HUNERYAGER GARY D
Form 4
July 31, 2012

FORM 4

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

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

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL
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(Print or Type Responses)

1. Name and Address of Reporting Person *
HUNERYAGER GARY D
(Last) (First) (Middle)
P.O. BOX 321
(Street)
OKLAHOMA CITY, OK 73101
(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
OGE ENERGY CORP. [OGE]

3. Date of Earliest Transaction (Month/Day/Year)
07/27/2012

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer
(Check all applicable)
_____ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
VP - Internal Audits

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security	2. Conversion or Exercise	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any	4. Transaction Code	5. Number of Derivative Securities	6. Date Exercisable and Expiration Date (Month/Day/Year)	7. Title and Amount of Underlying	8. Price of Derivative Security

(Instr. 3)	Price of Derivative Security	(Month/Day/Year)	(Instr. 8)		Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)				Securities (Instr. 3 and 4)		(Instr. 5)
			Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares	
Stock Equiv Units	(1)	07/27/2012	A		2.129		(2)	(2)	Com Stk	2.129	$ 53.57

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
HUNERYAGER GARY D P.O. BOX 321 OKLAHOMA CITY, OK 73101			VP - Internal Audits	

Signatures

Patricia D. Horn	07/31/2012
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Security converts to common stock on a one-for-one basis.

(2) The Common Stock Units were accrued under the Deferred Compensation Plan of OGE Energy Corp. and are to be settled 100% in cash at a specified future date or following termination of service.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. th="100%" style="border-collapse:collapse;width:100.0%;">

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Letter from the president

Dear Shareholder,

We are pleased to provide the annual report of Western Asset Income Fund for the twelve-month reporting period ended December 31, 2010. Please read on for a detailed look at prevailing economic and market conditions during the Fund s reporting period and to learn how those conditions have affected Fund performance.

As always, we remain committed to providing you with excellent service and a full spectrum of investment choices. We also remain committed to supplementing the support you receive from your financial advisor. One way we accomplish this is through our website, www.leggmason.com/cef. Here you can gain immediate access to market and investment information, including:

- Fund prices and performance,
- Market insights and commentaries from our portfolio managers, and
- A host of educational resources.

We look forward to helping you meet your financial goals.

Sincerely,

R. Jay Gerken, CFA

President

February 9, 2011

Investment commentary

Economic review

Despite continued headwinds from high unemployment and issues in the housing market, the U.S. economy continued to expand over the twelve months ended December 31, 2010. Toward the end of the reporting period, fears regarding moderating economic growth were replaced with optimism for a strengthening economy in 2011. With investor sentiment improving, U.S. equities moved sharply higher in the fourth quarter, while rising interest rates negatively impacted some sectors of the fixed-income market. All told, during 2010, investors who took on additional risk in their portfolios were generally rewarded.

In September 2010, the National Bureau of Economic Research (NBER), the organization charged with determining when recessions start and end, announced that the recession that began in December 2007 had concluded in June 2009. However, the NBER said, In determining that a trough occurred in June 2009, the committee did not conclude that economic conditions since that month have been favorable or that the economy has returned to operating at normal capacity. The NBER s point is well-taken given continued areas of weakness in the U.S. economy.

Although the U.S. Department of Commerce continued to report positive U.S. gross domestic product (GDP)i growth, the expansion has moderated since peaking at 5.0% in the fourth quarter of 2009. A slower drawdown in business inventories and renewed consumer spending were contributing factors spurring the economy s solid growth at the end of 2009. However, the economy grew at a more modest pace in 2010. According to the Commerce Department, GDP growth was 3.7%, 1.7% and 2.6% during the first, second and third quarters of 2010, respectively. The initial estimate for fourth quarter GDP was a 3.2% expansion.

Turning to the job market, while the unemployment rate moved lower in December 2010, it remained elevated throughout the reporting period. While 384,000 new jobs were created during the fourth quarter and the unemployment rate fell from 9.8% in November to 9.4% in December 2010, there continued to be some disturbing trends in the labor market. The unemployment rate has now exceeded 9.0% for twenty consecutive months, the longest period since the government began tracking this data in 1949. In addition, the U.S. Department of Labor reported in December that a total of 14.5 million Americans looking for work have yet to find a job, and 44% of these individuals have been out of work for more than six months.

There was mixed news in the housing market during the period. According to the National Association of Realtors (NAR), existing-home sales increased 7.0% and 8.0% in March and April, respectively, after sales had fallen for the period from December 2009 through February 2010. The rebound was largely attributed to people rushing to take advantage of the government s $8,000 tax credit for first-time home buyers that expired at the end of April. However, with the end of the tax credit, existing-home sales then declined from May through July. Sales then generally rose from August through the end of

IV Western Asset Income Fund

Investment commentary (cont d)

the year. In total, existing-home sales volume in 2010 was 4.9 million, the lowest amount since 1997. Looking at home prices, the NAR reported that the median existing-home price for all housing types rose a tepid 0.3% in 2010. The inventory of unsold homes was an 8.1 month supply in December at the current sales level, versus a 9.5 month supply in November.

The manufacturing sector was one area of the economy that remained relatively strong during 2010. Based on the Institute for Supply Management s PMI[ii], the manufacturing sector has grown seventeen consecutive months since it began expanding in August 2009. After reaching a six-year peak of 60.4 in April 2010 (a reading below 50 indicates a contraction, whereas a reading above 50 indicates an expansion), PMI data indicated somewhat more modest growth through the remainder of the year. However, in December, the manufacturing sector expanded at its fastest pace in seven months, with a reading of 57.0 versus 56.6 in November.

Financial market overview

The financial markets experienced several periods of volatility during the reporting period that tested the resolve of novice and experienced investors alike. During most of the first four months of the reporting period, the financial markets were largely characterized by healthy investor risk appetite and solid results by stocks and lower-quality bonds. The market then experienced sharp sell-offs in late April and in May, and again beginning in mid-November. During those periods, investors tended to favor the relative safety of U.S. Treasury securities. However, these setbacks proved to be only temporary and, in each case, risk aversion was replaced with solid demand for riskier assets.

Due to signs that certain areas of the economy were moderating in the second half of the reporting period, the Federal Reserve Board (Fed)[iii] took further actions to spur the economy. At its August 10th meeting, the Fed announced an ongoing program that calls for using the proceeds from expiring agency debt and agency mortgage-backed securities to purchase longer-dated Treasury securities.

In addition, the Fed remained cautious throughout the reporting period given pockets of weakness in the economy. At its meeting in September 2010, the Fed said, The Committee will continue to monitor the economic outlook and financial developments and is prepared to provide additional accommodation if needed to support the economic recovery. . . . This led to speculation that the Fed may again move to purchase large amounts of agency and Treasury securities in an attempt to avoid a double-dip recession and ward off deflation.

The Fed then took additional action in early November. Citing that the pace of recovery in output and employment continues to be slow, the Fed announced another round of quantitative easing to help stimulate the economy, entailing the purchase of $600 billion of long-term U.S. Treasury securities by the end of the second quarter of 2011. This, coupled with the Fed s previously announced program to use the proceeds of expiring securities to purchase Treasuries, means it

could buy a total of $850 billion to $900 billion of Treasury securities by the end of June 2011. At its final meeting of the year in December, the Fed said it will regularly review the pace of its securities purchases and the overall size of the asset-purchase program in light of incoming information and will adjust the program as needed to best foster maximum employment and price stability.

Fixed-income market review

Continuing the trend that began in the second quarter of 2009, nearly every spread sector (non-Treasury) outperformed equal-duration[iv] Treasuries during most of the first four months of the reporting period. Over that time, investor confidence was high given encouraging economic data, continued low interest rates, benign inflation and rebounding corporate profits. Robust investor appetite was then replaced with heightened risk aversion toward the end of April and during the month of May. This was due to the escalating sovereign debt crisis in Europe, uncertainties regarding new financial reforms in the U.S. and some worse-than-expected economic data. Most spread sectors then produced positive absolute returns in June and July, as investor demand for these securities again increased. There was another bout of risk aversion in August, given fears that the economy may slip back into a recession. However, with the Fed indicating the possibility of another round of quantitative easing, most spread sectors rallied in September and October. The spread sectors started to weaken again toward the middle of November as financial troubles in Ireland resulted in a re-emergence of the European sovereign debt crisis. While several spread sectors regained their footing in December, others remained weak given ongoing uncertainties in Europe and concerns regarding economic growth in China and its potential impact on the global economy.

Both short- and long-term Treasury yields fluctuated but, overall, moved lower during the twelve months ended December 31, 2010. When the period began, two- and ten-year Treasury yields were 1.14% and 3.85%, respectively. On April 5, 2010, two- and ten-year Treasury yields peaked at 1.18% and 4.01%, respectively. Subsequent to hitting their highs for the period, yields largely declined during much of the next six months, with two-year Treasuries hitting their low for the year of 0.33% on November 4, 2010. Ten-year Treasuries reached their 2010 trough of 2.41% in early October. Yields then moved sharply higher given expectations for stronger growth in 2011 and the potential for rising inflation. When the period ended on December 31, 2010, two-year Treasury yields were 0.61% and ten-year Treasury yields were 3.30%. For the twelve months ended December 31, 2010, the Barclays Capital U.S. Aggregate Index[v] returned 6.54%.

The U.S. high-yield bond market produced strong results during the reporting period. The asset class posted positive returns during each month, except for May and November 2010 when risk aversion rose sharply. The high-yield market was supported by better-than-expected corporate profits and overall strong investor demand. All told, the

Investment commentary (cont d)

Barclays Capital U.S. High Yield 2% Issuer Cap Index[vi] returned 14.94% for the twelve months ended December 31, 2010.

As always, thank you for your confidence in our stewardship of your assets.

Sincerely,

R. Jay Gerken, CFA

President

January 28, 2011

All investments are subject to risk including the possible loss of principal. Past performance is no guarantee of future results. All index performance reflects no deduction for fees, expenses or taxes. Please note that an investor cannot invest directly in an index.

i Gross domestic product (GDP) is the market value of all final goods and services produced within a country in a given period of time.

ii The Institute for Supply Management s PMI is based on a survey of purchasing executives who buy the raw materials for manufacturing at more than 350 companies. It offers an early reading on the health of the manufacturing sector.

iii The Federal Reserve Board (Fed) is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices and a sustainable pattern of international trade and payments.

iv Duration is the measure of the price sensitivity of a fixed-income security to an interest rate change of 100 basis points. Calculation is based on the weighted average of the present values for all cash flows.

v The Barclays Capital U.S. Aggregate Index is a broad-based bond index comprised of government, corporate, mortgage- and asset-backed issues, rated investment grade or higher, and having at least one year to maturity.

vi The Barclays Capital U.S. High Yield 2% Issuer Cap Index is an index of the 2% Issuer Cap component of the Barclays Capital U.S. Corporate High Yield Index, which covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market.

Fund overview

Q. What is the Fund s investment strategy?

A. The Fund seeks a high level of current income, consistent with prudent investment risk, through investment in a diversified portfolio of debt securities. To a lesser extent, the Fund may also invest in privately placed debt securities and in certain equity securities. Capital appreciation is a secondary investment objective.

The Fund s investment policies provide that its portfolio be invested as follows: at least 75% in debt securities rated within the four highest grades, and in government securities, bank debt, commercial paper, cash or cash equivalents; up 25% in other fixed-income securities, convertible bonds, convertible preferred and preferred stock; and not more than 25% in securities restricted as to resale.

At Western Asset Management Company (Western Asset), the Fund s adviser, we utilize a fixed-income team approach, with decisions derived from interaction among various investment management sector specialists. The sector teams are comprised of Western Asset s senior portfolio managers, research analysts and an in-house economist. Under this team approach, management of client fixed-income portfolios will reflect a consensus of interdisciplinary views within the Western Asset organization. The portfolio managers responsible for development of investment strategy, day-to-day portfolio management, oversight and coordination of the Fund are Stephen A. Walsh, S. Kenneth Leech and Ryan K. Brist.

Q. What were the overall market conditions during the Fund s reporting period?

A. During the twelve months ended December 31, 2010, the riskier segments of the fixed-income market produced strong results and outperformed U.S. Treasuries. This was due, in part, to improving economic conditions following the lengthy downturn from mid-2008 through mid-2009. Also supporting the spread sectors (non-U.S. Treasuries) was overall solid demand from investors seeking incremental yields given the low rates available from short-term fixed-income securities.

The spread sectors rallied during most of the reporting period, with notable exceptions being in late April and May 2010, as well as August and November 2010. Starting toward the end of April, there was a flight to quality, triggered by concerns regarding the escalating sovereign debt crisis in Europe. In addition, investor sentiment was negatively impacted by uncertainties surrounding financial reform legislation in the U.S. and signs that economic growth was moderating. Collectively, this caused investors to flock to the relative safety of Treasury securities, driving their yields lower and prices higher.

Robust investor risk appetite largely resumed during June and July, and again in September and October. These turnarounds occurred as the situation in Europe appeared to stabilize, the financial reform bill was signed into law and the Federal Reserve Board (Fed)i continued to indicate that it would keep short-term rates low for an extended period. Investor risk aversion briefly returned in November when

Fund overview (cont d)

fears regarding the European debt crisis re-emerged. However, investor sentiment improved in December, given expectations for strengthening economic conditions in 2011.

The yields on two- and ten-year Treasuries began the fiscal year at 1.14% and 3.85%, respectively. Treasury yields fluctuated during the twelve-month reporting period given mixed signals regarding the economy and uncertainties regarding Fed monetary policy. Yields moved sharply lower in October 2010 in anticipation of additional quantitative easing (QE2) by the Fed. Yields then reversed course toward the end of the period as certain economic data were stronger than expected and there were concerns regarding future inflation. During the fiscal year, two-year Treasury yields moved as high as 1.18% and as low as 0.33%, while ten-year Treasuries rose as high as 4.01% and fell as low as 2.41%. On December 31, 2010, yields on two- and ten-year Treasuries were 0.61% and 3.30%, respectively.

The overall credit market, as represented by the Barclays Capital U.S. Credit Index[ii] (the Index), returned 8.47% over the same period. Comparatively, riskier fixed-income securities, including high-yield bonds, produced stronger results. Over the fiscal year, the Barclays Capital U.S. High Yield 2% Issuer Cap Index[iii] returned 14.94%. During this period, as measured by the Index, lower-quality BBB-rated bonds outperformed high-quality AAA-rated securities, returning 10.03% and 5.13%, respectively.

Q. How did we respond to these changing market conditions?

A. A number of adjustments were made to the Fund s portfolio during the reporting period. The Fund maintained its lower-quality bias versus the Index, but we pared our exposure to certain BBB-rated and non-investment grade securities to capture profits and reduce our overall risk exposure. While we maintained an overweight to Financials, we decreased our exposure during the fiscal year, especially in the banking industry given its strong results. Our allocation to the Utilities sector was reduced due to our concerns for potential increases in capital expenditures to meet new Clean Air Act legislation requirements. Our allocation to the Transportation[1] sector was increased based on signs that the U.S. economy was strengthening. We also added to our exposure to the Energy sector, as we felt valuations for certain securities had become attractive in the wake of the oil spill in the Gulf of Mexico. Finally, we raised the Fund s cash position to have added flexibility to invest in attractive opportunities in the future.

The Fund employed U.S. Treasury futures during the reporting period to manage its duration[iv] and yield curve[v] positioning. Overall, the use of these derivative instruments detracted from performance during the twelve-month reporting period.

Performance review

For the twelve months ended December 31, 2010, Western Asset Income Fund returned 10.86% based on its net asset value (NAV)vi and 7.28% based on its New York Stock Exchange (NYSE) market price per

1 Transportation consists of the following industries: Airlines, Railroads and other transportation-related services.

share. The Fund s unmanaged benchmarks, the Barclays Capital U.S. Corporate High Yield Indexvii and the Barclays Capital U.S. Credit Index, returned 15.12% and 8.47%, respectively, over the same time frame. The Lipper Corporate Debt Closed-End Funds BBB-Rated Category Averageviii returned 12.90% for the same period. Please note that Lipper performance returns are based on each fund s NAV.

During the twelve-month period, the Fund made distributions to shareholders totaling $0.79 per share. The performance table shows the Fund s twelve-month total return based on its NAV and market price as of December 31, 2010. **Past performance is no guarantee of future results.**

Performance Snapshot as of December 31, 2010

Price Per Share	**12-Month Total Return***
$13.82 (NAV)	10.86%
$12.89 (Market Price)	7.28%

All figures represent past performance and are not a guarantee of future results.

*** Total returns are based on changes in NAV or market price, respectively. Total returns assume the reinvestment of all distributions in additional shares.**

Q. What were the leading contributors to performance?

A. Relative to the Index, the largest contributor to the Fund s performance during the reporting period was an overweight to high-yield corporate bonds. High yield was among the best-performing fixed-income sectors during the reporting period given declining default rates and solid demand from investors looking to generate incremental yield. Among the Fund s strongest high-yield holdings were overweight positions in **GMAC Inc.**, **HCA Inc.** and **Sprint Capital Corp.**

A number of individual holdings also significantly contributed to results. In particular, overweights in subordinated Financials issued by **American International Group Inc.** and **Bank of America Corp.** were among our best performers during the reporting period. Overall, these bonds rallied as confidence in the banking system improved and it became apparent that banks would be able to continue paying their coupons. In addition, the fundamentals in the banking industry were better, as capital reserves increased and corporate earnings were often better-than-expected.

The portfolio s quality biases were also additive to performance. Relative to the Index, our overweight to BBB and below-rated securities benefited from improved demand, as investors looked to receive high incremental yield given the low interest rate environment.

Our sector positioning was, overall, a positive for performance. In particular, an overweight to Financials was beneficial. During the twelve months ended December 31, 2010, Financials was the best-performing sector in the Index. Having an underweight to non-corporate bonds was also rewarded, as this portion of the Index returned 6.36% during the reporting period, whereas corporate bonds in the Index gained 9.00%.

Q. What were the leading detractors from performance?

A. Relative to the Index, the largest detractor from the Fund s performance for the period was our overweight to the relatively poor-performing Energy sector. The Energy sector lagged the

Fund overview (cont d)

overall Index given continued volatility in natural gas and oil prices, coupled with fears that relatively modest economic growth would reduce global demand for energy going forward.

A number of individual holdings also detracted from the Fund s results during the reporting period. In particular, overweights to European telecommunication companies **Telecom Italia Capital** and **Telefonica Emisiones SAU** were the largest detractors. Both companies were negatively impacted by the ongoing sovereign debt crisis in Europe.

Looking for additional information?

The Fund is traded under the symbol PAI and its closing market price is available in most newspapers under the NYSE listings. The daily NAV is available on-line under the symbol XPAIX on most financial websites. *Barron s* and the *Wall Street Journal* s Monday edition both carry closed-end fund tables that provide additional information. In addition, the Fund issues a quarterly press release that can be found on most major financial websites as well as www.leggmason.com/cef.

In a continuing effort to provide information concerning the Fund, shareholders may call 1-888-777-0102 (toll free), Monday through Friday from 8:00 a.m. to 5:30 p.m. Eastern Time, for the Fund s current NAV, market price and other information.

Thank you for your investment in Western Asset Income Fund. As always, we appreciate that you have chosen us to manage your assets and we remain focused on achieving the Fund s investment goals.

Sincerely,

Western Asset Management Company

January 18, 2011

RISKS: *Bonds are subject to a variety of risks, including interest rate, credit and inflation risks. As interest rates rise, bond prices fall, reducing the value of a fixed-income investment s price. The Fund may invest in high-yield bonds, which are rated below investment grade and carry more risk than higher-rated securities. To the extent that the Fund invests in asset-backed, mortgage-backed or mortgage-related securities, its exposure to prepayment and extension risks may be greater than investments in other fixed-income securities. Leverage may result in greater volatility of NAV and the market price of common shares and increases a shareholder s risk of loss. The Fund may invest, to a limited extent, in foreign securities, including emerging markets, which are subject to additional risks. The Fund may make significant investments in derivative instruments. Derivative instruments can be illiquid, may disproportionately increase losses, and have a potentially large impact on Fund performance.*

Portfolio holdings and breakdowns are as of December 31, 2010 and are subject to change and may not be representative of the portfolio managers current or future investments. Please refer to pages 9 through 20 for a list and percentage breakdown of the Fund s holdings.

The mention of sector breakdowns is for informational purposes only and should not be construed as a recommendation to purchase or sell any securities. The information provided regarding such sectors is not a sufficient basis upon which to make an investment decision. Investors seeking financial advice regarding the appropriateness of investing in any securities or investment strategies discussed should consult their financial professional. The Fund s top five

sector holdings (as a percentage of net assets) as of December 31, 2010 were: Corporate Bonds & Notes (93.3%), Short-Term Investments (1.5%), Preferred Stocks (1.1%), Sovereign Bonds (0.9%) and Asset-Backed Securities (0.8%). The Fund s portfolio composition is subject to change at any time.

All investments are subject to risk including the possible loss of principal. Past performance is no guarantee of future results. All index performance reflects no deduction for fees, expenses or taxes. Please note that an investor cannot invest directly in an index.

