthly, in arrears, on the first business day of each month, at the prime rate of interest established by CB&T from time-to-time plus one quarter percent (.25%) per annum (3.5% at September 30, 2014). Upon a default under the CB&T Credit Facility such interest rate increases by 2.00%. The CB&T Credit Facility required the payment of an origination fee of \$100,000 and other issuance costs and is subject to certain ongoing administrative fees and expenses. As of September 30, 2014, total amount available to borrow under the CB&T Credit Facility was \$17,355,000 and the balance outstanding was \$17,355,000 (leaving \$0 available). As of the date of this filing, the balance outstanding is \$17,355,000 and there is no additional amount available to borrow.

### Opus Bank

In April, 2014, we entered into the Opus Credit Facility which provides us with a new revolving line of credit. Subject to various conditions, borrowings under the Opus Credit Facility will be used by us for general corporate purposes and to finance the origination of new commercial real estate loans. The maximum borrowings under the revolving Opus Credit Facility is the lesser of \$20,000,000 or the Maximum Allowed Advance amount determined pursuant to a borrowing base calculation described in the Opus Credit Agreement. At any time that the aggregate principal amount of the total borrowings under the Opus Credit Facility exceeds the Maximum Allowed Advance permitted pursuant to the borrowing base calculation, we must promptly repay an amount equal to such excess.

Advances under the Opus Credit Facility may be made by Opus until April 1, 2016. All borrowings under the Opus Credit Facility bear interest payable monthly, in arrears, on the first business day of each month, as follows: (i) continuing through October 1, 2014 the rate of interest will be 4.5%; (ii) commencing October 1, 2014, and on each successive six month anniversary during the term (the "Rate Change Date"), the rate of interest will be reset to the Six Month LIBOR rate of interest (currently .33%) as reported on such Rate Change Date plus four percent (4.0%) per annum but in no event will the interest rate be lower than 4.5% per annum. Upon a default under the Opus Credit Facility such interest rate increases by an additional 5.00%. Commencing on May 1, 2016, in addition to the required interest payments, we are also required to make mandatory monthly principal payments and all amounts under the Opus Credit Facility are to be repaid not later than April 1, 2017. As of September 30, 2014, the total amount available to borrow under the Opus Credit Facility was \$11,511,000 and the balance outstanding was \$3,498,000 (leaving \$8,013,000 available). As of the date of this filing, the total amount available to borrow is approximately \$5,648,000 and the balance outstanding is approximately \$5,863,000.

### Potential Future Debt

We are in the process of securing temporary or permanent financing for the retail development in TSV. We are also in the process of securing financing on the 169 renovated condominium units in TOTB.

### *Commitments and Contingencies*

As of September 30, 2014, we have commitments to advance additional funds to borrowers of construction, rehabilitation and other loans (including interest reserves) in the total amount of approximately \$3,058,000.

We have an obligation to pay all required costs to remediate and monitor contamination of the real properties owned by 1850 De La Cruz, LLC ("1850"). As part of the Operating Agreement executed by the Company and its joint venture partner in 1850, Nanook, we have indemnified Nanook against all obligations related to the expected costs to monitor and remediate the contamination. In 2008, we accrued an amount that a third party consultant had estimated will need to be paid to monitor and remediate the site. The majority of clean-up activities were completed during 2012 as part of the tenant's construction of a new building on the site. Thus, approximately \$460,000 was paid by the Company from the previously established liability, and an additional \$100,000 was accrued during the year ended December 31, 2012 as a result of an updated estimate of future costs to be incurred. If additional amounts are required, it will be an obligation of the Company. As of September 30, 2014 and December 31, 2013, approximately \$61,000 and \$63,000, respectively, of this obligation remains accrued on our books. All costs for this remediation will be paid from cash reserves.

During the course of due diligence performed by a potential buyer of TOTB Miami in 2012, a low level of arsenic was found in the ground water of a monitoring well located on the property owned by TOTB Miami. While the level of arsenic exceeds the minimum level acceptable for drinking water standards, the water under this property is subject to tidal influence and is not used for domestic consumption. TOTB Miami has retained an environmental consultant to perform additional testing and analysis with the goal of petitioning the appropriate governmental agency to issue a no further action letter for this property due to the low level of contamination and the low quality of the ground water under the property. At this time, the costs of any potential remediation and/or monitoring are unknown and cannot be estimated. As of September 30, 2014 and December 31, 2013, approximately \$78,000 and \$65,000, respectively, had been accrued and/or paid for testing and analysis.

We have entered into various contracts related to the construction of the retail portion of the land owned by TSV. The aggregate amount of these contracts as of the date of this filing is approximately \$20,043,000, of which approximately \$18,144,000 was incurred as of September 30, 2014. All costs for this project will be paid from cash reserves, from the recently obtained lines of credit and/or financing to be obtained in the future. It is possible that additional change orders will be submitted and construction costs may be higher than expected.