The information provided is not intended to be a forecast of future events, a guarantee of future results or investment advice. Views expressed may differ from those of the firm as a whole.

i The Federal Reserve Board (Fed) is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices and a sustainable pattern of international trade and payments.

ii The Barclays Capital U.S. Credit Index is an index composed of corporate and non-corporate debt issues that are investment grade (rated Baa3/BBB- or higher).

iii The Barclays Capital U.S. High Yield 2% Issuer Cap Index is an index of the 2% Issuer Cap component of the Barclays Capital U.S. Corporate High Yield Index, which covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market.

iv Duration is the measure of the price sensitivity of a fixed-income security to an interest rate change of 100 basis points. Calculation is based on the weighted average of the present values for all cash flows.

v The yield curve is the graphical depiction of the relationship between the yield on bonds of the same credit quality but different maturities.

vi Net asset value (NAV) is calculated by subtracting total liabilities and outstanding preferred stock (if any) from the closing value of all securities held by the Fund (plus all other assets) and dividing the result (total net assets) by the total number of the common shares outstanding. The NAV fluctuates with changes in the market prices of securities in which the Fund has invested. However, the price at which an investor may buy or sell shares of the Fund is the Fund s market price as determined by supply of and demand for the Fund s shares.

vii The Barclays Capital U.S. Corporate High Yield Index covers the universe of fixed-rate, non-investment grade debt, including corporate and non-corporate sectors. Pay-in-kind (PIK) bonds, Eurobonds and debt issues from countries designated as emerging markets are excluded, but Canadian and global bonds (SEC registered) of issuers in non-emerging market countries are included. Original issue zero coupon bonds, step-up coupon structures and 144-As are also included.

viii Lipper, Inc., a wholly-owned subsidiary of Reuters, provides independent insight on global collective investments. Returns are based on the twelve-month period ended December 31, 2010, including the reinvestment of all distributions, including returns of capital, if any, calculated among the 26 funds in the Fund s Lipper category.

Fund at a glance (unaudited)

Investment breakdown (%) as a percent of total investments

The bar graph above represents the Fund s portfolio as of December 31, 2010, and does not include derivatives such as futures contracts. The Fund s portfolio is actively managed. As a result, the composition of its portfolio holdings and sectors is subject to change at any time.

Spread duration (unaudited)

Economic Exposure December 31, 2010

Spread duration measures the sensitivity to changes in spreads. The spread over Treasuries is the annual risk-premium demanded by investors to hold non-Treasury securities. Spread duration is quantified as the % change in price resulting from a 100 basis points change in spreads. For a security with positive spread duration, an increase in spreads would result in a price decline and a decline in spreads would result in a price increase. This chart highlights the market sector exposure of the Fund s sectors relative to the selected benchmark sectors as of the end of the reporting period.

ABS	Asset Backed Securities
BCI	Barclays Capital U.S. Credit Index
EM	Emerging Markets
HY	High Yield
IG Credit	Investment Grade Credit
MBS	Mortgage Backed Securities
PAI	Western Asset Income Fund

Effective duration (unaudited)

Interest Rate Exposure December 31, 2010

Effective duration measures the sensitivity to changes in Treasury yields. Effective duration is quantified as the % change in price resulting from a 100 basis points change in Treasury yields. For a security with positive effective duration, an increase in Treasury yields would result in a price decline and a decline in Treasury yields would result in a price increase. This chart highlights the interest rate exposure of the Fund s portfolio relative to the selected benchmark as of the end of the reporting period.

ABS	Asset Backed Securities
BCI	Barclays Capital U.S. Credit Index
EM	Emerging Markets
HY	High Yield
IG Credit	Investment Grade Credit
MBS	Mortgage Backed Securities
PAI	Western Asset Income Fund

Schedule of investments

December 31, 2010

Western Asset Income Fund

Security	Rate	Maturity Date		Face Amount		Value	
Corporate Bonds & Notes 93.3%							
Consumer Discretionary 6.8%							
Auto Components 0.1%							
BorgWarner Inc., Senior Notes	4.625%	9/15/20	$	130,000	$	***128,345***	
Automobiles 0.7%							
Motors Liquidation Co., Senior Debentures	8.250%	7/15/23		2,710,000		***941,725***	(a)
Hotels, Restaurants & Leisure 0.2%							
NCL Corp. Ltd., Senior Secured Notes	11.750%	11/15/16		180,000		***209,925***	
Household Durables 0.4%							
Stanley Black & Decker Inc., Senior Notes	5.200%	9/1/40		580,000		***544,991***	
Internet & Catalog Retail 0.2%							
QVC Inc., Senior Secured Notes	7.375%	10/15/20		300,000		***314,250***	(b)
Media 4.5%							
Comcast Cable Holdings LLC	9.800%	2/1/12		375,000		408,162	
Comcast Corp., Bonds	6.400%	5/15/38		950,000		1,015,232	
Comcast Corp., Notes	6.450%	3/15/37		120,000		128,216	
Comcast Corp., Senior Notes	6.950%	8/15/37		160,000		180,971	
News America Inc., Senior Notes	6.550%	3/15/33		545,000		579,401	
Omnicom Group Inc., Notes	6.250%	7/15/19		370,000		410,720	
TCI Communications Inc.	8.750%	8/1/15		160,000		196,942	
Time Warner Cable Inc., Senior Notes	8.750%	2/14/19		520,000		661,683	
Time Warner Entertainment Co., LP, Senior Notes	8.375%	7/15/33		530,000		668,848	
Time Warner Inc., Senior Debentures	7.700%	5/1/32		595,000		726,311	
United Business Media Ltd., Notes	5.750%	11/3/20		640,000		614,438	(b)
WPP Finance UK, Senior Notes	8.000%	9/15/14		180,000		207,081	
Total Media						***5,798,005***	
Multiline Retail 0.7%							
Macy s Retail Holdings Inc.	5.350%	3/15/12		270,000		278,775	
Macy s Retail Holdings Inc., Debentures	6.650%	7/15/24		180,000		178,200	
Macy s Retail Holdings Inc., Notes	5.750%	7/15/14		400,000		423,000	
Total Multiline Retail						***879,975***	
Total Consumer Discretionary						**8,817,216**	
Consumer Staples 3.8%							
Beverages 0.3%							
Anheuser-Busch InBev Worldwide Inc., Senior Notes	5.375%	1/15/20		370,000		***400,928***	
Food & Staples Retailing 1.1%							
Delhaize Group, Senior Notes	6.500%	6/15/17		290,000		328,765	
Safeway Inc., Senior Notes	3.950%	8/15/20		690,000		653,396	
Wal-Mart Stores Inc., Senior Notes	6.500%	8/15/37		380,000		446,442	
Total Food & Staples Retailing						***1,428,603***	

See Notes to Financial Statements.

Schedule of investments (cont d)

December 31, 2010

Western Asset Income Fund

Security	Rate	Maturity Date		Face Amount		Value
Food Products 0.3%						
Kraft Foods Inc., Senior Notes	5.375%	2/10/20	$	340,000	$	***365,931***
Tobacco 2.1%						
Lorillard Tobacco Co., Senior Notes	8.125%	6/23/19		340,000		378,328
Lorillard Tobacco Co., Senior Notes	8.125%	5/1/40		390,000		399,891
Philip Morris International Inc., Senior Notes	6.875%	3/17/14		490,000		564,634
Reynolds American Inc., Senior Notes	7.250%	6/1/12		1,360,000		1,454,309
Total Tobacco						***2,797,162***
Total Consumer Staples						**4,992,624**
Energy 13.5%						
Energy Equipment & Services 0.5%						
Baker Hughes Inc., Senior Notes	7.500%	11/15/18		370,000		463,960
Baker Hughes Inc., Senior Notes	5.125%	9/15/40		240,000		234,428
Total Energy Equipment & Services						***698,388***
Oil, Gas & Consumable Fuels 13.0%						
Anadarko Finance Co., Senior Notes	7.500%	5/1/31		465,000		514,173
Anadarko Petroleum Corp., Senior Notes	6.375%	9/15/17		35,000		38,126
Apache Corp.	6.900%	9/15/18		100,000		122,098
Apache Corp., Senior Notes	6.000%	1/15/37		190,000		208,945
BP Capital Markets PLC, Senior Notes	3.125%	10/1/15		740,000		739,492
ConocoPhillips, Notes	6.500%	2/1/39		810,000		963,173
ConocoPhillips, Senior Notes	6.000%	1/15/20		360,000		419,131
Devon Financing Corp. ULC, Debentures	7.875%	9/30/31		380,000		501,006
Duke Capital LLC, Senior Notes	6.250%	2/15/13		800,000		867,602
El Paso Corp., Medium-Term Notes	7.800%	8/1/31		2,000,000		1,989,486
Enbridge Energy Partners LP	9.875%	3/1/19		120,000		157,799
Energy Transfer Partners LP, Senior Notes	9.700%	3/15/19		170,000		219,718
Enterprise Products Operating LLC, Senior Notes	6.125%	10/15/39		320,000		333,059
EOG Resources Inc., Senior Notes	5.875%	9/15/17		540,000		612,370
Hess Corp., Notes	7.875%	10/1/29		1,180,000		1,480,924
Hess Corp., Senior Bonds	6.000%	1/15/40		300,000		314,449
Kerr-McGee Corp., Notes	6.950%	7/1/24		300,000		326,094
Kinder Morgan Energy Partners LP, Senior Notes	7.125%	3/15/12		530,000		565,401
LUKOIL International Finance BV, Bonds	6.356%	6/7/17		310,000		323,950(b)
Newfield Exploration Co., Senior Notes	6.625%	4/15/16		560,000		575,400
Pemex Project Funding Master Trust, Senior Bonds	6.625%	6/15/35		2,635,000		2,681,097
Petrobras International Finance Co., Global Notes	5.875%	3/1/18		879,000		935,975
Petroplus Finance Ltd., Senior Notes	7.000%	5/1/17		600,000		531,000(b)
Shell International Finance BV, Senior Notes	6.375%	12/15/38		250,000		296,307
Williams Cos. Inc., Debentures	7.500%	1/15/31		76,000		85,352

See Notes to Financial Statements.

Western Asset Income Fund

Security	Rate	Maturity Date		Face Amount		Value
Oil, Gas & Consumable Fuels continued						
Williams Cos. Inc., Senior Notes	8.750%	3/15/32	$	926,000	$	1,132,903
Total Oil, Gas & Consumable Fuels						***16,935,030***
Total Energy						**17,633,418**
Financials 35.0%						
Capital Markets 4.9%						
Credit Suisse AG, Subordinated Notes	5.400%	1/14/20		480,000		490,212
Goldman Sachs Capital I, Capital Securities	6.345%	2/15/34		555,000		528,832
Goldman Sachs Capital II, Junior Subordinated Bonds	5.793%	6/1/12		880,000		745,800(c)(d)
Goldman Sachs Group Inc., Senior Notes	6.000%	5/1/14		40,000		44,066
Goldman Sachs Group Inc., Senior Notes	5.375%	3/15/20		270,000		279,007
Goldman Sachs Group Inc., Subordinated Notes	6.750%	10/1/37		640,000		654,333
Kaupthing Bank HF, Senior Notes	5.750%	10/4/11		480,000		128,400(a)(b)(e)
Kaupthing Bank HF, Senior Notes	7.625%	2/28/15		620,000		165,850(a)(b)(e)
Kaupthing Bank HF, Subordinated Notes	7.125%	5/19/16		1,250,000		0(a)(b)(e)(f)(g)
Lehman Brothers Holdings Capital Trust VII, Medium-Term Notes	5.857%	5/31/12		1,745,000		175(a)(c)(d)
Lehman Brothers Holdings Inc.	5.750%	5/17/13		350,000		80,937(a)
Lehman Brothers Holdings Inc., Subordinated Notes	6.500%	7/19/17		110,000		11(a)
Merrill Lynch & Co. Inc., Senior Notes	6.400%	8/28/17		300,000		317,181
Merrill Lynch & Co. Inc., Senior Notes, Medium-Term Notes	6.050%	8/15/12		400,000		423,560
Merrill Lynch & Co. Inc., Subordinated Notes	5.700%	5/2/17		1,000,000		1,003,361
Merrill Lynch & Co. Inc., Subordinated Notes	6.110%	1/29/37		320,000		288,856
Morgan Stanley, Medium-Term Notes	6.625%	4/1/18		100,000		108,477
Morgan Stanley, Senior Notes	6.000%	5/13/14		860,000		929,213
Morgan Stanley, Senior Notes	5.500%	7/24/20		100,000		101,027
Morgan Stanley, Subordinated Notes	4.750%	4/1/14		60,000		61,442
Total Capital Markets						***6,350,740***
Commercial Banks 8.5%						
BAC Capital Trust XIV, Junior Subordinated Notes	5.630%	3/15/12		585,000		415,467(c)(d)
Banco Mercantil del Norte SA, Subordinated Bonds	6.135%	10/13/16		750,000		770,623(b)(c)
BankAmerica Capital III, Junior Subordinated Notes	0.859%	1/15/27		215,000		152,845(c)
BankAmerica Institutional Capital A, Junior Subordinated Bonds	8.070%	12/31/26		130,000		130,813(b)
BankAmerica Institutional Capital B, Junior Subordinated Bonds	7.700%	12/31/26		480,000		480,000(b)
Barclays Bank PLC, Subordinated Notes	10.179%	6/12/21		240,000		298,862(b)

See Notes to Financial Statements.

Schedule of investments (cont d)

December 31, 2010

Western Asset Income Fund

Security	**Rate**	**Maturity Date**	**Face Amount**	**Value**
Commercial Banks continued				
BB&T Capital Trust II, Junior Subordinated Notes	6.750%	6/7/36	$ 230,000	$ 228,134
BPCE SA, Subordinated Bonds	12.500%	9/30/19	361,000	414,912(b)(c)(d)
Commonwealth Bank of Australia, Senior Notes	5.000%	10/15/19	60,000	62,803(b)
Credit Agricole SA, Subordinated Notes	8.375%	10/13/19	1,050,000	1,078,875(b)(c)(d)
First Union Capital I, Junior Subordinated Notes	7.935%	1/15/27	420,000	432,070
Glitnir Banki HF, Notes	6.330%	7/28/11	400,000	119,000(a)(b)(e)
Glitnir Banki HF, Subordinated Bonds	7.451%	9/14/16	210,000	0(a)(b)(d)(e)(f)(g)
Glitnir Banki HF, Subordinated Notes	6.693%	6/15/16	680,000	0(a)(b)(e)(f)(g)
HBOS Capital Funding LP, Tier 1 Notes, Perpetual Bonds	6.071%	6/30/14	560,000	456,400(b)(c)(d)
HSBC Finance Capital Trust IX, Junior Subordinated Notes	5.911%	11/30/35	1,350,000	1,242,000(c)
ICICI Bank Ltd., Subordinated Bonds	6.375%	4/30/22	200,000	200,512(b)(c)
Landsbanki Islands HF	7.431%	10/19/17	730,000	0(a)(b)(d)(e)(f)(g)
Rabobank Nederland NV, Junior Subordinated Notes	11.000%	6/30/19	858,000	1,108,965(b)(c)(d)
Resona Preferred Global Securities Cayman Ltd., Junior Subordinated Bonds	7.191%	7/30/15	1,095,000	1,086,798(b)(c)(d)
Royal Bank of Scotland Group PLC, Junior Subordinated Notes, Medium-Term Notes	7.640%	9/29/17	100,000	66,500*(d)
Royal Bank of Scotland Group PLC, Senior Notes	6.400%	10/21/19	220,000	221,398
Royal Bank of Scotland Group PLC, Senior Subordinated Notes	6.375%	2/1/11	150,000	150,484
Royal Bank of Scotland Group PLC, Subordinated Notes	5.000%	11/12/13	70,000	69,128
Royal Bank of Scotland Group PLC, Subordinated Notes	5.000%	10/1/14	510,000	490,608
SunTrust Capital, Trust Preferred Securities	6.100%	12/15/36	520,000	475,800(c)
Wachovia Capital Trust III, Junior Subordinated Bonds	5.800%	3/15/11	630,000	546,525(c)(d)
Wells Fargo Capital X, Capital Securities	5.950%	12/15/36	450,000	434,369

See Notes to Financial Statements.

Western Asset Income Fund

Security	Rate	Maturity Date		Face Amount		Value
Consumer Finance continued						
HSBC Finance Corp., Senior Subordinated Notes	6.676%	1/15/21	$	1,000,000	$	1,010,281(b)
SLM Corp., Medium-Term Notes	8.000%	3/25/20		210,000		212,920
SLM Corp., Medium-Term Notes, Senior Notes	5.050%	11/14/14		130,000		124,239
SLM Corp., Medium-Term Notes, Senior Notes	5.625%	8/1/33		180,000		141,237
Total Consumer Finance						***6,116,685***
Diversified Financial Services 12.0%						
AES El Salvador Trust, Senior Notes	6.750%	2/1/16		750,000		725,560(b)
AIG SunAmerica Global Financing VI, Senior Secured Notes	6.300%	5/10/11		880,000		893,200(b)
Bank of America Corp., Notes, Preferred Securities	8.000%	1/30/18		150,000		151,170(c)(d)
Bank of America Corp., Senior Notes	7.625%	6/1/19		70,000		80,600
Bank of America Corp., Senior Notes	5.625%	7/1/20		60,000		61,170
Beaver Valley Funding Corp., Senior Secured Bonds	9.000%	6/1/17		199,000		216,379
Capital One Bank USA N.A., Senior Subordinated Notes	6.500%	6/13/13		330,000		361,337
Capital One Capital VI	8.875%	5/15/40		190,000		197,838
Citigroup Inc., Senior Notes	6.375%	8/12/14		620,000		685,228
Citigroup Inc., Senior Notes	5.500%	10/15/14		270,000		290,911
Citigroup Inc., Senior Notes	6.010%	1/15/15		210,000		230,375
Citigroup Inc., Senior Notes	8.500%	5/22/19		1,280,000		1,589,037
Citigroup Inc., Senior Notes	8.125%	7/15/39		450,000		572,462
Citigroup Inc., Subordinated Notes	6.125%	8/25/36		550,000		527,014
General Electric Capital Corp., Senior Notes	5.900%	5/13/14		1,000,000		1,106,759
General Electric Capital Corp., Senior Notes	6.000%	8/7/19		1,120,000		1,246,102
General Electric Capital Corp., Senior Notes	4.375%	9/16/20		1,060,000		1,043,206
General Electric Capital Corp., Subordinated Debentures	6.375%	11/15/67		600,000		594,000(c)
ILFC E-Capital Trust II, Bonds	6.250%	12/21/65		790,000		616,200(b)(c)
International Lease Finance Corp., Senior Notes	8.750%	3/15/17		190,000		203,775(b)
International Lease Finance Corp., Senior Notes	8.875%	9/1/17		470,000		507,013
International Lease Finance Corp., Senior Secured Notes	6.500%	9/1/14		80,000		84,800(b)
JPMorgan Chase & Co., Subordinated Notes	6.125%	6/27/17		720,000		789,936
JPMorgan Chase Capital XXV, Junior Subordinated Notes	6.800%	10/1/37		1,000,000		1,031,091
UFJ Finance Aruba AEC	6.750%	7/15/13		355,000		395,862
ZFS Finance USA Trust II, Bonds	6.450%	12/15/65		1,440,000		1,416,600(b)(c)
Total Diversified Financial Services						***15,617,625***

See Notes to Financial Statements.

Schedule of investments (cont d)

December 31, 2010

Western Asset Income Fund

Security	Rate	Maturity Date		Face Amount		Value
Insurance 3.7%						
Allstate Corp., Junior Subordinated Debentures	6.500%	5/15/57	$	480,000	$	481,200(c)
American International Group Inc., Junior Subordinated Debentures	6.250%	3/15/37		80,000		70,748
American International Group Inc., Senior Notes	6.400%	12/15/20		90,000		94,429
ASIF Global Financing XIX	4.900%	1/17/13		30,000		30,900(b)
AXA SA, Subordinated Bonds	8.600%	12/15/30		200,000		224,105
CNA Financial Corp., Senior Notes	5.875%	8/15/20		260,000		258,875
Delphi Financial Group Inc., Senior Notes	7.875%	1/31/20		170,000		181,612
Liberty Mutual Group, Junior Subordinated Bonds	7.800%	3/15/37		300,000		295,500(b)
Liberty Mutual Group, Senior Notes	5.750%	3/15/14		270,000		280,828(b)
MetLife Inc., Junior Subordinated Debentures	6.400%	12/15/36		1,160,000		1,090,400
Prudential Financial Inc., Junior Subordinated Debentures	8.875%	6/15/38		340,000		395,250(c)
Prudential Holdings LLC, Bonds, FSA-Insured	7.245%	12/18/23		260,000		290,134(b)
Teachers Insurance & Annuity Association of America College Retirement Equity Fund, Notes	6.850%	12/16/39		400,000		468,001(b)
Travelers Cos. Inc., Senior Notes	5.350%	11/1/40		500,000		492,630
Willis North America Inc., Senior Notes	5.625%	7/15/15		230,000		241,681
Total Insurance						***4,896,293***
Real Estate Investment Trusts (REITs) 0.1%						
Digital Realty Trust LP, Senior Notes	5.875%	2/1/20		20,000		20,347
Health Care REIT Inc., Senior Notes	5.875%	5/15/15		130,000		141,677
Total Real Estate Investment Trusts (REITs)				Total assets		

209,070,040

239,011,273

259,562,455

271,994,245

241,923,921

Total indebtedness

14,526,903

Explanation of Responses:

31,747,433

38,361,934

66,374,544

49,019,549

Total liabilities

17,711,258

38,021,546

44,034,578

72,485,398

53,177,310

Non-controlling interests

—

—

—

4,528,849

4,174,753

Total equity

191,358,782

200,989,727

215,527,877

199,508,847

188,746,611

Book value per share

$
22.56

$

22.10

$
21.03

$
19.03

$
17.14

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

Forward Looking Statements

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

Overview and Background

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

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

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Explanation of Responses:

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

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

Our operating results are affected primarily by:

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

Between 2008 and 2013, we experienced increased delinquent loans and foreclosures which created substantial losses. As a result, we owned significantly more real estate than in the past, which reduced cash flow and net income. As of December 31, 2018, approximately 22% of our loans were impaired and/or past maturity, up from 11% as of December 31, 2017. As of December 31, 2018, we owned approximately $56.6 million (book value) of real estate held for sale or investment, which is approximately 27% of total assets, a decrease of $23.8 million or 30% of total assets as compared to December 31, 2017. During 2018, we sold twenty-three real estate properties (including eleven condominium units at Zalanta) for aggregate net sales proceeds of $29,966,000 (including notes receivable totaling $8,679,000) and net gains totaling $4,611,000. We will continue to attempt to sell certain of our properties but may need to sell them for losses. In addition, under the REIT tax rules, we may be subject to a "prohibited transaction" penalty tax on tax gains from the sale of our properties in certain circumstances.

Although management currently believes that none of our delinquent loans will result in a credit loss to the Company, real estate values could decrease in the future. Management continues to perform frequent evaluations of collateral values for our loans using internal and external sources, including the use of updated independent appraisals. As a result of these evaluations, the allowance for loan losses and our investments in real estate could increase or decrease in the near term, and such changes could be material.

Proposed Merger with Ready Capital

We entered into the Merger Agreement with Ready Capital on November 7, 2018. In connection with the proposed Merger, the Company's stockholders will exchange their shares of the Company's Common Stock for newly issued shares of Ready Capital and the Management Agreement with OFG will be terminated. Pursuant to the terms of the Merger Agreement, each share of the Company's Common Stock will be converted into 1.441 shares of Ready Capital's common stock.

The operations of the Company's business are subject to certain restrictions contained in the Merger Agreement pending the closing of the Merger. Completion of the proposed Merger is subject to the satisfaction of certain customary conditions, and is subject to the approval of the stockholders of both Ready Capital and the Company. We cannot provide any assurance that the proposed Merger will close in a timely manner or at all.

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, subject to applicable restrictions contained in the Merger Agreement, seek to increase distributions to stockholders through active portfolio management and execution of our business plan which is outlined below:

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

Current Market Conditions, Risks and Recent Trends

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

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

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

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

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

Critical Accounting Policies

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

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

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

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

Real Estate Held for Sale

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

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

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

Real Estate Sales—We evaluate if real estate sale transactions qualify for recognition under the full accrual method, considering whether, among other criteria, the buyer’s initial and continuing investments are adequate to demonstrate a commitment to pay, any receivable due to the Company is not subject to future subordination, the Company has transferred to the buyer the usual risks and rewards of ownership and the Company does not have a substantial continuing involvement with the sold real estate. At the time the sale is consummated, a gain or loss is recognized as the difference between the sale price less disposal cost and the carrying value of the real estate.

Real Estate Held for Investment

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

Income Taxes

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

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

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

difficult to forecast.

Tax Positions - The accounting guidance prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. A tax position is recognized as a benefit only if it is “more likely than not” that the position would be sustained in a tax examination, with a tax examination being presumed to occur. We have analyzed our various federal and state filing positions and believe that our income tax filing positions and deductions are well documented and supported. There was no reserve for uncertain tax positions recorded as of December 31, 2018 and 2017. See discussion of tax issue related to the Company’s 2012 federal tax return under “Commitments and Contingencies” below.

Significant Developments During 2018 and Subsequent Events

Proposed Merger with Ready Capital - We entered into the Merger Agreement with Ready Capital on November 7, 2018. In connection with the proposed Merger, the Company's stockholders will exchange their shares of the Company's Common Stock for newly issued shares of Ready Capital Common Stock. Completion of the proposed Merger is subject to the satisfaction of certain customary conditions, and is subject to the approval of the stockholders of both Ready Capital and the Company. The Company cannot provide any assurance that the proposed Merger will close in a timely manner or at all.

Loan Activity – We originated 18 new loans during 2018 totaling $78,867,000 (when fully funded) with a weighted average interest rate of 7.6% (excluding carryback loans on the sales of real estate). During 2018, we received full or partial repayment on 28 loans in the total amount of $78,692,000 with a weighted average interest rate of 7.6%. During 2018, we extended the maturity dates of 19 loans with outstanding principal balances aggregating $47,915,000 with a weighted average interest rate of 8.3%. During 2018, we recorded charge-offs from the specific loan loss allowance on one impaired loan totaling $187,000 and recorded a net decrease in the general allowance for loan losses of $163,000 (net of $76,000 recovery of bad debts received), for a total decrease in the allowance of $350,000.

Real Estate Property Sales – We sold 23 real estate properties (three partially) during 2018 for aggregate net sales proceeds of $29,966,000 (including notes receivable totaling $8,679,000) and net gains totaling $4,611,000.

Stock Repurchases – We repurchased 608,574 shares of our Common Stock during 2018 pursuant to the 2018 Repurchase Plan at a total cost of $10,033,000 and an average cost of $16.49 per share. The 2018 Repurchase Plan terminated in September 2018.

Amendment to Management Agreement – Effective April 1, 2018, the Management Agreement was amended to implement changes to the Manager's compensation structure that are described in Item 1 – "Compensation to the Manager" of this Annual Report and in our consolidated financial statements under "Note 12 – Transactions with Affiliates" in Item 8 of this Annual Report.

Subsequent Events – The following events have occurred during the first quarter of 2019 and are discussed in further detail in our consolidated financial statements under "Note 16 – Subsequent Events" in Item 8 of this Annual Report:

- The Company sold two real estate properties in January 2019 for net sales proceeds totaling $2,706,000 and gain totaling $466,000.
- The Company extended the maturity dates on five loans that were past maturity as of December 31, 2018 with principal balances totaling approximately $15,010,000 in January and February 2019.

Comparison of Results of Operations for Years Ended 2018 and 2017

The following table sets forth our results of operations for the years ended December 31, 2018 and 2017:

	Year Ended December 31,		Increase/(Decrease)	
	2018	2017	Amount	Percent
Revenues:				
Interest and related income from loans	$12,281,261	$10,840,730	$1,440,531	13 %
Rental and other income from real estate properties	4,129,261	4,505,385	(376,124)	(8) %
Other income	386,499	187,013	199,486	107 %
Total revenues	16,797,021	15,533,128	1,263,893	8 %
Expenses:				
Management fees to Manager	2,906,333	3,546,085	(639,752)	(18) %
Servicing fees to Manager	95,143	362,411	(267,268)	(74) %
General and administrative expense	3,389,524	2,234,230	1,155,294	52 %
Rental and other expenses on real estate properties	3,858,962	4,980,900	(1,121,938)	(23) %
Depreciation and amortization	761,717	1,138,515	(376,798)	(33) %
Interest expense	2,132,776	1,587,695	545,081	34 %
(Recovery of) provision for loan losses	(239,144)	(360,012)	120,868	(34) %
Impairment losses on real estate properties	1,053,161	1,423,286	(370,125)	(26) %
Total expenses	13,958,472	14,913,110	(954,638)	(6) %
Operating income	2,838,549	620,018	2,218,531	nm
Gain on sales of real estate, net	4,610,824	14,728,921	(10,118,097)	(69) %
Settlement expense	—	(2,627,436)	2,627,436	(100) %
Net income before income taxes	7,449,373	12,721,503	(5,272,130)	(41) %
Income tax expense	(559,842)	(4,041,655)	3,481,813	(86) %
Net income	$6,889,531	$8,679,848	$(1,790,317)	(20) %

nm – not meaningful

Revenues

Interest and related income from loans increased $1,441,000 (13% increase) to $12,281,000 for the year ended December 31, 2018, as compared to $10,841,000 for the year ended December 31, 2017. The increase was primarily due to an increase in the average balance of performing loans between the year ended December 31, 2018 and the year ended December 31, 2017 of approximately 4%, to discount and loan fee amortization on certain loans and to the collection of late charges by the Company on loans beginning in April 2018.

Other income increased $199,000 (107% increase) during the year ended December 31, 2018, as compared to 2017, primarily due to increased income from our investment in 1850 De La Cruz, LLC as the applicable lease was extended effective July 15, 2018 at the current market rate which resulted in an increase in monthly rental income of approximately $74,000 per month of which 50% ($37,000) was earned by the Company.

Rental and other income from real estate properties decreased $376,000 (8% decrease) to $4,129,000 for the year ended December 31, 2018, as compared to $4,505,000 for the year ended December 31, 2017, primarily due to the sale of certain operating properties during 2017 and 2018, net of increased rent on certain of the Company’s remaining rental properties.

Expenses

Management fees decreased $640,000 (18% decrease) and servicing fees decreased $267,000 (74% decrease) during the year ended December 31, 2018, as compared to 2017. The decrease in these fees resulted from the impact of the Interim Management Fee that was effective from July 1, 2017 through March 31, 2018 and the Amendment to the

Management Agreement, effective April 1, 2018, that further changed the management fee calculation and eliminated payment of servicing fees to the Manager (and made additional changes to the compensation of the Manager as described in Item 1 – "Compensation to the Manager" of this Annual Report and in our consolidated financial statements under "Note 12 – Transactions with Affiliates" in Item 8 of this Annual Report. Management fees for the year ended December 31, 2018 were approximately $1,343,000 lower than the management fees that would have been payable to the Manager using the Prior Management Fee calculation.

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General and administrative expense increased $1,155,000 (52% increase) during the year ended December 31, 2018, as compared to 2017. The increase was due primarily to increased legal and other costs relating to the pending Merger with Ready Capital, and increased director fees, net of the elimination of salary related expense reimbursements to the Manager beginning April 1, 2018 as a result of the Amendment to the Management Agreement.

Rental and other expenses on real estate properties decreased $1,122,000 (23% decrease) during the year ended December 31, 2018, as compared to 2017, primarily due to the sale of certain properties during 2017 and 2018.

Depreciation and amortization expense decreased $377,000 (33% decrease) during the year ended December 31, 2018, as compared to 2017, primarily due to the sale of certain depreciable properties during 2017 and 2018 and the discontinuation of depreciation on certain properties that were moved to Held for Sale during 2017 and 2018.

Interest expense increased $545,000 (34% increase) during the year ended December 31, 2018 as compared to 2017, due primarily to increased interest expense on the ZRV construction loan as construction was completed in mid-2017 and capitalization of interest was discontinued and also due to higher balances outstanding and a higher average interest rate on the CB&T line of credit (including the unused commitment fee) during the year ended December 31, 2018, as compared to 2017.

The recovery of loan losses of $239,000 during the year ended December 31, 2018 was the result of an analysis performed on the loan portfolio. The general loan loss allowance decreased $163,000 during the year ended December 31, 2018 primarily due to a decrease in the balance of performing residential and land loans during the year which have a higher historical loss factor as compared to commercial loans. In addition, the Company received a recovery of bad debts of $76,000 during 2018. The specific loan loss allowance decreased $187,000 during the year ended December 31, 2018 as a result of a charge-off against the allowance for loan losses from the partial payoff of an impaired loan during the year.

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

The impairment losses on real estate properties of $1,053,000 and $1,423,000, respectively, during the years ended December 31, 2018 and 2017 were the result of agreements to sell certain of our properties for prices that were lower than the book value or the result of updated appraisals or other valuation information obtained on certain of our real estate properties during those years.

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

<u>Gain on Sales of Real Estate</u>

Gain on sales of real estate decreased $10,118,000 during the year ended December 31, 2018, as compared to 2017, as a result of the sale of twenty-three real estate properties (three partially) during 2018, resulting in gains totaling $4,611,000 (see further detail under “Real Estate Properties Held for Sale and Investment” below), as compared to the sale eight real estate properties (two partially) during the year ended December 31, 2017, resulting in gains totaling $14,729,000.
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We believe, from period to period in the near term, there will be fluctuations in net income resulting from the lag time between the sale of our real estate assets and deployment of the proceeds into new loan investments.

Income Tax Expense

Income tax expense (primarily related to our taxable REIT subsidiaries) decreased $3,482,000 (86% decrease) during the year ended December 31, 2018, as compared to 2017. This decrease was primarily the result of a larger valuation allowance recorded against deferred tax assets as a result of higher construction costs and lower expected gains from future sales of ZRV assets in the Company's analysis during the year ended December 31, 2017, as compared to the year ended December 31, 2018. The Company's effective tax rate for 2018 differed from the statutory tax rate primarily due to an increase in the valuation allowance on deferred tax assets. The Company's effective tax rate for 2017 differed from the statutory tax rate primarily due to an increase in the valuation allowance on deferred tax assets and the change in the Federal corporate tax rate from 34% to 21% in 2018 and beyond as a result of the Tax Cuts and Jobs Act signed into law by President Trump on December 22, 2017, which required us to remeasure our deferred tax assets at the lower rate. Management has estimated future taxable gains and losses on sale of ZRV real estate assets to determine how much of the deferred tax assets are realizable. This realizability analysis is inherently subjective and actual results could differ from these estimates.

Comparison of Results of Operations for Years Ended 2017 and 2016

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

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

nm – not meaningful

Revenues

Interest and related income from loans increased $1,919,000 (22% increase) to $10,841,000 for the year ended December 31, 2017, as compared to $8,922,000 for the year ended December 31, 2016. The increase was primarily

due to an increase in the average balance of performing loans between the year ended December 31, 2017 and the year ended December 31, 2016 of approximately 26%.

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

Expenses

Management fees increased $260,000 (8% increase) and servicing fees increased $64,000 (21% increase) during the year ended December 31, 2017, as compared to 2016. The servicing fee increase was due to an increase in the average balance of loans in our portfolio of 21% during the year ended December 31, 2017, as compared to 2016. The management fees did not increase as much as the service fees as a result of the increased loan balances because the Board and the Manager agreed to adjust the Prior Management Fee to the Interim Management Fee during the period from July 1, 2017 to March 31, 2018, and the Interim Management Fee calculation resulted in a management fee for the year ended December 31, 2017 that was approximately $440,000 lower than the fee that would have been payable to the Manager using the Prior Management Fee calculation.

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

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

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

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

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

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

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

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

Gain on Sales of Real Estate

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

Income Tax (Expense) Benefit

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

Net Income Attributable to Non-Controlling Interests

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

Explanation of Responses:

Financial Condition

December 31, 2018 and 2017

Loan Portfolio

Our portfolio of loan investments decreased from 61 as of December 31, 2017 to 59 as of December 31, 2018, and the average loan balance increased from $2,396,000 as of December 31, 2017 to $2,418,000 as of December 31, 2018.

As of December 31, 2018 and 2017, we had seven and nine impaired loans, respectively, totaling approximately $11,862,000 (8.3% of the portfolio) and $8,534,000 (5.8%), respectively. This included matured loans totaling $7,276,000 and $7,107,000 as of December 31, 2018 and 2017, respectively. In addition, seven and seven loans of approximately $19,515,000 (13.7%) and $7,585,000 (5.2%) were past maturity but less than ninety days delinquent in monthly payments as of December 31, 2018 and 2017, respectively (combined total of $31,377,000 (22.0%) and $16,119,000 (11.0%), respectively, that are past maturity and/or impaired). Of the impaired and past maturity loans, none were in the process of foreclosure and none involved loans to borrowers who were in bankruptcy. We foreclosed on two loans secured by the same property during the year ended December 31, 2018 with principal balances totaling approximately $1,937,000 and obtained the property via the trustee sale. We foreclosed on no loans during the year ended December 31, 2017. In February 2019 (subsequent to year-end), we filed a Notice of Default on two impaired loans secured by the same property totaling $4,388,000.

Of the $8,534,000 in loans that were impaired as of December 31, 2017, four with principal balances totaling $4,566,000 remained impaired, three with principal balances totaling $2,029,000 were paid off and two with principal balances totaling $1,939,000 were foreclosed upon.

As of December 31, 2018 and 2017, approximately $142,484,000 (99.9%) and $145,958,000 (99.9%) of our loans are interest only and/or require the borrower to make a “balloon payment” on the principal amount upon maturity of the loan. To the extent that a borrower has an obligation to pay loan principal in a large lump sum payment, its ability to satisfy this obligation may be dependent upon its ability to sell the property, obtain suitable refinancing or otherwise raise a substantial cash amount. As a result, these loans involve a higher risk of default than fully amortizing loans. Borrowers occasionally are not able to pay the full amount due at the maturity date. We may allow these borrowers to continue making the regularly scheduled monthly payments for certain periods of time to assist the borrower in meeting the balloon payment obligation without formally filing a notice of default. These loans for which the principal and any accrued interest is due and payable, but the borrower has failed to make such payment of principal and/or accrued interest are referred to as “past maturity loans”. As of December 31, 2018 and 2017, we had eleven and thirteen past maturity loans totaling approximately $26,791,000 and $14,692,000, respectively.
There were no loans modified as troubled debt restructurings during the years ended December 31, 2018. There was one loan with a principal balance of $1,145,000 modified as a troubled debt restructuring during the year ended December 31, 2017.

As of December 31, 2018 and 2017, we held the following types of loan investments:

	December 31, 2018	December 31, 2017
<u>By Property Type</u>:		
Commercial	$132,519,461	$127,873,281
Residential	5,209,357	13,170,795
Land	4,953,425	5,127,574
	$142,682,243	$146,171,650
<u>By Position</u>:		
Senior loans	$137,808,788	$142,782,492

Junior loans	4,873,455	3,389,158
	$142,682,243	$146,171,650

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The types of property securing our commercial real estate loans are as follows as of December 31, 2018 and 2017:

	December 31, 2018	December 31, 2017
Commercial Real Estate Loans:		
Office	$26,052,765	$29,480,103
Retail	57,108,646	32,329,395
Storage	5,996,619	15,807,016
Apartment	15,382,892	24,582,181
Hotel	8,985,000	11,777,351
Industrial	2,856,911	2,690,000
Warehouse	3,000,000	3,000,000
Marina	3,638,121	3,580,000
Assisted care	7,550,858	1,650,000
Golf course	1,550,000	1,212,851
Restaurant	397,649	1,764,384
	$132,519,461	$127,873,281

Scheduled maturities of loan investments as of December 31, 2018 and the interest rate sensitivity of such loans are as follows:

	Fixed Interest Rate	Variable Interest Rate	Total
Year ending December 31:			
2018 (past maturity)	$21,874,240	$4,916,586	$26,790,826
2019	55,144,317	15,780,197	70,924,514
2020	4,319,448	33,577,666	37,897,114
2021	5,519,317	1,351,912	6,871,229
Thereafter (through 2028)	198,560	—	198,560
	$87,055,882	$55,626,361	$142,682,243

Currently, our variable rate loans use as indices the Prime, three-month or six-month LIBOR rates 5.50%, 2.80% and 2.87% respectively, at December 31, 2018) or include terms whereby the interest rate we charge is increased at a later date. Premiums over these indices have varied from 3.0% to 9.0% and may be higher or lower depending upon market conditions at the time the loan is made.

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The following is a schedule by geographic location of loan investments as of December 31, 2018 and 2017:

	December 31, 2018		December 31, 2017	
	Balance	Percentage	Balance	Percentage
California	$98,865,551	69.29%	$110,884,117	75.86%
Arizona	—	—%	815,890	0.56%
Colorado	6,447,573	4.52%	4,380,616	3.00%
Hawaii	1,445,964	1.01%	1,450,000	0.99%
Illinois	—	—%	1,364,384	0.93%
Indiana	—	—%	388,793	0.27%
Michigan	8,985,000	6.30%	10,714,764	7.33%
Nevada	—	—%	1,653,107	1.13%
Ohio	—	—%	3,755,000	2.57%
Pennsylvania	5,519,317	3.87%	—	—%
Texas	17,565,952	12.31%	6,625,000	4.53%
Washington	—	—%	3,159,460	2.16%
Wisconsin	3,852,886	2.70%	980,519	0.67%
	$142,682,243	100.00%	$146,171,650	100.00%

As of December 31, 2018 and 2017, our loans secured by real property collateral located in Northern California totaled approximately 60% ($86,161,000) and 54% ($78,465,000), respectively, of the loan portfolio. The Northern California region (which includes Monterey, Fresno, Kings, Tulare and Inyo counties and all counties north) is a large geographic area which has a diversified economic base. The ability of borrowers to repay loans is influenced by the economic strength of the region and the impact of prevailing market conditions on the value of real estate.