We have also entered into contracts for the initial demolition and concrete remediation, design, architectural and engineering services related to the renovation of the vacant apartment building owned by TOTB North in the aggregate amount of approximately \$2,577,000 of which approximately \$1,079,000 has been incurred to September 30, 2014 in addition to other capitalized costs related to the construction project of \$375,000 (total of \$1,454,000). All costs for this project will be paid from cash reserves or the recently obtained construction loan.

#### **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 us. The contingency reserves held in cash and cash equivalents were approximately \$3,896,000 and \$3,895,000 as of September 30, 2014 and December 31, 2013, respectively.

#### **Item 4. Controls and Procedures**

Management of the Company carried out an evaluation, 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 Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended) as of the end of the fiscal quarter ended September 30, 2014. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2014, which is the end of the period covered by this quarterly report on Form 10-Q, the Company's disclosure controls and procedures are effective.

There have been no changes in the Company's internal control over financial reporting in the fiscal quarter ending September 30, 2014 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

### **PART II. OTHER INFORMATION**

#### **Item 1. Legal Proceedings**

In the normal course of business, the Company may become involved in various types of legal proceedings including, but not limited to, assignment of rents, bankruptcy proceedings, appointment of receivers, unlawful detainers, and judicial foreclosure. These proceedings may seek to enforce the provisions of the deeds of trust, collect the debt owed under the promissory notes, or to protect, or recoup the Company's investment from the real property secured by the deeds of trust. The Company believes that it is not party to any pending legal or arbitration proceedings that would have a material effect on its financial condition or results of operations or cash flows, although it is possible that the outcome of any such proceedings could have a material impact on net income in any

particular period.

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

On August 9, 2013, the Board of Directors authorized the Repurchase Plan which permitted the Company to repurchase up to the lesser of \$7 million of its common stock or five percent of the shares of common stock outstanding as of that date. As of September 30, 2014 and December 31, 2013, the Company had repurchased 430,118 and 403,910 shares of its common stock, respectively, for a total cost of approximately \$5,349,000 and \$5,024,000 (including commissions) and an average cost of \$12.44 per share. No further repurchases were made under the Repurchase Plan which expired on May 19, 2014.

## **Item 6. Exhibits**

### **(a) Exhibits:**

- \* 3.1 Articles of Amendment and Restatement of Owens Realty Mortgage, Inc., incorporated herein by reference to Annex B to Proxy Statement/Prospectus on Form S-4 which was filed with the SEC on February 13, 2013
  - \* 3.2 Bylaws of Owens Realty Mortgage, Inc., incorporated herein by reference to Annex C to Proxy Statement/Prospectus on Form S-4 which was filed with the SEC on February 13, 2013
  - \* 3.3 Articles Supplementary, dated November 13, 2014, 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 herein by reference to exhibit 4.1 to Proxy Statement/Prospectus on Form S-4 which was filed with the SEC on January 25, 2013
  - \*\* 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 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.



**SIGNATURES**

Pursuant to the requirements 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: November 13, 2014

By: /s/ William C. Owens  
William C. Owens, Chief Executive Officer and President  
(Principal Executive Officer)

Dated: November 13, 2014

By: /s/ Bryan H. Draper  
Bryan H. Draper, Chief Financial Officer, Treasurer and Secretary  
(Principal Financial and Accounting Officer)

## EXHIBIT 31.1

### CHIEF EXECUTIVE OFFICER CERTIFICATION

I, William C. Owens, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Owens Realty Mortgage, Inc. (the “Registrant”);
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant’s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - (c) Evaluated the effectiveness of the Registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the Registrant’s internal control over financial reporting that occurred during the Registrant’s most recent fiscal quarter (the Registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant’s internal control over financial reporting; and
5. The Registrant’s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant’s auditors and the audit committee of the Registrant’s board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant’s ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant’s internal control over financial reporting.

Dated: November 12, 2014

/s/ William C. Owens  
William C. Owens  
Chief Executive Officer and President

## EXHIBIT 31.2

### CHIEF FINANCIAL OFFICER CERTIFICATION

I, Bryan H. Draper, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Owens Realty Mortgage, Inc. (the "Registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - (c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Dated: November 12, 2014

/s/ Bryan H. Draper

Bryan H. Draper

Chief Financial Officer and Secretary

**EXHIBIT 32**

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350**

William C. Owens, as Chief Executive Officer and President of Owens Realty Mortgage, Inc. (the “Registrant”), and Bryan H. Draper, as Chief Financial Officer and Secretary of the Registrant, hereby certify, pursuant to 18 U.S.C. § 1350, that:

(1) the Registrant’s Report on Form 10-Q for the quarter ended September 30, 2014, as filed with the Securities and Exchange Commission on the date hereof (the “Report”) fully complies with the applicable requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ William C. Owens

William C. Owens

Chief Executive Officer and President

November 12, 2014

/s/ Bryan H. Draper

Bryan H. Draper

Chief Financial Officer and Secretary

November 12, 2014