Our investment in loans decreased by $3,489,000 (2.4%) during the year ended December 31, 2018 primarily as a result of loan payoffs, net of new loan originations during the year. As of December 31, 2018 and 2017, we had twelve and fourteen construction/rehabilitation loans in our portfolio with aggregate outstanding principal balances totaling $26,044,000 and $21,751,000, respectively.

Allowance for Loan Losses

The allowance for loan losses (decreased) increased by approximately $(350,000), $(879,000) and $864,000 (provision, net of reversals and charge-offs) during the years ended December 31, 2018, 2017 and 2016, respectively. The Manager believes that the allowance for loan losses is sufficient given the estimated underlying collateral values of impaired loans. There is no precise method used by the Manager to predict delinquency rates or losses on specific loans. The Manager has considered the number and amount of delinquent loans, loans subject to workout agreements and loans in bankruptcy in determining allowances for loan losses, but there can be no absolute assurance that the allowance is sufficient. Because any decision regarding the allowance for loan losses reflects judgment about the probability of future events, there is an inherent risk that such judgments will prove incorrect. In such event, actual losses may exceed (or be less than) the amount of any reserve. To the extent that we experience losses greater than the amount of its reserves, we may incur a charge to earnings that will adversely affect operating results and the amount of any dividends paid.

Changes in the allowance for loan losses for the years ended December 31, 2018, 2017 and 2016 were as follows:

	2018	2017	2016
Balance, beginning of period	$1,827,806	$2,706,822	$1,842,446
(Recovery of) provision for loan losses	(239,144)	(360,012)	1,284,896
Charge-offs	(186,708)	(546,004)	(447,520)
Recoveries	76,234	27,000	27,000

Balance, end of period	$1,478,188	$1,827,806	$2,706,822

As of December 31, 2018 and 2017, there was a general allowance for loan losses of $1,478,188 and $1,641,098, respectively, and a specific allowance for loan losses of $0 and $186,708, respectively.

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Real Estate Properties Held for Sale and Investment

As of December 31, 2018, we held title to thirteen properties that were acquired through foreclosure, with a total carrying amount of approximately $56,643,000 (including properties held in four limited liability companies and one corporation), net of accumulated depreciation of $2,680,000. As of December 31, 2018, properties held for sale total $34,094,000 and properties held for investment total $22,549,000. We foreclosed on two loans secured by the same property during the year ended December 31, 2018. We did not foreclose on any loans during the year ended December 31, 2017. When we acquire property by foreclosure, we typically earn less income on those properties than could be earned on loans and we may not be able to sell the properties in a timely manner.

Changes in real estate held for sale and investment during the years ended December 31, 2018, 2017 and 2016 were as follows:

	2018	2017	2016
Balance, beginning of period	$80,466,125	$113,123,398	$153,838,412
Real estate acquired through foreclosure	2,062,729	—	700,800
Investments in real estate properties	496,826	11,274,904	29,061,735
Amortization of deferred financing costs capitalized to construction project	—	76,260	119,471
Sales of real estate properties	(24,609,167)	(41,505,148)	(66,183,589)
Impairment losses on real estate properties	(1,053,161)	(1,423,286)	(3,227,807)
Depreciation of properties held for investment	(720,842)	(1,080,003)	(1,185,624)
Balance, end of period	$56,642,510	$80,466,125	$113,123,398

Seven of our thirteen properties do not currently generate revenue. Seven of the Company’s twenty-one commercial leases are set to expire during 2019. All of the Company’s twelve residential leases are either on a month-to-month basis or will expire in 2019. The Company expects that new leases will be signed with existing or new tenants for the majority of these spaces and at rental rates that are at market and are at or above expiring rental amounts.

For purposes of assessing potential impairment of value during 2018, 2017 and 2016, we obtained updated appraisals or other valuation support on several of our real estate properties held for sale and investment, which resulted in additional impairment losses on certain properties in the aggregate amount of approximately $1,053,000, $1,423,000 and $3,228,000, respectively, recorded in the consolidated statements of income.

2018 Sales Activity

During the year ended December 31, 2018, we sold twenty-three real estate properties (three partially) with details as follows:

	Net Sales Proceeds	Gain (Loss)
Assisted living facility, Bensalem, Pennsylvania*	$5,470,700	$(494,786)
Residential condominium units (11 units), South Lake Tahoe, California (held within ZRV)**	13,558,657	1,114,255
Office condominium complex (10 units – 7 sales), Roseville, California	5,995,715	3,561,143
1/7th interest in single family home, Lincoln City, Oregon	88,161	(9,486)
One improved residential lot, Coeur D’Alene, Idaho	392,120	303,519
Golf course, Auburn, California (held within Lone Star Golf, Inc.)***	2,176,047	136,178
Unimproved, residential and commercial land, Bethel Island, California	2,284,260	—
	$29,965,660	$4,610,823

* Net sales proceeds included carryback loan of $5,875,000, net of $468,705 discount ($5,406,295 net).
** Net sales proceeds included two carryback loans totaling $1,462,500.

***Net sales proceeds included two carryback loans totaling $1,810,270. One with a principal balance of $260,000 was repaid during 2018.

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2017 Sales Activity

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

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

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

2016 Sales Activity

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

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

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

2018 Foreclosure Activity

During the year ended December 31, 2018, the Company foreclosed on two loans secured by two homes and 20 acres of residential land located in San Ramon, California with principal balances aggregating approximately $1,937,000 and obtained the property via the trustee's sale. In addition, accrued interest and advances made on the loan (for items such as legal fees and delinquent property taxes) in the total amount of approximately $125,000 were capitalized to the basis of the property. The fair market value of the property acquired was estimated to approximate the Company's recorded investment in the loans.

2017 Foreclosure Activity

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

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2016 Foreclosure Activity

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

Equity Method Investment in Limited Liability Company

1850 De La Cruz, LLC

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

During the years ended December 31, 2018, 2017 and 2016, we received capital distributions from 1850 in the total amount of $385,000, $185,000 and $180,000, respectively. The net income to the Company from its investment in 1850 De La Cruz was approximately $383,000, $185,000 and $179,000 for the years ended December 31, 2018, 2017 and 2016, respectively.

Interest and Other Receivables

Interest and other receivables decreased from approximately $2,430,000 as of December 31, 2017 to $1,105,000 as of December 31, 2018 ($1,326,000 or 54.6% decrease) due primarily to the repayment of advances in the amount of approximately $486,000 on one impaired loan with the sale of the final collateral securing the loan and the reduction of a $700,000 receivable due from the tenant of the assisted living facility located in Bensalem, Pennsylvania as part of the sale that was closed during the first quarter of 2018.

Deferred Financing Costs

Deferred financing costs accounted for as assets increased from approximately $27,000 as of December 31, 2017 to $351,000 as of December 31, 2018 ($324,000 increase) due primarily to a loan fee and other related issuance costs paid upon the renewal of the Company's line of credit during the third quarter of 2018.

Deferred Tax Assets, Net

Deferred tax assets decreased from $3,207,000 as of December 31, 2017 to approximately $2,697,000 as of December 31, 2018 ($510,000 or 15.9% decrease) due primarily to an increase in the valuation allowance recorded against deferred tax assets as a result of lower expected gains from the sales of ZRV assets in the future.

Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities decreased from approximately $1,390,000 as of December 31, 2017 to $1,246,000 as of December 31, 2018 ($145,000 or 10.4% decrease), due primarily to a decrease in payables as a result of the sales of real estate properties during 2017 and 2018.

Forward Contract Liability – Share Repurchase

Forward contract liability decreased from $2,731,000 as of December 31, 2017 to $0 as of December 31, 2018 due to the Settlement Agreement between the Company and Freestone for the purchase of 810,937 of the Freestone Shares. As of December 31, 2017, 669,058 of the Freestone Shares had been repurchased and the remaining 141,879 shares were repurchased on January 12, 2018; thus, requiring the Company to record a liability as of December 31, 2017. There was no such liability as of December 31, 2018.

Line of Credit Payable

Line of credit payable increased from $1,555,000 as of December 31, 2017 to $1,728,000 as of December 31 2018 ($173,000 or 11.1% increase) due primarily to advances on the line of credit for loan originations and stock repurchases in 2018, net of repayments from loan principal received and proceeds from sales of real estate properties.

Notes and Loans Payable on Real Estate

Notes and loans payable decreased from approximately $30,192,000 as of December 31, 2017 to approximately $12,799,000 as of December 31, 2018 ($17,394,000 or 57.6% decrease) due primarily to the sale of eleven condominiums at ZRV and the repayment of the note payable from the sales proceeds during 2018. The ZRV loan was repaid in full during 2018.

Asset Quality

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

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

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

Based upon this evaluation, a determination is made as to whether the allowance for loan losses is adequate to cover probable incurred credit losses in the Company’s loan portfolio. Additions to the allowance for loan losses are made by charges to the provision for loan losses. Loan losses deemed to be uncollectible are charged against the allowance for

loan losses. Recoveries of previously charged off amounts are credited to the allowance for loan losses. As of December 31, 2018, management believes that the allowance for loan losses of approximately $1,478,000 is adequate in amount to cover probable incurred credit losses. Because of the number of variables involved, the magnitude of the swings possible and management's inability to control many of these factors, actual results may and do sometimes differ significantly from estimates made by management. As of December 31, 2018, seven loans totaling approximately $11,862,000 were impaired. Four of these loans totaling approximately $7,276,000 were past maturity. During the year ended December 31, 2018, we recorded a net decrease in the allowance for loan losses of approximately $350,000 (charge-off against the specific loan loss allowance of $187,000 and decrease in general allowance of $163,000, net of recovery of bad debts of $76,000). Management believes that the allowance for loan losses is sufficient given the estimated fair value of the collateral underlying impaired and past maturity loans and based on historical loss and delinquency factors applied to performing loans by class.

Liquidity and Capital Resources

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

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

We require liquidity to:

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

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

- the use of our cash and cash equivalent balances of $1,014,000 (not including restricted cash) as of December 31, 2018;
- cash generated from operating activities, including interest income from our loan portfolio and income generated from our real estate properties;
- proceeds from the sales of real estate properties;
- proceeds from our line of credit;
- proceeds from future borrowings including additional lines of credit; and
- proceeds from potential future offerings of our equity securities.

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

	Year Ended December 31,		
	2018	2017	2016
Net cash provided by (used in) operating activities	$4,860,977	$(1,695,167)	$(763,292)
Net cash provided by investing activities	30,629,671	28,071,852)	40,542,620
Net cash used in financing activities	(36,647,163)	(27,640,112)	(41,326,298)

During the years ended December 31, 2018 and 2017, our cash and cash equivalents decreased approximately $1,157,000 and $1,263,000, respectively.

Operating Activities

Cash flows from operating activities are primarily rental and other income from real estate properties, net of real estate expenses, and interest received from our investments in loans, partially offset by payment of operating expenses. For the years ended December 31, 2018 and 2017, cash flows received from operating activities increased $6,556,000 and decreased $932,000, respectively, as compared to the previous year. The increase during 2018 primarily reflects increased operating income and a decrease in amounts paid to satisfy accounts payable balances during 2018 as compared to 2017. The decrease during 2017 reflects the settlement expense related to the purchase of the Freestone Shares and higher management and service fees and general and administrative expenses, net of increased interest income earned on loans and lower interest expense during 2017, as compared to 2016.

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Explanation of Responses:

Investing Activities

Net cash provided by investing activities for the periods presented reflect our investing activity. For the years ended December 31, 2018 and 2017, cash flows from investing activities increased $2,558,000 and decreased $12,471,000, respectively, as compared to the previous year. Approximately $30,630,000 was provided by investing activities during 2018 as $99,919,000 was received from the sales of real estate properties and the payoff of loans, which was partially offset by an aggregate of $69,289,000 that was used for investment in loans and improvements to real estate properties during the year.
Approximately $28,072,000 was provided by investing activities during 2017 as $125,145,000 was received from the sales of real estate properties and the payoff of loans, which was partially offset by an aggregate of $97,057,000 that was used for investment in loans and improvements to real estate properties during the year.

Financing Activities

Net cash used in financing activities during 2018 totaled approximately $36,647,000 and consisted primarily of $17,373,000 of net repayments on our line of credit and notes payable, $12,369,000 of treasury stock purchases, $6,465,000 of dividends paid to stockholders and $440,000 payment of deferred financing costs. Net cash used in financing activities during 2017 totaled approximately $27,640,000 and consisted primarily of $6,850,000 of net repayments on our lines of credit and notes payable, $16,532,000 of treasury stock purchases and $4,245,000 of dividends paid to stockholders.

Dividends

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

Off-Balance Sheet Arrangements

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

Contractual Obligations and Commitments

The table below summarizes our known contractual obligations as of December 31, 2018 and in future periods in which we expect to settle such obligations. The table does not reflect the effect of actual repayments or draws on the obligations or any new financing obtained subsequent to year end.

	Payment due by Period				
Contractual Obligations	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Recourse indebtedness:					
Line of credit payable (1)	$1,728,000	$ —	$ 1,728,000	$—	$ —
Loan payable on real estate	12,872,556	387,136	12,485,420	—	—
Total recourse indebtedness	14,600,556	387,136	14,213,420	—	—
Non-recourse indebtedness:					
Notes payable on real estate	—	—	—	—	—
Total non-recourse indebtedness	—	—	—	—	—
Total indebtedness	14,600,556	387,136	14,213,420	—	—
Interest payable (2)	1,234,032	635,151	598,881	—	—
Funding commitments to borrowers (3)	29,301,255	29,301,255	—	—	—
Total Obligations	$45,135,843	$ 30,323,542	$ 14,812,301	$—	$ —

(1) As of December 31, 2018, the Company had the ability to borrow $47,235,000 on its line of credit.

(2) Variable-rate indebtedness assumes a prime rate of 5.5% (actual rate at December 31, 2018) through the original maturity date of the financing. Interest payable is based on balances outstanding as of December 31, 2018.

(3) Amounts represent the commitments we have made to fund borrowers in our existing lending arrangements as of December 31, 2018.

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

Management Agreement and Charter

The Manager provides services to the Company pursuant to the Management Agreement with the Manager dated May 20, 2013 and amended as of April 1, 2018, and is entitled to receive a management fee, late fees, other miscellaneous fees, and the reimbursement of certain expenses as described in Item 1 – "Compensation to the Manager" of this Annual Report and in our consolidated financial statements under "Note 12 – Transactions with Affiliates" in Item 8 of this Annual Report.

Company Debt

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

CB&T Line of Credit

As of December 31, 2018, the Company has one credit facility and as of that date, the total amount available to borrow under the CB&T Credit Facility was $47,235,000 and the balance outstanding was $1,728,000, including $0 on the sublimit facility (leaving $45,507,000 available). As of March 13, 2019, the total amount available to borrow under the CB&T Credit Facility was $45,109,000 and there was no balance outstanding (leaving $45,109,000 available). Interest on borrowings under the CB&T line of credit facility are payable monthly and all amounts outstanding under the facility are to be repaid not later than May 15, 2020 and advances may be made up to that date.

Tahoe Stateline Venture, LLC Loan Payable
The balance of the TSV Loan was approximately $12,873,000 as of December 31, 2018 and $12,777,000 as of March 13, 2019, and no further funds are available to borrow under this loan agreement. TSV makes monthly payments of principal and accrued interest and the balance of the loan is due on the maturity date, which is January 1, 2021.

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Commitments and Contingencies

As of December 31, 2018, we have commitments to advance additional funds to borrowers of construction, rehabilitation and other loans (including interest reserves) in the total amount of approximately $29,301,000.
The Company recently discovered that its 2012 federal income tax return was erroneously prepared and filed on IRS Form 1120-REIT, instead of on IRS Form 1120, resulting in the Company's REIT election technically being made beginning with its 2012 tax year instead of beginning with its 2013 tax year as was intended. Consequently, the Company was in technical violation of certain REIT qualification requirements in 2012 and 2013. Under the REIT provisions of the federal income tax laws, there are "savings clauses" available for use by REITs to cure the types of technical violations that occurred. These available savings clauses were designed to assist public REITs in curing inadvertent failures and are self-executing provided that the REIT has "reasonable cause" for the technical violations and complies with certain other procedural requirements, including, in the case of the Company, the payment of a $50,000 penalty to the IRS. Upon discovery of the error, the Company sought advice of experienced REIT tax counsel and has obtained an opinion of such counsel to the effect that the Company will have reasonable cause for the technical violations and thereby be able to avail itself of the savings clauses. Consequently, the Company intends to fulfill the relevant procedural requirements of the savings clauses, including payment of the $50,000 penalty. In the event that the Company was not able to satisfy the requirements of the savings clauses, the Company potentially could have been prevented from qualifying as a REIT through its 2017 taxable year (but in such case would re-elect REIT status for its 2018 taxable year). The potential tax liability to the Company if it is not successful in using the savings clauses are estimated to be in the range of $3,000,000 to $9,000,000, not including interest and penalties. Based on the advice and opinion of counsel and its own review and analysis of the relevant facts, the Company has concluded at a more-likely-than-not level that it will be able to benefit from the savings clause provisions to maintain uninterrupted REIT status during its existence and thus has not accrued any potential income tax liability related to this matter, other than the $50,000 penalty discussed above, which has been accrued and recorded in income tax expense during the year ended December 31, 2018. In particular, based on the Company's review of the facts and circumstances surrounding the filing of the 2012 federal tax return, the Company believes that it acted with ordinary business care and prudence, as required by the definition of "reasonable cause", in reasonably relying on the advice of its former outside tax advisor with respect to the proper preparation and IRS form filing for its short 2012 tax year. Additionally, the Company's confidence in its position is bolstered by the legislative language and legislative history behind the savings clauses, which provide that Congress viewed REIT disqualification as a result of inadvertent technical violations to be inappropriate, and instead imposed a reasonable penalty regime in the form of the savings clauses.

Contingency Reserves

We are required to maintain cash, cash equivalents and marketable securities as contingency reserves in an aggregate amount of at least 1.50% of Capital (as defined in our charter). Although the Manager believes the contingency reserves are adequate, it could become necessary for us to sell or otherwise liquidate certain of our investments or other assets to cover such contingencies on terms which might not be favorable to the Company. The contingency reserves held in restricted cash and/or cash and cash equivalents were approximately $3,253,000 and $3,464,000 as of December 31, 2018 and 2017, respectively.

Item 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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

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

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Owens Realty Mortgage, Inc. (the "Company") as of December 31, 2018 and 2017, the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2018, and the related notes and schedules III and IV (collectively referred to as the "financial statements"). We also have audited the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control – Integrated Framework: (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2018 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control – Integrated Framework: (2013) issued by COSO.

Basis for Opinions

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

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

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

Definition and Limitations of Internal Control Over Financial Reporting

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

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

/s/ Crowe LLP

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

Sacramento, California
March 15, 2019

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OWENS REALTY MORTGAGE, INC.

Consolidated Balance Sheets
December 31,

Assets	2018	2017
Cash, cash equivalents and restricted cash	$4,514,301	$5,670,816
Loans, net of allowance for loan losses of $1,478,188 in 2018 and $1,827,806 in 2017	141,204,055	144,343,844
Interest and other receivables	1,104,638	2,430,457
Other assets, net of accumulated depreciation and amortization of $85,944 in 2018 and $309,686 in 2017	416,615	725,341
Deferred financing costs, net of accumulated amortization of $82,635 in 2018 and $265,276 in 2017	351,199	26,823
Deferred tax assets, net	2,697,480	3,207,322
Investment in limited liability company	2,139,242	2,140,545
Real estate held for sale	34,093,790	56,110,472
Real estate held for investment, net of accumulated depreciation of $2,679,823 in 2018 and $3,316,753 in 2017	22,548,720	24,355,653
Total assets	$209,070,040	$239,011,273
Liabilities and Equity		
Liabilities:		
Dividends payable	$1,696,576	$1,572,047
Due to Manager	242,170	277,671
Accounts payable and accrued liabilities	1,245,609	1,390,329
Deferred gains	—	302,895
Forward contract liability – share repurchase	—	2,731,171
Line of credit payable	1,728,000	1,555,000
Notes and loans payable on real estate	12,798,903	30,192,433
Total liabilities	17,711,258	38,021,546
Commitments and Contingencies (Note 15)		
Equity:		
Stockholders’ equity:		
Preferred stock, $.01 par value per share, 5,000,000 shares authorized, no shares issued and outstanding at December 31, 2018 and 2017	—	—
Common stock, $.01 par value per share, 50,000,000 shares authorized, 11,198,119 shares issued, 8,482,880 and 9,095,454 shares outstanding at December 31, 2018 and 2017	111,981	111,981
Additional paid-in capital	182,437,522	182,437,522
Treasury stock, at cost – 2,715,239 and 2,102,665 shares at December 31, 2018 and 2017	(41,753,190)	(31,655,119)
Retained earnings	50,562,469	50,095,343
Total stockholders’ equity	191,358,782	200,989,727
Total liabilities and equity	$209,070,040	$239,011,273

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

Consolidated Statements of Income
Years Ended December 31,

	2018	2017	2016
Revenues:			
Interest and related income from loans	$12,281,261	$10,840,730	$8,922,142
Rental and other income from real estate properties	4,129,261	4,505,385	7,977,400
Other income	386,499	187,013	179,449
Total revenues	16,797,021	15,533,128	17,078,991
Expenses:			
Management fees to Manager	2,906,333	3,546,085	3,286,470
Servicing fees to Manager	95,143	362,411	298,770
General and administrative expense	3,389,524	2,234,230	1,568,890
Rental and other expenses on real estate properties	3,858,962	4,980,900	7,060,526
Depreciation and amortization	761,717	1,138,515	1,258,305
Interest expense	2,132,776	1,587,695	2,859,294
(Recovery of) provision for loan losses	(239,144)	(360,012)	1,284,896
Impairment losses on real estate properties	1,053,161	1,423,286	3,227,807
Total expenses	13,958,472	14,913,110	20,844,958
Operating income (loss)	2,838,549	620,018	(3,765,967)
Gain on sales of real estate, net	4,610,824	14,728,921	24,497,763
Settlement expense	—	(2,627,436)	—
Net income before income tax expense	7,449,373	12,721,503	20,731,796
Income tax (expense) benefit	(559,842)	(4,041,655)	7,248,977
Net income	6,889,531	8,679,848	27,980,773
Less: Net income attributable to non-controlling interests	—	—	(3,571,003)
Net income attributable to common stockholders	$6,889,531	$8,679,848	$24,409,770
Per common share data:			
Basic and diluted earnings per common share	$0.79	$0.85	$2.38
Basic and diluted weighted average number of common shares outstanding	8,764,568	10,162,496	10,247,477
Dividends declared per share of common stock	$0.76	$0.38	$0.32

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

Consolidated Statements of Stockholders' Equity
Years Ended December 31, 2018, 2017 and 2016

	Common Stock		Additional Paid-in Capital	Treasury Stock		Retained Earnings	Total Stockholders' Equity	Non- controllin Interests
	Shares	Amount		Shares	Amount			
Balances, January 1, 2016	11,198,119	$ 111,981	$ 182,437,522	(950,642)	$(12,852,058)	$25,282,553	$194,979,998	$4,528,849
Net income	—	—	—	——	—	24,409,770	24,409,770	3,571,003
Dividends declared	—	—	—	——	—	(3,279,193)	(3,279,193)	—
Tax payment made on behalf of stockholders (Note 9)	—	—	—	—	—	(582,698)	(582,698)	—
Contribution from non-controlling interest	—	—	—	—	—	—	—	44,207
Distributions to non-controlling interests	—	—	—	——	—	—	—	(8,144,05
Balances, December 31, 2016	11,198,119	$ 111,981	$ 182,437,522	(950,642)	$(12,852,058)	$45,830,432	$215,527,877	$—
Net income	—	—	—	—	—	8,679,848	8,679,848	—
Dividends declared	—	—	—	—	—	(3,774,670)	(3,774,670)	—
Tax payment made on behalf of stockholders (Note 9)	—	—	—	—	—	(640,267)	(640,267)	—
Purchase of treasury stock	—	—	—	(1,152,023)	(18,803,061)	—	(18,803,061)	—
Balances, December 31, 2017	11,198,119	$111,981	$182,437,522	(2,102,665)	$(31,655,119)	$50,095,343	$200,989,727	$—
Net income	—	—	—	—	—	6,889,531	6,889,531	—
Net effect of adoption of new accounting standards	—	—	—	—	—	166,895	166,895	
	—	—	—	—	—	(6,589,300)	(6,589,300)	—

Dividends declared								
Purchase of treasury stock	—	—	—	(612,574)	(10,098,071)	—	(10,098,071)	—
Balances, December 31, 2018	11,198,119	$ 111,981	$ 182,437,522	(2,715,239)	$(41,753,190)	$50,562,469	$191,358,782	$—

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

	2018	2017	2016
Cash flows from operating activities:			
Net income	$6,889,531	$8,679,848	$27,980,773
Adjustments to reconcile net income to net cash (used in) provided by operating activities:			
Gain on sales of real estate, net	(4,610,824)	(14,728,921)	(24,497,763)
Deferred income tax benefit	509,842	4,041,655	(7,248,977)
Distribution received from equity method investee	384,500	185,000	180,000
Income in earnings of equity method investee	(383,197)	(185,063)	(179,450)
(Reversal of) provision for loan losses	(239,144)	(360,012)	1,284,896
Impairment losses on real estate properties	1,053,161	1,423,286	3,227,807
Depreciation and amortization	761,717	1,138,515	1,258,305
Amortization of deferred financing costs	267,932	317,419	456,168
Accretion of discount on loans	(241,061)	—	—
Deferred loan fees, net of amortization	385,682	—	—
Changes in operating assets and liabilities:			
Interest and other receivables	575,657	(266,122)	(441,985)
Other assets	227,432	34,172	(420,759)
Accounts payable and accrued liabilities	(225,062)	(2,351,676)	(2,314,291)
Due to Manager	(35,501)	(82,956)	(48,016)
Forward contract liability	(459,688)	459,688	—
Net cash provided by (used in) operating activities	4,860,977	(1,695,167)	(763,292)
Cash flows from investing activities:			
Principal collected on loans	78,632,376	69,266,337	55,849,884
Investments in loans	(68,792,474)	(85,824,680)	(78,272,140)
Investment in real estate properties	(496,826)	(11,232,758)	(26,406,879)
Net proceeds from disposition of real estate properties	21,286,595	55,879,123	89,401,642
Purchases of vehicles and equipment	—	(16,170)	(29,887)
Net cash provided by investing activities	30,629,671	28,071,852	40,542,620
Cash flows from financing activities			
Advances on notes payable	243,267	10,543,172	23,966,383
Repayments on notes payable	(17,789,514)	(13,972,820)	(36,380,880)
Advances on lines of credit	71,634,706	19,945,000	79,416,793
Repayments of lines of credit	(71,461,706)	(23,366,000)	(95,356,293)
Payment of deferred financing costs	(439,591)	(12,500)	(279,599)
Distributions to non-controlling interests	—	—	(8,144,059)
Contribution from non-controlling interest	—	—	44,207
Purchase of treasury stock	(12,369,554)	(16,531,578)	—
Dividends paid	(6,464,771)	(4,245,386)	(4,592,850)
Net cash used in financing activities	(36,647,163)	(27,640,112)	(41,326,298)
Net decrease in cash, cash equivalents and restricted cash	(1,156,515)	(1,263,427)	(1,546,970)
Cash, cash equivalents and restricted cash at beginning of year	5,670,816	6,934,243	8,481,213

Cash, cash equivalents and restricted cash at end of year	$4,514,301	$5,670,816	$6,934,243
Supplemental Disclosures of Cash Flow Information			
Cash paid during the year for interest (excluding amounts capitalized)	$1,893,988	$1,291,743	$2,495,000
Cash paid during the year for interest that was capitalized	—	472,357	555,453
Supplemental Disclosure of Non-Cash Activity			
Increase in real estate from loan foreclosures	2,062,729	—	700,800

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Decrease in loans, net of allowance for loan losses, from loan foreclosures	(1,937,475)	—	(631,232)
Decrease in interest and other receivables from adding balances to loans	—	—	(69,568)
Decrease in interest and other receivables from loan foreclosures	(44,912)	—	—
Increase in loans from sales of real estate	8,679,065	450,000	1,595,000
Amortization of deferred financing costs capitalized to construction project	—	(76,260)	(119,471)
Capital expenditures financed through accounts payable	—	(42,146)	(2,654,856)
Dividends declared but not paid	(1,696,576)	(1,572,047)	(1,402,496)
Repurchase of treasury stock accrued as forward contract liability	—	(2,271,483)	—
Reversal of deferred gain on adoption of ASU 2014-09	(302,895)	—	—
Loan discounts established on adoption of ASU 2014-09	136,000	—	—

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

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OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

NOTE 1 – ORGANIZATION

Owens Realty Mortgage, Inc. (the “Company”) was incorporated on August 9, 2012, under the laws of the State of Maryland. The Company is authorized to issue 50,000,000 shares of its $0.01 par value common stock (the “Common Stock”). In addition, the Company is authorized to issue 5,000,000 shares of preferred stock at $0.01 par value per share. The Company was created to effect the merger (the “OMIF 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 OMIF 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 (“REIT”) for Federal income tax purposes. The OMIF Merger was completed on May 20, 2013. The Company now, by virtue of the OMIF 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 OMIF 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. The consolidated financial statements reflect the extinguishment of OMIF’s partners’ capital and replacement with 11,198,119 shares of Common Stock and additional paid –in capital as if the OMIF Merger occurred on January 1, 2013.

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

Proposed Merger with Ready Capital Corporation

On November 7, 2018, the Company, Ready Capital Corporation, a Maryland corporation ("Ready Capital"), and ReadyCap Merger Sub, LLC, a Delaware limited liability company and a wholly owned subsidiary of Ready Capital ("Merger Sub"), entered into an Agreement and Plan of Merger (the "Merger Agreement"), pursuant to which, subject to the terms and conditions therein, the Company will be merged with and into Merger Sub, with Merger Sub continuing as the surviving company (the "Merger").

Under the terms of the Merger Agreement, at the effective time of the Merger (the "Effective Time"), each share of the Company’s Common Stock issued and outstanding immediately prior to the Effective Time (excluding any cancelled shares) will be converted into the right to receive from Ready Capital 1.441 shares of common stock, par value $0.0001, of Ready Capital (the "Ready Capital Common Stock") (the "Exchange Ratio"). The Merger Agreement provides that the Company and Ready Capital will pay a special dividend in cash on the last business day prior to the closing of the Merger with a record date that is three business days before the payment date. Cash will be paid in lieu of fractional shares of Ready Capital Common Stock that would have been received as a result of the Merger.

Completion of the proposed Merger is subject to the satisfaction of certain customary conditions, and is subject to the approval of the stockholders of both Ready Capital and the Company. The Company cannot provide any assurance that the proposed Merger will close in a timely manner or at all.

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OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

Certain reclassifications have been made to the 2016 and 2017 consolidated financial statements to conform to the 2018 presentation. None of the reclassifications had an impact on net income or equity.

Management Estimates

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

Recently Issued Accounting Standards

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments – Credit Losses (Topic 326) – Measurement of Credit Losses on Financial Instruments". The amendments in ASU 2016-13 eliminate the probable and incurred credit loss recognition threshold in current GAAP and, instead, reflect an entity's current estimate of all expected credit losses. The amendments in ASU 2016-13 broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. The use of forecasted information incorporates more timely information in the estimate of expected credit loss. This standard is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted for interim and annual reporting periods beginning after December 15, 2018. The Company is currently evaluating the impact that ASU 2016-13 will have on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)", which sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract (i.e., lessees and lessors). ASU 2016-02 amends existing guidance related to leases, primarily by requiring the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under the current accounting guidance. This standard became effective for interim and annual reporting periods beginning January 1, 2019. The Company does not currently have any lease obligations. The Company will account for its operating leases where it is the lessor on its balance sheet similar to its prior accounting with the underlying leased asset recognized as real estate. The Company will account for executory costs and certain other non-lease components separately from the lease component of the lease with the lease component continuing to be recognized on a straight-line basis over the lease term and the executory costs and certain other non-lease components being accounted for under the new revenue recognition guidance in ASU 2014-09, discussed below. The adoption of ASU 2016-02 did not have a material impact on the Company's consolidated financial statements since executory costs and certain other non-lease components are not significant.

In July 2018, the FASB issued ASU 2018-11, "Leases (Topic 842): Targeted Improvements" an amendment to ASU 2016-02 discussed above, that will allow lessors to elect, as a practical expedient, not to allocate the total consideration to lease and nonlease components based on their relative standalone selling prices. This practical expedient will allow lessors to elect a combined single lease component presentation if: (i) the timing and pattern of

the revenue recognition of the combined single lease component is the same, and (ii) the related lease component and, the combined single lease component would be classified as an operating lease. Nonlease components that do not meet the criteria of this practical expedient will be accounted for under the new revenue recognition ASU 2014-09.

OWENS REALTY MORTGAGE, INC.

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In August 2018, the FASB issued ASU 2018-13, “Fair Value Measurement (Topic 820) – Disclosure Framework – Changes in the Disclosure Requirements for Fair Value Measurements”. The amendments in ASU 2018-13 modify certain disclosure requirements on fair value measurements in Topic 820. In addition, certain disclosure requirements were removed and others were added. This standard is effective for interim and annual reporting periods beginning after December 15, 2019. The Company does not believe that adoption of ASU 2018-13 will have a material impact on its consolidated financial statements or related disclosures.

Recently Adopted Accounting Pronouncements

On January 1, 2018, the Company adopted Accounting Standards Update (“ASU”) 2017-01, “Business Combinations (Topic 805) – Clarifying the Definition of a Business”. The amendments in ASU 2017-01 clarify the definition of a business by more clearly outlining the requirements for an integrated set of assets and activities to be considered a business and by establishing a practical framework to determine when the integrated set of assets and activities is a business. The adoption of ASU 2017-01 during the quarter ended March 31, 2018 did not have an impact on the Company’s consolidated financial statements.

On January 1, 2018, the Company adopted ASU 2016-18, “Statement of Cash Flows (Topic 230) – Restricted Cash”. The amendments in ASU 2016-18 require that a statement of cash flows explain the change during the period in the total of cash, cash equivalents and amounts generally described as restricted cash and cash equivalents together when reconciling the beginning and end of period total amounts shown on the statement of cash flows. The adoption of ASU 2016-18 during the quarter ended March 31, 2018 resulted in the Company including its restricted cash with cash and cash equivalents when reconciling the beginning and ending amounts shown on its consolidated statement of cash flows.

On January 1, 2018, the Company adopted ASU 2016-15, “Statement of Cash Flows (Topic 230) – Classification of Certain Cash Receipts and Cash Payments”. The amendments in ASU 2016-15 reflect eight targeted changes to how cash receipts and cash payments are presented and classified in the statement of cash flows. The adoption of ASU 2016-15 during the quarter ended March 31, 2018 resulted in the Company reporting distributions it receives from its equity method investment in cash flows from operating activities rather than financing activities on its consolidated statement of cash flows. The Company elected the “Cumulative Earnings Approach” upon adoption of ASU 2016-15.

On January 1, 2018, the Company adopted ASU 2014-09, “Revenue from Contracts with Customers and all subsequent amendments to the ASU (collectively, “ASC 606”), which (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revised when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as real estate held for sale. The majority of the Company’s revenues come from interest income and other sources, including loans and leases, that are outside the scope of ASC 606. The Company’s revenue from real estate properties is not significantly impacted by ASC 606, as rental income from leasing arrangements is specifically excluded from ASC 606, and will be evaluated with the adoption of the lease accounting standard, ASU 2016-02, discussed above.

The Company adopted ASC 606 using the modified retrospective method applied to all contracts not completed as of January 1, 2018. Results for reporting periods beginning after January 1, 2018 are presented under ASC 606 while prior period amounts continue to be reported in accordance with legacy GAAP. The Company recorded a net increase in beginning retained earnings of $167,000 as of January 1, 2018 due to the cumulative effect of adopting ASC 606 for four past real estate sales transactions where the sale was financed by the Company. The transition adjustment

resulted in the recognition of previously deferred gains on two sales in the total amount of approximately $303,000 and the recording of net discounts against two carryback loans in the total amount of approximately $136,000.

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On January 1, 2018, the Company adopted ASU 2016-01, “Financial Instruments- Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities”. ASU 2016-01 enhances the reporting model for financial instruments to provide users of financial statements with more decision-useful information. ASU 2016-01 contains several provisions, including but not limited to 1) requiring equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income; 2) simplifying the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; 3) eliminating the requirement to disclose the method(s) and significant assumptions used to estimate fair value; and 4) requiring separate presentation of financial assets and liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements. ASU 2016-01 also changes certain financial statement disclosure requirements, including requiring disclosures of the fair value of financial instruments be made on the basis of exit price. The adoption of ASU 2016-01 during the quarter ended March 31, 2018 resulted in the Company using an exit price methodology for disclosing the fair value of the Company’s financial instruments in Note 14.

Cash, Cash Equivalents and Restricted Cash

Cash and cash equivalents include funds on deposit with financial institutions. Restricted cash includes contingency reserves required pursuant to the Company’s charter and non-interest bearing deposits required pursuant to the Company’s line of credit of $3,500,000 (see Note 7).

Concentration of Credit Risk

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

Loans and Allowance for Loan Losses

Loans are generally stated at the principal amount outstanding, net of unamortized loan discounts and deferred loan fees which totaled $364,000 and $386,000 as of December 31, 2018, respectively. There were no loan discounts or deferred loan fees as of December 31, 2017. Advances under the terms of a loan to pay property taxes, insurance, legal and other costs are generally capitalized and reported as interest and other receivables. The Company’s portfolio consists primarily of real estate loans generally collateralized by first, second and third deeds of trust. Interest income on loans is accrued using the simple interest method. Loans are generally placed on nonaccrual status when the borrowers are past due greater than ninety days or when full payment of principal and interest is not expected. When a loan is classified as nonaccrual, interest accruals discontinue and all past due interest is included in the recorded investment in the impaired loan that is measured as described below. Interest accruals are resumed on such loans only when they are brought fully current with respect to interest and principal and when, in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest. Cash receipts on nonaccrual loans are used to reduce any outstanding accrued interest, and then are recorded as interest income, except when such payments are specifically designated as principal reduction or when management does not believe the Company’s investment in the loan is fully recoverable. The Company does not incur origination costs. However, beginning April 1, 2018, the Company receives 30% of all fees (other than certain administrative fees) paid by borrowers in connection with the Company making loans, including 30% of all origination, modification and extension fees. Owens Financial Group,

Inc. (“OFG” or the “Manager”) is entitled to the remaining 70% of all such fees (see Note 12 – “Transactions with Affiliates”). When collected, such loan fees are recorded as a credit to the applicable loan’s principal balance and are then amortized to interest income using the effective interest method over the life of the loan.

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

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

A restructuring of a debt constitutes a troubled debt restructuring (“TDR”) if the Company for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs 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 incurred losses inherent in the portfolio taken as a whole.

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

Land Loans – These loans generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified costs and time lines. Trends in the

construction industry significantly impact the credit quality of these loans as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

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OWENS REALTY MORTGAGE, INC.

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

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

Other Assets

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

Deferred Financing Costs

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

Rental Income

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

Real Estate Held for Sale

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

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

The Company records a gain or loss from the sale of real estate when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Company finances the sale of real estate to the buyer, the Company assesses whether the buyer is committed to perform their obligations under the contract and whether the collectability of the transaction price is probable. Once these criteria are met, the real estate is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In

determining the gain or loss on the sale, the Company adjusts the transaction price and related gain (loss) on sale if a significant financing component is present. This adjustment is based on management’s estimate of the fair value of the loan extended to the buyer to finance the sale.

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

Real Estate Held for Investment

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

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

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

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

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

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Explanation of Responses:

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

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

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

The accounting guidance prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. A tax position is recognized as a benefit only if it is "more likely than not" that the position would be sustained in a tax examination, with a tax examination being presumed to occur. The Company has analyzed its various federal and state filing positions and believes that its income tax filing positions and deductions are well documented and supported. There was no reserve for uncertain tax positions recorded as of December 31, 2018 and 2017. Interest and penalties related to income tax matters, if any, are recorded as part of income tax expense in the consolidated statement of income. See discussion of the tax issue related to the Company's 2012 federal income tax return in Note 11.

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

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

NOTE 3 - LOANS AND ALLOWANCE FOR LOAN LOSSES

The following tables show the changes in the allowance for loan losses by portfolio segment for the years ended December 31, 2018, 2017 and 2016 and the allocation of the allowance for loan losses and loans as of December 31, 2018 and 2017 by portfolio segment and by impairment methodology:

2018	Commercial	Residential	Land	Total
Allowance for loan losses:				
Beginning balance	$ 1,069,458	$451,537	$306,811	$1,827,806
Charge-offs	—	(186,708)	—	(186,708)
Recoveries	—	76,234	—	76,234
Provision (Reversal)	(9,944)	(218,779)	(10,421)	(239,144)
Ending balance	$ 1,059,514	$122,284	$ 296,390	$ 1,478,188
Ending balance: individually evaluated for impairment	$—	$—	$—	$—
Ending balance: collectively evaluated for impairment	$1,059,514	$122,284	$296,390	$1,478,188
Ending balance	$ 1,059,514	$122,284	$296,390	$1,478,188
Loans:				
Ending balance	$ 132,519,461	$ 5,209,357	$4,953,425	$142,682,243
Ending balance: individually evaluated for impairment	$ 9,304,587	$ 2,557,526	$—	$11,862,113
Ending balance: collectively evaluated for impairment	$ 123,214,874	$ 2,651,831	$4,953,425	$130,820,130

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Notes to Consolidated Financial Statements

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

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

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

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Explanation of Responses:

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Notes to Consolidated Financial Statements

The following tables show an aging analysis of the loan portfolio by the time monthly payments are past due at December 31, 2018 and 2017. All of the loans that were 90 days or more past due in payments as listed below were on non-accrual status as of December 31, 2018 and 2017.

December 31, 2018	Loans 30-59 Days Past Due	Loans 60-89 Days Past Due	Loans 90 or More Days Past Due	Other Impaired/Non-Accrual Loans	Total Past Due Loans	Current Loans	Total Loans
Commercial	$ 4,388,000	$4,916,587	$ —	$—	$9,304,587	$123,214,874	$132,519,461
Residential	2,358,966	—	—	198,560	2,557,526	2,651,831	5,209,357
Land	—	—	—	—	—	4,953,425	4,953,425
	$6,746,966	$ 4,916,587	$ —	$ 198,560	$11,862,113	$130,820,130	$142,682,243

The above table as of December 31, 2018 includes seven past maturity loans in the Current Loans category of approximately $19,515,000 (all Commercial of which $10,835,000 was less than 30 days past maturity, $3,000,000 was 30-59 days past maturity, $1,505,000 was 60-89 days past maturity and $4,175,000 was greater than 90 days past maturity). These loans were current in making monthly interest payments and in the process of being extended, paid off or refinanced. In addition, of the delinquent loans above, $2,359,000 of Residential loans and $4,917,000 of Commercial loans were past maturity.

December 31, 2017	Loans 30-59 Days Past Due	Loans 60-89 Days Past Due	Loans 90 or More Days Past Due	Other Impaired/ Non-Accrual Loans	Total Past Due Loans	Current Loans	Tota Loa
Commercial	$ —	$ —	$ —	$1,212,851	$1,212,851	$126,660,430	$
Residential	1,938,895	2,737,538	2,430,878	214,048	7,321,359	5,849,436	
Land	—	—	—	—	—	5,127,574	5,12
	$1,938,895	$ 2,737,538	$ 2,430,878	$ 1,426,899	$8,534,210	$ 137,637,440	$146

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

Explanation of Responses:

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

The following tables show information related to impaired loans as of and for the years ended December 31, 2018, 2017 and 2016:

	As of December 31, 2018			Year Ended December 31, 2018	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$9,467,157	$ 9,304,587	$ —	$1,855,535	$173,711
Residential	2,557,526	2,557,526	—	5,966,958	380,761
Land	—	—	—	—	—
	$12,024,683	$ 11,862,113	$ —	$7,822,493	$554,472
With an allowance recorded:					
Commercial	$—	$ —	$ —	$—	$—
Residential	—	—	—	114,327	—
Land	—	—	—	—	—
	$—	—	$ —	$114,327	$—
Total:					
Commercial	$9,467,157	$ 9,304,587	$—	$1,855,535	$173,711
Residential	2,557,526	2,557,526	—	6,081,285	380,761
Land	—	—	—	—	—
	$12,024,683	$ 11,862,113	$ —	$7,936,820	$554,472

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OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

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

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Notes to Consolidated Financial Statements

	Year Ended December 31, 2016	
	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:		
Commercial	$1,684,877	$38,187
Residential	236,042	20,598
Land	—	—
	$1,920,919	$58,785
With an allowance recorded:		
Commercial	$ 865,285	$ —
Residential	6,209,540	—
Land	—	—
	$7,074,825	$—
Total:		
Commercial	$2,550,162	$ 38,187
Residential	6,445,582	20,598
Land	—	—
	$8,995,744	$58,785

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

Troubled Debt Restructurings

The Company had recorded specific loan loss allowances of approximately $0 and $187,000 on loans totaling $199,000 and $2,739,000 (recorded investments before allowance) to borrowers whose loan terms had been modified

in troubled debt restructurings as of December 31, 2018 and 2017, respectively. The Company has not committed to lend additional amounts to any of these borrowers, other than discussed below.

No loans were modified as troubled debt restructurings during the year ended December 31, 2018. During the year ended December 31, 2017, the terms of one impaired loan with a principal balance of $1,145,000 were modified as a troubled debt restructuring. The maturity date was extended by one year and the Company agreed to advance another $165,000 (of which $68,000 was advanced at the time of modification) to the borrower to cover past due and future interest payments. All other terms of the loan remained the same. The loan and related collateral were analyzed and it was determined that no specific loan loss allowance was required as of December 31, 2017. These loans were repaid in full during 2018.

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Notes to Consolidated Financial Statements

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

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

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

There were no loans modified as troubled debt restructurings during the previous twelve months that defaulted during the years ended December 31, 2018, 2017 and 2016. Generally, the Company considers a loan as having defaulted if its payments are delinquent 90 days or more.

NOTE 4 – INVESTMENT IN LIMITED LIABILITY COMPANY

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

During the years ended December 31, 2018, 2017 and 2016, the Company received capital distributions from 1850 in the total amount of $385,000, $185,000 and $180,000, respectively. The net income to the Company from its investment in 1850 was approximately $383,000, $185,000 and $179,000 for the years ended December 31, 2018, 2017 and 2016, respectively.

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

NOTE 5 - REAL ESTATE HELD FOR SALE

Real estate properties held for sale as of December 31, 2018 and 2017 consisted of properties acquired through foreclosure classified by property type as follows:

	December, 2018	December 31, 2017
Residential	$16,855,359	$24,627,710
Land	7,359,111	14,389,620
Retail	7,737,181	7,632,893
Golf course	—	1,999,449
Marina	1,269,650	2,207,675
Assisted care	—	5,253,125
Office	872,489	—
	$34,093,790	$56,110,472

Transfers

During the year ended December 31, 2018, the Company transferred five properties with book values totaling approximately $6,725,000 from “Held for investment” to “Held for sale”. In addition, during the year ended December 31, 2018, the Company transferred one property with a book value of approximately $6,561,000 from “Held for sale” to “Held for investment” because the property is no longer listed for sale.

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

During the year ended December 31, 2016, the Company transferred four properties with carrying amounts totaling approximately $10,052,000 from “Held for Investment” to “Held for Sale” as the properties were listed for sale and sales were expected within a one year period.

No losses were recorded as a result of transfers between “Held for sale” and “Held for investment” categories for the years ended December 31, 2018, 2017 and 2016.

Impairment Losses

During the year ended December 31, 2018, the Company recorded impairment losses totaling approximately $1,053,000 on the marina property located in Isleton, California (impairment of $938,000) due to a new appraisal obtained and a reduction in the listing price of the property and, thus, the net fair market value estimated by management, on the unimproved residential and commercial land located in Bethel Island, California (impairment of $54,000) as a result of the sale of the land in October 2018 and on the unimproved industrial land located in San Jose, California (impairment of $61,000) as a result of the sale of the land in January 2019 (subsequent to year end).

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

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

Sales

During the year ended December 31, 2018, the Company sold twenty-three real estate properties (including eleven condominiums at Zalanta) for aggregate net sales proceeds of approximately $21,287,000 and carryback notes totaling $8,679,000, resulting in net gain on sales of real estate totaling approximately $4,611,000.

During the year ended December 31, 2017, the Company sold fifteen real estate properties (including seven condominiums at Zalanta) for aggregate net sales proceeds of approximately $55,879,000 and carryback notes totaling $450,000, resulting in net gain on sales of real estate totaling approximately $14,729,000. All but one of the gains from 2017 sales were accounted for using the full accrual method. One sale resulted in the recording of deferred gain of approximately $93,000.

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

Foreclosures

During the year ended December 31, 2018, the Company foreclosed on two loans secured by two homes and 20 acres of residential land located in San Ramon, California with principal balances aggregating approximately $1,937,000 and obtained the property via the trustee’s sale. In addition, accrued interest and advances made on the loan (for items such as legal fees and delinquent property taxes) in the total amount of approximately $125,000 were capitalized to the basis of the property. The fair market value of the property acquired was estimated to approximate the Company’s recorded investment in the loans.

There were no foreclosures during the year ended December 31, 2017.

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

REIT subsidiary, East G, LLC, in June 2016. The property was sold during 2017.

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Notes to Consolidated Financial Statements

NOTE 6 - REAL ESTATE HELD FOR INVESTMENT

Real estate held for investment as of December 31, 2018 and 2017 consisted of properties acquired through foreclosure classified by property type as follows:

	December 31, 2018	December 31, 2017
Retail	$15,987,697	$16,623,238
Land	6,561,023	2,018,068
Residential	—	2,356,995
Office	—	3,357,352
	$22,548,720	$24,355,653

The balances of land and the major classes of depreciable property for real estate held for investment as of December 31, 2018 and 2017 are as follows:

	December 31, 2018	December 31, 2017
Land and land improvements	$7,908,072	$5,112,063
Buildings and improvements	17,320,471	22,560,343
	25,228,543	27,672,406
Less: Accumulated depreciation and amortization	(2,679,823)	(3,316,753)
	$22,548,720	$24,355,653

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

Depreciation expense was approximately $721,000, $1,080,000 and $1,186,000 for the years ended December 31, 2018, 2017 and 2016, respectively.

Foreclosures

There was no real estate held for investment acquired through foreclosure during the years ended December 31, 2018, 2017 and 2016.

NOTE 7 – LINE OF CREDIT PAYABLE

The Company borrows funds under a restated secured revolving credit facility with California Bank & Trust and other lenders described below (the "CB&T Line of Credit"). As of December 31, 2018 and 2017, the outstanding balance and total commitment under the CB&T Line of Credit consisted of the following:

	December 31, 2018		December 31, 2017	
	Outstanding Balance	Total Commitment	Outstanding Balance	Total Commitment
CB&T Line of Credit	$1,728,000	$47,235,245	$1,555,000	$27,259,000

CB&T Line of Credit

Effective September 4, 2018, the Company entered into a Second Amended and Restated Credit Agreement with ZB, N.A. dba California Bank & Trust ("CB&T") as administrative agent, swingline lender and a lender, and First Bank and Umpqua Bank as additional lenders (the "Restated Credit Agreement"). The Restated Credit Agreement and a new Security Agreement among the parties collectively amends and restates the prior Credit Agreement, Advance Formula Agreement, Security Agreement and related promissory notes among the Company and CB&T and the other lenders (the "Prior Credit Facility").

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Notes to Consolidated Financial Statements

The maximum borrowings available (total commitment) to the Company under the CB&T Line of Credit is the lesser of $75 million or the amount determined pursuant to a borrowing base calculation described in the Restated Credit Agreement (the "Total Current Commitment"). At the option of CB&T as the Agent, up to $10 million of the CB&T Line of Credit may be made available as swing line loans. The Restated Credit Agreement also includes a sublimit facility that permits the Company to borrow up to $25 million, subject to certain additional limitations while underlying collateral of the Company is being further evaluated by the lenders for transfer to the borrowing base. Borrowings under the CB&T Line of Credit mature on May 15, 2020, subject to early termination in the event of default or at the election of the Company, and advances can be made up to that date. The Company is required to keep $3,500,000 in total non-interest bearing accounts with CB&T, First Bank and Umpqua Bank that is reported in cash, cash equivalents and restricted cash in the accompanying consolidated balance sheets.

As of December 31, 2018, the Company has borrowed $1,728,000 pursuant to the Restated Credit Agreement (including $0 borrowed against the sublimit facility), and the Company's maximum borrowing availability pursuant to the borrowing base calculations is approximately $47,235,000 ($45,507,000 of additional borrowing available). Effective September 4, 2018, such borrowings under the Restated Credit Agreement bear interest payable at an annual rate equal to, at the Company's election, either (1) the prime rate published in the Wall Street Journal plus, depending on the amount of the facility utilization, a margin of either (x) 0.25% or 0.0% for revolving and swing line loans or (y) 1.0% or 0.75% for sublimit loans, or (2) the LIBOR Rate (as defined in the Restated Credit Agreement) plus, depending on the amount of the facility utilization, a margin of either (x) 3.00% or 2.75% for revolving and swing line loans or (y) 3.75% or 3.50% for sublimit loans. The interest rate under the Prior Credit Facility was the prime rate plus one quarter percent (0.25%) per annum or the prime rate plus one percent (1.00%) per annum on any borrowings on the sublimit facility. The applicable interest rate (based on the prime rate selection) was 5.75% as of December 31, 2018. Upon a default under the Restated Credit Agreement the applicable interest rate increases by 2.00% and an additional fee of 5.0% of the payment amount applies to any late payments. The Company is also required to pay quarterly and at maturity (or upon earlier termination of the facility) an unused commitment fee, if the average amounts borrowed are less than 50% of the total commitment amount, equal to 0.20% per annum applied to the un-utilized borrowing capacity under the Restated Credit Agreement.

Amounts owing under the CB&T Line of Credit may be prepaid at any time without premium or penalty, subject to customary breakage costs in the case of borrowings with respect to which a LIBOR Rate election is in effect. The restated CB&T Line of Credit also required the payment of an origination fee of $412,500 and other issuance costs for a total of approximately $434,000 and is subject to certain ongoing administrative fees. Interest expense on the CB&T Line of Credit (including the Prior Credit Facility) was approximately $919,000, $312,000 and $881,000 during the years ended December 31, 2018, 2017 and 2016, respectively (including $89,000, $158,000 and $131,000, respectively, in amortization of deferred financing costs and $44,000 in unused commitment fees in 2018).

Borrowings are secured by certain assets of the Company. These collateral assets will include the grant to the lenders of first-priority deeds of trust on certain real property assets and trust deeds of the Company to be identified by the parties from time-to-time and all personal property of the Company, which collateral includes the assets described in the new Security Agreement and in other customary collateral agreements that will be entered into and/or modified by the parties from time-to-time. As of December 31, 2018, the carrying amount and classification of loans securing the CB&T Line of Credit (including loans securing the sublimit facility) were as follows:

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Notes to Consolidated Financial Statements

Loans:	December 31, 2018
Commercial	$69,569,181
Residential	—
Total	$69,569,181

The CB&T Line of Credit agreements contain financial covenants which are customary for a loan of this type. Management is not aware of any breach of these covenants as of December 31, 2018.

NOTE 8 - NOTES AND LOANS PAYABLE ON REAL ESTATE

The Company had the following notes and loans payable outstanding as of December 31, 2018 and 2017:

	December 31, 2018	Interest Rate	December 31, 2017	Interest Rate	Payment Terms/Frequency	Maturity Date
Tahoe Stateline Venture, LLC Loan Payable	$12,872,555	4.22%	$13,242,514	4.22%	Amortizing Monthly	January 2021
Zalanta Construction Loan Payable	—	N/A	17,176,288	6.00%	Interest Monthly Principal Quarterly	November 2018
Principal amount	$12,872,555		$30,418,802			
Less unamortized deferred financing costs	(73,652)		(226,369)			
Notes and loans payable, net	$12,798,903		$30,192,433			

The following table shows maturities by year on these notes and loans payable as of December 31, 2018:

Years ending December 31:	
2019	$387,135
2020	403,792
2021	12,081,628
2022	—
2023	—
Thereafter	—
	$12,872,555

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

The maturity date of the TSV Loan is January 1, 2021 (the “Maturity Date”). All outstanding borrowings under the TSV Loan documents bear interest initially at a rate of 3.47% per annum (the “Long Term Adjustable Rate”), and on January 1, 2018 the Long Term Adjustable Rate was reset to Lender’s then current market rate for three year fixed rate loans from comparable commercial real estate secured transactions, as determined by Lender in its sole discretion (4.22%). Upon a default under the TSV Loan documents, the interest rate on the outstanding principal balance increases by an

additional five percent (5.00%) per annum, and the rate on any other outstanding obligations thereunder increases to ten percent (10.00%) per annum. Prepayments under the TSV Loan documents are subject to certain prepayment fees; provided that during the 90 day period immediately prior to the Maturity Date, TSV may prepay the entire unpaid balance of the Loan in full, without any Prepayment Fee or penalty.

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

The Credit Agreement required the payment of a closing fee of $108,750 and certain administrative fees totaling approximately $218,000. The majority of these costs were paid out of proceeds from the loan and capitalized to deferred financing costs and are being amortized to interest expense using the effective interest method through the Maturity Date. During the years ended December 31, 2018, 2017 and 2016, approximately $586,000, $502,000 and $515,000, respectively, of interest expense was incurred (including approximately $36,000, $36,000 and $36,000, respectively, of deferred financing costs amortized to interest expense).

The TSV Loan documents contain financial covenants which are customary for loans of this type. Management is not aware of any breach of these covenants as of December 31, 2018.

Zalanta Construction Loan Payable

In August 2016, ZRV and Zalanta Resort at the Village - Phase II, LLC (“ZRV II” and, together with ZRV, the “Borrowers”) entered into a Construction Loan Agreement (the “Loan Agreement”) and related documents with Western Alliance Bank as the lender (“Lender”) that provided the Borrowers with a loan (the “ZRV Loan”) of up to $31,000,000, subject to the terms and conditions of the ZRV Loan documents, for the purpose of financing the construction of a mixed-use retail and residential condominium building (the “Project”) on land (the “Premises”) owned by ZRV in South Lake Tahoe. The ZRV Loan was repaid in full in October 2018.

Borrowings under the ZRV Loan documents were for payment or reimbursement of approved Project costs. All borrowings under the ZRV Loan bore interest at the Wall Street Journal Prime Rate plus 1.50% (calculated on a floating daily basis) (the “Note Rate”). The Note Rate as of December 31, 2017 was 6.00%.

Interest only payments were payable monthly from an established interest reserve. In addition, commencing on August 18, 2017 and continuing on the last day of each quarter thereafter during the term of the ZRV Loan, Borrowers were required to make a quarterly repayment of $6 million of principal (the “Curtailment Requirement”). On July 27, 2018, the maturity of the ZRV Loan was extended to November 1, 2018 and the Curtailment Requirement was waived.

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

The Loan Agreement required the payment of an origination fee of $310,000 and other issuance costs totaling approximately $400,000 plus an extension fee of approximately $6,000 paid in 2018. The majority of these costs were paid out of the loan proceeds and capitalized to deferred financing costs and are being amortized to the Project using the straight-line method through the maturity date. During the years ended December 31, 2017 and 2016, approximately $76,000 and $83,000, respectively, of deferred financing costs was amortized to the Project. During the years ended December 31, 2017 and 2016, approximately $472,000 and $272,000, respectively, of interest was

incurred which was capitalized to the Project. During the years ended December 31, 2018 and 2017, approximately $608,000 and $774,000 of interest was expensed (including approximately $122,000 and $124,000 of deferred financing costs amortized to interest expense).

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NOTE 9 – STOCKHOLDERS' EQUITY

Dividends

The following table presents the tax treatment for dividends paid by the Company on its Common Stock for the years ended December 31, 2018, 2017 and 2016:

			Dividends Classified as Ordinary Income			Capital Gain Distribution		Dividends Classified as Return of Capital	
Year	Total Dividends Paid	Dividends Paid Per Share	Percent	Dividends Paid Per Share	Sec 199A Dividends Per Share	Percent	Dividend Paid Per Share	Percent	Dividends Paid Per Share
Common Stock:									
2018 (1)	$5,237,571	$ 0.601	91.21%	$ 0.548	0.548	8.79 %	$ 0.053	—%	$ 0.000
2017 (2)	$3,789,108	$ 0.380	87.67%	$ 0.333	0.000	12.33%	$ 0.047	—%	$ 0.000
2016 (3)	$3,279,193	$ 0.320	15.05%	$ 0.048	0.000	84.95%	$ 0.272	—%	$ 0.000

(1) Cash distributions made on January 14, 2019 with a record date of December 31, 2018 are treated as received by shareholders on December 31, 2018, to the extent of the Company's tax earnings and profits for 2018. Therefore, $0.041 per share of the January 14, 2019 cash distribution is included in the 2018 Form 1099 while the remainder in the amount of $0.159 per share will be treated as a 2019 distribution for U.S. federal income tax purposes and is not included on the 2018 Form 1099.
(2) Dividends declared and paid in 2017 per above do not include $640,267 which represented capital gains tax on 2017 undistributed capital gains paid on behalf of shareholders to the U.S. Treasury in January 2018 (and recorded as dividends paid and payable in the consolidated financial statements).
(3) Dividends declared and paid in 2016 per above do not include $582,698 which represented capital gains tax on 2016 undistributed capital gains paid on behalf of shareholders to the U.S. Treasury in January 2017 (and recorded as dividends paid and payable in the consolidated financial statements).

Stock Repurchases and Repurchase Programs

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

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

average cost of $16.18 per share. The 2017 Repurchase Plan was terminated effective December 29, 2017.

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On March 12, 2018, the Board of Directors authorized a Rule 10b5-1 stock repurchase plan (the “2018 Repurchase Plan”) which authorized the Company to purchase up to $10 million of its Common Stock. Under the 2018 Repurchase Plan, repurchases were to be funded from available working capital, and the repurchased shares returned to the status of authorized but unissued shares of Common Stock. The 2018 Repurchase Plan provided for stock repurchases to commence on March 19, 2018 and was subject to certain price, volume and timing constraints specified in the brokerage agreement. During the year ended December 31, 2018, the Company repurchased 608,574 shares under the 2018 Repurchase Plan at a total cost of approximately $10,033,000 (including commissions) and an average cost of $16.49 per share. The 2018 Repurchase Plan was terminated effective September 17, 2018 as the funds authorized pursuant to the Plan were fully utilized to purchase Common Stock.

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

NOTE 10 – CONTINGENCY RESERVES

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

The contingency reserves required per the charter as of December 31, 2018 and 2017 were approximately $3,253,000 and $3,464,000 and are reported as restricted cash and/or cash and cash equivalents in the accompanying consolidated balance sheets.

NOTE 11 - INCOME TAXES

The Company operates in such a manner as to qualify as a REIT, under the provisions of the Internal Revenue Code of 1986, as amended (the "Code"); therefore, applicable REIT taxable income is included in the taxable income of its shareholders, to the extent distributed by the Company. To maintain REIT status for federal income tax purposes, the Company is generally required to distribute at least 90% of its REIT taxable income to its shareholders as well as comply, generally, with certain other qualification requirements as defined under the Code. As a REIT, the Company is not subject to federal corporate income tax to the extent that it distributes 100% of its REIT taxable income each year. During 2018, 2017 and 2016, the Company distributed at or in excess of 100% of its REIT taxable income to its

stockholders. During 2018, 2017 and 2016, the Company had net capital gains from the sales of real estate properties totaling approximately $458,000, $2,297,000 and $4,451,000, respectively. All of the 2018 capital gains were distributed in the form of dividends to shareholders during 2018. Management decided to retain all or a portion of the capital gains in 2017 and 2016 within the Company and not distribute them as is permitted for REITs. However, the retention of capital gains required the Company to make a payment to the U.S. Treasury Department on behalf of shareholders at the highest corporate tax rate (35%) in the total amount of approximately $640,000 and $583,000 in January 2018 and 2017, respectively. This tax payment was accrued as dividends payable in the Company's financial statements as of December 31, 2017 and 2016. Shareholders' pro-rata portion of the amount paid is to be reflected as tax payments on the individual shareholders' tax returns.

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Notes to Consolidated Financial Statements

The Company recently discovered that its 2012 federal income tax return was erroneously prepared and filed on IRS Form 1120-REIT, instead of on IRS Form 1120, resulting in the Company's REIT election technically being made beginning with its 2012 tax year instead of beginning with its 2013 tax year as was intended. Consequently, the Company was in technical violation of certain REIT qualification requirements in 2012 and 2013. Under the REIT provisions of the federal income tax laws, there are "savings clauses" available for use by REITs to cure the types of technical violations that occurred. These available savings clauses were designed to assist public REITs in curing inadvertent failures and are self-executing provided that the REIT has "reasonable cause" for the technical violations and complies with certain other procedural requirements, including, in the case of the Company, the payment of a $50,000 penalty to the IRS. Upon discovery of the error, the Company sought advice of experienced REIT tax counsel and has obtained an opinion of such counsel to the effect that the Company will have reasonable cause for the technical violations and thereby will be able to avail itself of the savings clauses. Consequently, the Company intends to fulfill the relevant procedural requirements of the savings clauses, including payment of the $50,000 penalty. In the event that the Company was not able to satisfy the requirements of the savings clauses, the Company potentially could have been prevented from qualifying as a REIT through its 2017 taxable year (but in such case would re-elect REIT status for its 2018 taxable year). The potential tax liability to the Company if it is not successful in using the savings clauses are estimated to be in the range of $3,000,000 to $9,000,000, not including interest and penalties. Based on the advice and opinion of counsel and its own review and analysis of the relevant facts, the Company has concluded at a more-likely-than-not level that it will be able to benefit from the savings clause provisions to maintain uninterrupted REIT status during its existence and thus has not accrued any potential income tax liability related to this matter, other than the $50,000 penalty discussed above, which has been accrued and recorded in income tax expense for the year ended December 31, 2018.

The Company's total tax expense for the year ended December 31, 2018 was $559,842 which included the $50,000 penalty accrued at the REIT level (as discussed above) and $509,842 incurred for the TRS entities as more fully detailed below.

Taxable income from non-REIT activities managed through the Company's taxable REIT subsidiaries ("TRS") (currently Lone Star Golf, Inc. and ZRV) is subject to federal, state and local income taxes. The Company did not record a provision for current income taxes related to Lone Star for the years ended December 31, 2018, 2017 and 2016 as it was in a net loss position. In addition, deferred taxes related to temporary differences in book and taxable income as well as net operating losses ("NOLs") of Lone Star would likely not be realizable due to Lone Star's loss history (full amount of deferred tax assets offset by a valuation allowance). The NOLs totaled approximately $1,189,000 for Federal and California as of December 31, 2018. All of the NOLs expire between 2033 and 2038 except for the 2018 Federal NOL of approximately $405,000 which does not expire. The Company sold the Lone Star golf course in September 2018 for cash and two notes receivable (one of which was repaid in November 2018). Thus, it is expected that the Lone Star TRS will continue in existence until the remaining loan is repaid in full, at which time the TRS will be dissolved.

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

During 2016, the Company converted ZRV into a TRS and contributed two additional real estate assets into ZRV. These properties included 75 improved, residential lots previously held within Baldwin Ranch Subdivision, LLC and a medical office condominium complex previously held within AMFU, LLC. The conversion of ZRV into a TRS and contribution of the additional real estate assets resulted in the Company recording a deferred tax asset and income tax benefit in the amount of approximately $7,249,000 primarily due to a $15,450,000 aggregate remaining difference between the book and tax basis of the subject real estate assets as of December 31, 2016. During 2017, ZRV recorded income tax expense of $4,041,655 that was primarily the result of an increase in the valuation allowance recorded against deferred tax assets as a result of higher construction costs and lower expected gains from the sales of ZRV assets in the future and due to a decrease in the Federal corporate tax rate from 34% to 21% in 2018 and beyond as a result of the Tax Cuts and Jobs Act signed into law by President Trump on December 22, 2017, which required ZRV to remeasure its net deferred tax asset at the lower rate. During 2018, ZRV recorded income tax expense of $509,842 that was primarily a result of an increase in the valuation allowance recorded against deferred tax assets as a result of lower expected gains from the sales of ZRV assets in the future.

The components of the income tax expense (benefit) as it relates to the Company’s taxable income (loss) from domestic TRSs during the years ended December 31, 2018, 2017 and 2016 were as follows:

	Year Ended December 31, 2018		
	Federal	State and Local	Total
Change in valuation allowance	$388,408	$129,166	$517,574
Other	(39,625)	31,893	(7,732)
Income tax expense (benefit)	$348,783	$161,059	$509,842

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

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

A reconciliation of the income tax provision (benefit) based upon the statutory tax rates to the effective rates of our taxable REIT subsidiaries is as follows for the year ended December 31, 2018 and 2017:

	Year Ended December 31, 2018	Year Ended December 31, 2017

Tax (benefit) expense at Federal statutory rate	$(5,867)	$(149,766)
State income tax expense (benefit), net of Federal effect	127,236	250,193
Other	65	(19,485)
Change in Federal valuation allowance	388,408	2,602,441
Reduction in Federal corporate tax rate	—	1,358,272
Income tax expense (benefit)	$509,842	$4,041,655

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Significant components of the Company’s deferred tax assets (liabilities) for its TRS entities are as follows as of December 31, 2018 and 2017:

Deferred tax assets (liabilities):		December 31, 2018		December 31, 2017	
Real estate basis differences	$	4,144,365		4,255,681	
Net operating losses		1,499,186		1,380,138	
Total deferred tax assets		5,643,551		5,635,819	
Valuation allowance		(2,946,071	)	(2,428,497	)
Net deferred tax assets	$	2,697,480		3,207,322	

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

Management has estimated future taxable gains and losses on sale of ZRV real estate assets to determine how much of the deferred tax assets are realizable. This realizability analysis is inherently subjective and actual results could differ from these estimates. Based on an assessment of all factors, it was determined that a valuation allowance of $2,946,000 and $2,428,000 related to Federal and State NOLs and differences in the book and tax basis of assets in ZRV was required as of December 31, 2018 and 2017, respectively, as management does not expect that ZRV will generate enough taxable income in the future to realize all of the NOL and basis benefits. The Company’s Federal and California NOLs within ZRV totaled $6,671,000 and $1,404,000, respectively, as of December 31, 2018. ZRV has Arizona NOLs of $3,511,000 as of December 31, 2018; however, ZRV did not record a deferred tax asset related to the Arizona NOLs as it does not expect to file another Arizona tax return, and thus, the NOLs will not be used. All of the NOLs expire between 2036 and 2038, except for the 2018 Federal NOL of approximately $425,000 which does not expire.

As of December 31, 2018 and 2017, the Company recorded a reserve in the amount of $50,000 and $0, respectively, for uncertain income tax positions (see discussion of penalty above). There has been no interest incurred to date.

As of December 31, 2018, income tax returns for the calendar years ended 2015 through 2018 remain subject to examination by the IRS and/or any state or local taxing jurisdiction.

NOTE 12 - TRANSACTIONS WITH AFFILIATES

The Company is managed by OFG pursuant to the terms of our charter and the Management Agreement, as amended, between the Company and the Manager. Until July 1, 2017, the management fees paid monthly by the Company to the Manager were not to exceed 2.75% annually of the average unpaid balance of our loans at the end of each of the 12 months in the calendar year (the “Prior Management Fee”). During the period from July 1, 2017 through March 31, 2018, the Manager agreed to take a reduced management fee equal to the Interim Management Fee (the “Interim Management Fee”), which was a monthly management fee equal to 1/12th of 1.50% of the Company’s Stockholders’ Equity, as defined. Effective April 1, 2018, the Board of Directors and the Manager amended the Management Agreement to adopt the Interim Management Fee and make certain additional changes to reduce the management fee

payable as described below in “Amendment to Management Agreement” below.

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All of the Company’s loans are serviced by OFG, and until April 1, 2018, OFG received a monthly servicing fee, which, when added to all other fees paid in connection with the servicing of a particular loan, could 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. Servicing fees were eliminated effective April 1, 2018, as described below in “Amendment to Management Agreement”.

Management fees amounted to approximately $2,906,000, $3,546,000 and $3,286,000 for the years ended December 31, 2018 2017, and 2016, respectively, and are included in the accompanying consolidated statements of income. Servicing fees amounted to approximately $95,000, $362,000 and $299,000 for the years ended December 31, 2018, 2017 and 2016, respectively, are included in the accompanying consolidated statements of income. As of December 31, 2018 and 2017, the Company owed management and/or servicing fees to OFG in the amount of approximately $242,000 and $245,000, respectively.

Until April 1, 2018, OFG received all late payment charges from borrowers on loans owned by the Company. Beginning April 1, 2018, the Company receives 30% of all late payment charges and OFG receives 70% of such charges, as described below in “Amendment to Management Agreement”. The Company collected/earned approximately $57,000 in late payment charges during the year ended December 31, 2018. The amounts paid to or collected by OFG for late charges totaled approximately $139,000, $83,000 and $83,000 for the years ended December 31, 2018, 2017 and 2016, respectively.

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 $19,000, $23,000 and $20,000, respectively, during the years ended December 31, 2018, 2017 and 2016.

OFG originates all loans the Company invests in and, until April 1, 2018, received all loan origination and extension fees from borrowers. Beginning April 1, 2018, the Company receives 30% of all loan origination and extension fees and OFG receives 70% of such fees, as described below in “Amendment to Management Agreement”. The Company collected approximately $508,000 in loan origination and extension fees during the year ended December 31, 2018 and recognized revenue of approximately $123,000 from the amortization of such fees to interest income. During the years ended December 31, 2018, 2017 and 2016, OFG earned approximately $1,972,000, $2,492,000 and $2,514,000, respectively, on loans originated or extended of approximately $139,725,000, $122,240,000 and $101,594,000, respectively.

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. Until April 1, 2018, when the parties agreed to certain changes in the expenses paid to the Manager as described below in “Amendment to Management Agreement”, OFG was also reimbursed for the salary and related salary expense of OFG’s non-management and non-supervisory personnel performing services for the Company which could be performed by independent parties (subject to certain limitations in the Management Agreement). The amounts reimbursed to OFG by the Company for such services were $105,000, $381,000 and $440,000 during the years ended December 31, 2018, 2017 and 2016, respectively. As of December 31, 2018 and 2017, there was $0 and $32,000 payable to OFG for such services. The Company also reimbursed certain of OFG’s officers for allowed expenses in the total amount of approximately $3,000, $2,000 and $0 during the years ended December 31, 2018, 2017 and 2016, respectively.

The Company paid Investor’s Yield, Inc. (a wholly owned subsidiary of OFG) approximately $1,000, $1,000 and $9,000 in trustee’s fees related to certain foreclosure proceedings and other miscellaneous fees on Company loans during the years ended December 31, 2018, 2017 and 2016, respectively.

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Notes to Consolidated Financial Statements

Amendment to Management Agreement - Effective April 1, 2018, the Management Agreement was amended by Amendment No. 1 (the “Amendment”) to implement the following changes to the Manager’s compensation structure:

- Reduced Management Fee: The Amendment revises the management fee by making permanent the recent “Interim Management Fee” adjustment described above along with an additional adjustment such that the “Management Fee”, calculated and payable to the Manager monthly in arrears, equals (i) one-twelfth (1/12) multiplied by (ii) (a) 1.50% of the first $300,000,000 of the Company’s Stockholders’ Equity (as defined in the Amendment), and (b) 1.25% of the Stockholders’ Equity that is greater than $300,000,000.

- Company to Receive 30% of Loan Fees: The Company will receive thirty-percent (30%) of the gross fees and commissions paid to the Manager in connection with the Company making or investing in mortgage loans, including thirty-percent (30%) of gross fees paid in connection with the extension or modification of any loans, with the exception of certain miscellaneous administration fees collected in association with loan funding, demand, and partial release fees, with the remaining seventy-percent (70%) of such fees to be paid to the Manager.

- Company to Receive 30% of Late Payment Charges: The Company will receive thirty-percent (30%) of all late payment charges from borrowers on loans owned by the Company, with the remaining seventy-percent (70%) to be paid to the Manager.

- Elimination of Service Fees: The Company will no longer pay the Manager any servicing fees for the Manager’s services as servicing agent with respect to any of its mortgage loans.

- Elimination of Certain Expense Reimbursements: The Company will no longer reimburse the Manager for salary and related salary expense of the Manager's non-management and non-supervisory personnel.

NOTE 13 - RENTAL INCOME

The Company’s real estate properties held for sale and investment are leased to tenants under noncancellable leases with remaining terms ranging from one to ten years. Certain of the leases require the tenant to pay all or some operating expenses of the properties. The future minimum rental income from noncancellable operating leases due within the five years subsequent to December 31, 2018, and thereafter is as follows:

Year ending December 31:	
2019	$2,842,830
2020	2,163,672
2021	2,057,822
2022	1,837,332
2023	1,395,151
Thereafter (through 2028)	2,071,519
Total	$12,368,326

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NOTE 14 - FAIR VALUE

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

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

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

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

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

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

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

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

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

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

Impaired Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement or when monthly payments are delinquent greater than ninety days. Once a loan is identified as impaired, management measures impairment in accordance with ASC 310-10-35. Impairment is estimated by either the present value of expected cash flows discounted at the note rate or, as a practical expedient, the loan’s observable market price (if available) or the fair value of the underlying collateral, if collateral dependent. The fair value of the loan’s collateral is determined by third party appraisals, broker price opinions, comparable property sales or other indications of value. Those impaired loans not requiring an allowance represent loans for which the fair value of the collateral exceed the recorded investments in such loans. At December 31, 2018 and 2017, the majority of the total impaired loans were evaluated based on the fair value of the collateral by obtaining third party appraisals that valued the collateral primarily by utilizing an income or market approach or some combination of the two. In accordance with ASC 820, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser using observable market data, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available, when an appraisal includes significant unobservable inputs and assumptions or when management determines an adjustment to the appraised value is necessary in order to reflect management’s estimate of the fair value of the collateral, the Company records the impaired loan as nonrecurring Level 3. Unobservable market data included in appraisals often includes adjustments to comparable property sales for such items as location, size and quality to estimate fair values using a sales comparison approach. Unobservable market data also includes cash flow assumptions and capitalization rates used to estimate fair values under an income approach.

Real Estate Held for Sale and Investment

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

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The following table presents information about the Company's assets measured at fair value on a nonrecurring basis as of December 31, 2018 and 2017:

		Fair Value Measurements Using		
	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
2018 Nonrecurring:				
Impaired loans:				
NONE	$	$—	$—	$
Total	$	$—	$—	$
Real estate properties:				
Commercial	$1,269,650	$—	$—	$ 1,269,650
Land	1,850,342	—	1,850,342	—
Total	$3,119,992	$—	$1,850,342	$ 1,269,650
2017 Nonrecurring:				
Impaired loans:				
Residential	$1,115,999	$—	$—	$ 1,115,999
Total	$1,115,999	$—	$—	$ 1,115,999
Real estate properties:				
Commercial	$7,460,800	$—	$—	$ 7,460,800
Land	1,914,870			1,914,870
Total	$9,375,670	$—	$—	$ 9,375,670

There was no provision for loan losses or other gain or loss recorded based on the fair value of loan collateral less estimated selling costs for the impaired loans above during the years ended December 31, 2018 and 2017, respectively. There were charge-offs against the loan loss allowance totaling $187,000 and $546,000 during 2018 and 2017, respectively, for the 2017 impaired loan above. Impairment losses of approximately $1,053,000 and $1,423,000 were recorded on real estate properties during the years ended December 31, 2018 and 2017, respectively. The impairment losses recorded for the years ended December 31, 2018 and 2017 included $115,000 and $145,000, respectively, in the Land class and $938,000 and $1,278,000, respectively, in the Commercial class.
There were no assets or liabilities measured at fair value on a recurring basis, nor were there any liabilities measured at fair value on a nonrecurring bases at December 31, 2018 and 2017. During the year ended December 31, 2018, two properties with an aggregate book value of approximately $4,253,000 were transferred into Level 2 fair value measurements and an aggregate impairment loss of approximately $115,000 was recorded. One of the properties was sold in October 2018 and the other one in January 2019. During the year ended December 31, 2017, there were no transfers into or out of Levels 1 and 2.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at December 31, 2018 and 2017:

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Notes to Consolidated Financial Statements

December 31, 2018:

Description	Fair Value	Valuation Technique	Significant Unobservable Inputs	Input/Range	Weighted Average
Impaired Loans:					
NONE					
Real Estate Properties:					
Commercial	$ 1,269,650	Appraisal	Comparable Sales Adjustment	(45.3)% to 2.1%	N/A

December 31, 2017:

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

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

The approximate carrying amounts and estimated fair values of financial instruments at December 31, 2018 and 2017 are as follows:

		Fair Value Measurements at December 31, 2018			
	Carrying Value	Level 1	Level 2	Level 3	Total
Financial assets					
Cash, cash equivalents and restricted cash	$4,514,000	$4,514,000	$—	$—	$4,514,000
Loans, net	141,204,000	—	—	139,532,000	139,532,000
Investment in limited liability company	2,139,000	—	—	7,711,000	7,711,000
Accrued interest and advances receivable	1,023,000	—	—	1,023,000	1,023,000

Financial liabilities

Accrued interest payable	$86,000	—	41,000	45,000	$86,000
Lines of credit payable	1,728,000	—	1,728,000	—	1,728,000
Notes payable	12,799,000	—	—	12,568,000	12,568,000

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	Carrying Value	Fair Value Measurements at December 31, 2017 Level 1	Level 2	Level 3	Total
Financial assets					
Cash, cash equivalents and restricted cash	$5,671,000	$5,671,000	$—	$—	$5,671,000
Loans, net	144,344,000	—	—	144,255,000	144,255,000
Investment in limited liability company	2,141,000	—	—	4,819,000	4,819,000
Accrued interest and advances receivable	1,459,000	—	—	1,459,000	1,459,000
Financial liabilities					
Accrued interest payable	$115,000	—	77,000	38,000	$115,000
Lines of credit payable	1,555,000	—	1,555,000	—	1,555,000
Notes payable	30,192,000	—	17,176,000	13,233,000	30,409,000

The fair values of financial instruments in the above table as of December 31, 2018 were determined using an exit price methodology, whereas as of December 31, 2017 the fair values of certain financial instruments were determined using an entrance price methodology (see discussion of adoption of ASU 2016-01 in Note 2).

NOTE 15 - COMMITMENTS AND CONTINGENCIES

Contractual Obligations

As of December 31, 2018, the Company has commitments to advance additional funds to borrowers of construction, rehabilitation and other loans in the total amount of approximately $29,301,000 (including approximately $2,348,000 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. See Note 16 below “Litigation Relating to the Merger”.

NOTE 16 – SUBSEQUENT EVENTS

The Company sold two real estate properties in January 2019 for net sales proceeds totaling $2,706,000 and gain totaling $466,000.

The Company extended the maturity dates on five loans that were past maturity as of December 31, 2018 with principal balances totaling $15,010,000 in January and February 2019.

Special Meeting of Stockholders

On February 15, 2019, the Company announced that it has set March 21, 2019 as the new date for the special meeting of its stockholders to, among other things, consider and vote on a proposal to approve the previously announced Merger Agreement and to terminate the Management Agreement. The Company had previously announced that it expected the special meeting to occur on February 28, 2019, and that the impact of the government shutdown could affect the timing of the special meeting.

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Explanation of Responses:

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As announced on January 4, 2019, stockholders of record as of the close of business on January 14, 2019 will be entitled to vote at the special meeting on March 21, 2019. The Merger is subject to certain customary closing conditions and the receipt of approvals of stockholders of the Company and Ready Capital.

Determination of Exchange Ratio

On February 22, 2019, Ready Capital and the Company announced that they have determined the final exchange ratio in accordance with the terms of Merger Agreement. Pursuant to the terms and subject to the conditions set forth in the Merger Agreement, at the effective time of the Merger, each outstanding share of the Company's Common Stock will be converted into the right to receive from Ready Capital 1.441 shares of Ready Capital Common Stock. Cash will be paid in lieu of fractional shares of Ready Capital Common Stock that would have been received as a result of the Merger. There is no change to the final exchange ratio based on the determination date of January 31, 2019 from the base exchange ratio of 1.441 that was set out in the joint proxy statement/prospectus, dated February 15, 2019, that was filed by Ready Capital with the SEC and distributed to the parties' respective stockholders.

Litigation Relating to the Merger

A purported class action lawsuit has been filed by an individual who claims to be a stockholder of ORM. The lawsuit, Richard Scarantino v. Owens Realty Mortgage, Inc., et al., was filed in the Circuit Court for Baltimore City, Maryland on February 8, 2019. It names the Company, its directors and Ready Capital as defendants. The plaintiff alleges that the Company's directors breached their fiduciary duties because, according to the plaintiff, the consideration to be received by the Company's stockholders in the Merger "appears inadequate," some financial and other disclosures to the Company's stockholders regarding the Merger are deficient, and the terms of the Merger Agreement have precluded other bidders from making competing offers for the Company. The plaintiff seeks, among other things: injunctive relief preventing the defendants from proceeding with, consummating, or closing the Merger; rescission of the Merger or rescissory damages if the Merger is consummated prior to entry of final judgment by the court; an accounting of any damages suffered as a result of the wrongdoing alleged; and litigation costs (including attorneys' and expert fees and expenses). The Company believes the claims asserted in the Scarantino Lawsuit are without merit. On March 12, 2019, the plaintiff moved for a preliminary injuction seeking to prevent the March 21, 2019 meeting of the Company's stockholders to approve the merger from proceeding until further public disclosures about the transaction are filed by the Company. The court has not yet ruled on the motion.

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

NOTE 17 – SUMMARY QUARTERLY CONSOLIDATED FINANCIAL INFORMATION (UNAUDITED)

The following tables represent unaudited summarized quarterly financial data of the Company for the years ended December 31, 2018, 2017 and 2016 which, in the opinion of management, reflects all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the Company's results of operations.

	Three Months Ended			
	December 31, 2018	September 30, 2018	June 30, 2018	March 31, 2018
Total revenues	$3,735,550	$4,723,505	$4,346,044	3,991,920
Total expenses	3,790,374	3,696,281	2,978,230	3,493,586
Operating (loss) income	(54,824)	1,027,224	1,367,814	498,334
Gain on sale of real estate, net	2,126,084	1,372,925	957,239	154,577
Net income before income taxes	2,071,260	2,400,149	2,325,053	652,911
Income tax (expense) benefit	(243,122)	(150,910)	17,635	(183,445)
Net income attributable to common stockholders	$1,828,138	$2,249,239	$2,342,688	$469,466
Earnings per common share (basic and diluted)	$0.22	$0.26	$0.26	$0.05
Weighted average number of common shares outstanding (basic and diluted)	8,482,880	8,572,614	8,922,280	9,089,270
Dividends declared per share of Common Stock	$0.20	$0.20	$0.20	$0.16

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

OWENS REALTY MORTGAGE, INC.

Notes to Consolidated Financial Statements

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

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OWENS REALTY MORTGAGE, INC.
FINANCIAL STATEMENT SCHEDULE III - REAL ESTATE AND ACCUMULATED DEPRECIATION
DECEMBER 31, 2018

Description	Encumbrances	Initial Cost	Capitalized Costs	Sales	Impairment Write-downs	Accumulated Depreciation		Carrying Value	Date Acquired	Dep Liv
Retail Complex (TSV), South Lake Tahoe, California	$12,872,556 Note Payable	6,409,617	$ 12,299,570	$ (41,667)	—	$(2,679,823)		$15,987,697	Various	5-3
Retail Complex and 12 Residential Condominium Units (ZRV),South Lake Tahoe, California	None	5,016,443	37,299,922	(22,025,680)	—	—	Note 4	20,290,685	Various	N/A
Residential Land (ZRV II), South Lake Tahoe, California	None	2,032,963	4,528,060	—	—	—	Note 4	6,561,023	Various	N/A
73 Residential Lots, Auburn, California	None	13,746,625	376,746	(96,678)	(9,904,826)	—	Note 5	4,121,867	9/27/2007	N/A
12 Condominium & 3 Commercial Units, Tacoma, Washington	None	2,154,217	84,909	—	—	—	Note 6	2,239,126	7/8/2011	N/A
Two Houses on 20 Acres San Ramon, CA	None	2,062,729	—	—	—	—		2,062,729	11/13/2018	N/A
Marina & Boat Club with 179 Boat Slips,	None	1,809,663	713,318	—	(1,253,331)		Note 7	1,269,650	1/29/2013	N/A

Isleton, California										
Undeveloped, Industrial Land, San Jose, California	None	3,025,992	98,681	—	(1,274,331)	—	Note 8	1,850,342	12/27/2002	N/A
Miscellaneous Real Estate	None					—		2,259,391	Various	Var
TOTALS						$(2,679,823)		$56,642,510		

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

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

Balance at beginning of period (1/1/16)	$153,838,412
Additions during period:	
Acquisitions through foreclosure	700,800
Investments in real estate properties	29,061,735
Amortization of deferred financing costs capitalized to construction project	119,471
Subtotal	183,720,418
Deductions during period:	
Cost of real estate properties sold	66,183,589
Impairment losses on real estate properties	3,227,807
Depreciation of properties held for investment	1,185,624
Balance at end of period (12/31/16)	$113,123,398
Balance at beginning of period (1/1/17)	$113,123,398
Additions during period:	

Acquisitions through foreclosure	—
Investments in real estate properties	11,274,904
Amortization of deferred financing costs capitalized to construction project	76,260
Subtotal	124,474,562
Deductions during period:	
Cost of real estate properties sold	41,505,148
Impairment losses on real estate properties	1,423,286
Depreciation of properties held for investment	1,080,003
Balance at end of period (12/31/17)	$80,466,125
Balance at beginning of period (1/1/18)	80,466,125
Additions during period:	
Acquisitions through foreclosure	2,062,729
Investments in real estate properties	496,826
Subtotal	83,025,680
Deductions during period:	
Cost of real estate properties sold	24,609,167
Impairment losses on real estate properties	1,053,161
Depreciation of properties held for investment	720,842
Balance at end of period (12/31/18)	$56,642,510

NOTE 3: Changes in accumulated depreciation were as follows:

Balance at beginning of period (1/1/16)	$2,915,596
Additions during period:	
Depreciation expense	1,185,624
Subtotal	4,101,220
Deductions during period:	
Accumulated depreciation on real estate moved to held for sale	949,793
Balance at end of period (12/31/16)	$3,151,427
Balance at beginning of period (1/1/17)	$3,151,427
Additions during period:	
Depreciation expense	1,080,003
Subtotal	4,231,430
Deductions during period:	
Accumulated depreciation on real estate moved to held for sale	914,677
Balance at end of period (12/31/17)	$3,316,753
Balance at beginning of period (1/1/18)	3,316,753
Additions during period:	
Depreciation expense	720,842
Subtotal	4,037,595
Deductions during period:	
Accumulated depreciation on real estate moved to held for sale	1,357,772
Balance at end of period (12/31/18)	$2,679,823

NOTE 4: During the year ended December 31, 2017 $518,960 book value of land and $2,571,536 of construction and related costs related to common areas in the ZRV project were transferred from ZRV to ZRV II pursuant to a cost sharing agreement between the two entities (reflected in capitalized costs column).

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NOTE 5: Write-downs totaling $9,904,826 were recorded on this property during 2009 through 2012 based on broker's opinions of value and third party appraisals.
NOTE 6: Property was moved to Held for Sale during 2018 and accumulated depreciation up to that time of $332,183 is shown net with the Initial Cost above.
NOTE 7: Write-downs totaling $1,253,331 were recorded on this property in 2017 and 2018 based on management's estimate of value and third party appraisals. Property was moved to Held for Sale during 2017 and accumulated depreciation up to that time of $192,862 is shown net with the Initial Cost above.
NOTE 8: Write-downs totaling $1,274,331 were recorded on this property in 2010 through 2012, 2017 and 2018 based on third party appraisals and other valuation information. This property was sold in January 2019.
NOTE 9: The aggregate cost of the above real estate properties for Federal income tax purposes is approximately $78,429,000.
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OWENS REALTY MORTGAGE, INC.
FINANCIAL STATEMENT SCHEDULE IV - MORTGAGE LOANS ON REAL ESTATE
DECEMBER 31, 2018

Description	Interest Rate	Final Maturity date	Carrying Amount of Mortgages	Principal Amount of Loans Subject to Delinquent Principal	Principal Amount of Loans Subject to Delinquent Payments
TYPE OF PROPERTY					
Commercial	5.00-9.65%	Current to July 2021	$132,519,461	$24,431,860	$9,304,587
Residential	5.00-8.00%	Current to March 2028	5,209,357	2,358,966	2,557,526
Land	4.00-9.82%	January 2019 to October 2020	4,953,425	—	—
TOTAL			$142,682,243	$26,790,826	$11,862,113
AMOUNT OF LOAN					
$0-500,000	6.00-9.65%	Current to March 2028	$2,581,001	$573,606	$760,166
$500,001-1,000,000	5.00-8.00%	Current to October 2019	3,887,834	870,458	870,458
$1,000,001-5,000,000	4.00-9.82%	Current to July 2021	70,448,597	16,511,762	10,231,489
Over $5,000,000	5.00-8.25%	Current to March 2021	65,764,811	8,835,000	—
TOTAL			$142,682,243	$26,790,826	$11,862,113
POSITION OF LOAN					
First	4.00-9.65%	Current to March 2028	$137,808,788	$26,790,826	$11,862,113
Second	8.00-9.82%	July 2019 to October 2020	4,873,455	—	—
TOTAL			$142,682,243	$26,790,826	$11,862,113

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

Balance at beginning of period (1/1/16)	$106,743,807
Additions during period:	
New loans, including from sale of real property	79,867,140
Subtotal	186,610,947
Deductions during period:	
Collection of principal	55,849,884
Foreclosures	1,078,752
Balance at end of period (12/31/16)	$129,682,311
Balance at beginning of period (1/1/17)	$129,682,311

Additions during period:	
New loans, including from sale of real estate property	86,274,680
Subtotal	215,956,991
Deductions during period:	
Collection of principal	69,785,341
Foreclosures	—
Balance at end of period (12/31/17)	$146,171,650
Balance at beginning of period (1/1/18)	$146,171,650
Additions during period:	
New loans, including from sale of real estate property	77,471,539
Discount and loan fee amortization	227,801
Subtotal	223,870,990
Deductions during period:	
Collection of principal	78,742,850
Foreclosures	1,937,475
Loan fees collected	508,422
Balance at end of period (12/31/18)	$142,682,243

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NOTE 3: Included in the above loans are the following loans which exceed 3% of the total loans as of December 31, 2018:

Description	Interest Rate	Final Maturity Date	Periodic Payment Terms	Prior Liens	Face Amount of Mortgages	Carrying Amount of Mortgages	Principal Amount of Loans Subject to Delinquent Principal or Interest
Retail Building Irving, Texas	7.50%	6/1/19	Interest only, balance due at maturity	0	14,822,000	14,784,945	0
Retail Building Walnut Creek, California	7.25%	5/15/20	Interest only, balance due at maturity	0	9,000,000	8,953,623	0
Hotel Novi, Michigan	8.25%	12/31/18	Interest only, balance due at maturity	0	8,835,000	8,835,000	8,835,000
Office Building Pleasanton, California	7.50%	11/1/19	Interest only, balance due at maturity	0	8,250,000	8,200,150	0
Retail Building Folsom, California	7.75%	1/15/19	Interest only, balance due at maturity	0	8,006,000	7,170,186	0
Retail Building Antioch, California	8.00%	10/15/19	Interest only, balance due at maturity	0	7,000,000	6,979,074	0
Assisted Care Facility	5.00%	3/15/21	Interest only,	0	5,875,000	5,519,317	0

Bensalem, Pennsylvania			balance due at maturity				
Apartment Building Concord, California	7.50%	7/15/20	Interest only, balance due at maturity	0	6,350,000	5,322,516	0
Office Building Chula Vista, California	8.00%	11/1/18	Interest only, balance due at maturity	0	5,600,000	4,916,586	4,916,586
TOTALS				$ 0	$ 73,738,000	$ 70,681,397	$ 13,751,586

NOTE 4: The aggregate cost of the Company’s loans for Federal income tax purposes is approximately $143,046,000 as of December 31, 2018.

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

None.

Item 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Management of the Company carried out an evaluation, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company’s disclosure controls and procedures, as that term is defined in Rule 13a-15(e) under the Exchange Act. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures are effective as of December 31, 2018.

Changes in Internal Control over Financial Reporting

There have been no changes in the Company’s internal control over financial reporting, as that term is defined in Rule 13a-15(f) under the Exchange Act, in the fiscal quarter ending December 31, 2018 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

Management’s Report on Internal Control over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting, as that term is defined in Rule 13a-15(f) under the Exchange Act, for the Company. Under the supervision and with the participation of our principal executive officer and principal financial officer, an evaluation of the effectiveness of the internal control over financial reporting was conducted based on the framework established in the 2013 Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). There are inherent limitations in any internal control system over financial reporting, which may not prevent or detect misstatements. The Company’s internal control system over financial reporting is a process designed to provide reasonable assurance of achieving its objectives and management has concluded that the Company maintained effective internal control over financial reporting as of December 31, 2018.

Attestation Report of Independent Registered Public Accounting Firm

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

Item 9B. OTHER INFORMATION

There is no information required to be disclosed in a report on Form 8-K during the fourth quarter of the year ended December 31, 2018 that has not been so reported.

PART III

Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this item will be contained in the Company’s definitive Proxy Statement for its 2019 Annual Stockholder Meeting, to be filed with the SEC within 120 days after December 31, 2018, and is incorporated herein by reference.

Item 11. EXECUTIVE COMPENSATION

The information required by this item will be contained in the Company’s definitive Proxy Statement for its 2019 Annual Stockholder Meeting, to be filed with the SEC within 120 days after December 31, 2018, and is incorporated herein by reference.

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

The information required by this item will be contained in the Company's definitive Proxy Statement for its 2019 Annual Stockholder Meeting, to be filed with the SEC within 120 days after December 31, 2018, and is incorporated herein by reference.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item will be contained in the Company's definitive Proxy Statement for its 2019 Annual Stockholder Meeting, to be filed with the SEC within 120 days after December 31, 2018, and is incorporated herein by reference.

Item 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this item will be contained in the Company's definitive Proxy Statement for its 2019 Annual Stockholder Meeting, to be filed with the SEC within 120 days after December 31, 2018, and is incorporated herein by reference.

PART IV

Item 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a)

(1) List of Financial Statements filed as part of Item 8 in this Annual Report:

Report of Independent Registered Public Accounting Firm	63
Consolidated Balance Sheets - December 31, 2018 and 2017	65
Consolidated Statements of Income - December 31, 2018, 2017 and 2016	66
Consolidated Statements of Stockholders' Equity - December 31, 2018, 2017 and 2016	67
Consolidated Statements of Cash Flows - December 31, 2018, 2017 and 2016	68
Notes to Consolidated Financial Statements	70

(2) List of Financial Statement Schedules filed as part of Item 8 in this Annual Report:

Schedule III - Real Estate and Accumulated Depreciation – December 31, 2018	107
Schedule IV - Mortgage Loans on Real Estate – December 31, 2018	110

(3) List of Exhibits:

* 2.1	Agreement and Plan of Merger, dated November 7, 2018, by and among Ready Capital Corporation, ReadyCap Merger Sub, LLC and Owens Realty Mortgage, Inc. incorporated by reference to exhibit 2.1 of the current report on Form 8-K filed with the SEC on November 9, 2018
* 3.1	Articles of Amendment and Restatement of Owens Realty Mortgage, Inc., dated January 23, 2013, and related Certificate of Correction, dated September 17, 2013 incorporated by reference to exhibit 3.1 of the Annual Report on Form 10-K for the year ended December 31, 2014 filed with the SEC on March 16, 2015
* 3.2	Bylaws of Owens Realty Mortgage, Inc., incorporated herein by reference to Annex C to the Proxy Statement/Prospectus on Form S-4 filed with the SEC on February 13, 2013
* 3.3	Amendment No. 1 to the Bylaws of Owens Realty Mortgage, Inc., dated December 29, 2017, incorporated by reference to exhibit 3.1 of the current report on Form 8-K/A filed with the SEC on January 4, 2018

* 3.4	Amendment No. 2 to the Bylaws of Owens Realty Mortgage, Inc., dated May 7, 2018, incorporated by reference to exhibit 3.1 of the current report on Form 8-K filed with the SEC on May 9, 2018
* 3.5	Articles Supplementary, dated November 12, 2013, relating to the election to be subject to Subtitle 8 of Title 3 of the Maryland General Corporation Law, incorporated by reference to exhibit 3.1 of the current report on Form 8-K filed with the SEC on November 13, 2013

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*	4.1	Form of Common Stock Certificate, incorporated by reference to exhibit 4.1 to the Proxy Statement/Prospectus on Form S-4 filed with the SEC on January 25, 2013
*	10.1	Form of Management Agreement, dated May 20, 2013, by and between Owens Financial Group, Inc. and Owens Realty Mortgage, Inc., incorporated by reference to exhibit 10.1 of the current report on Form 8-K filed with the SEC on May 20, 2013
*	10.2	Amendment No. 1 to Management Agreement, executed April 2, 2018, by and between Owens Realty Mortgage, Inc. and Owens Financial Group, Inc., incorporated by reference to exhibit 1.1 of the current report on Form 8-K filed with the SEC on April 3, 2018
*	10.3	Second Amended and Restated Credit Agreement, dated as of September 4, 2018, by and among ZB, N.A. dba California Bank & Trust, as Administrative Agent and a Lender, First Bank as a Lender, Umpqua Bank as a Lender, and Owens Realty Mortgage, Inc. as Borrower, incorporated by reference to exhibit 10.1 of the current report on Form 8-K filed with the SEC on September 6, 2018
*	10.4	Security Agreement, dated as of September 4, 2018, by and among Owens Realty Mortgage, Inc., ZB, N.A. dba California Bank & Trust, as Agent for the Lenders, and each of the Lenders party to the Restated Credit Agreement, incorporated by reference to exhibit 10.2 to the current report on Form 8-K filed with the SEC on September 6, 2018
*	10.5	Settlement Agreement, dated December 29, 2017, by and among Owens Realty Mortgage, Inc., Freestone Opportunity Partners LP, Freestone Opportunity Qualified Partners LP, Freestone Investments LLC, Freestone Capital Management, LLC, Freestone Capital Holdings, LLC, Erik Morgan and Gary I. Furukawa, incorporated by reference to exhibit 10.1 of the current report on Form 8-K/A filed with the SEC on January 4, 2018
**	21.1	List of Subsidiaries of the Registrant
**	23.1	Consent of Crowe LLP
**	24.1	Power of Attorney
**	31.1	Certification of CEO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
**	31.2	Certification of CFO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
**	32.1	Certification of CEO and CFO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
***	101.INS	XBRL Instance Document
***	101.SCH	XBRL Taxonomy Extension Schema Document
***	101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
***	101.LAB	XBRL Taxonomy Extension Labels Linkbase Document
***	101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
***	101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

*Previously filed.
** Filed herewith.
***This exhibit is being furnished rather than filed, and shall not be deemed incorporated by reference into any filing, in accordance with Item 601 of Regulation S-K.

Item 16. FORM 10-K SUMMARY

Not applicable.
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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

OWENS REALTY MORTGAGE, INC.

Dated: March 15, 2019 By: /s/ Bryan H. Draper
Bryan H. Draper, Chief Executive Officer and President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Dated: March 15, 2019	By: /s/ Bryan H. Draper Bryan H. Draper, Director, Chief Executive Officer and President (Principal Executive Officer)
Dated: March 15, 2019	By: /s/ Melina A. Platt Melina A. Platt, Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)
Dated: March 15, 2019	By: /s/ William C. Owens William C. Owens, Director
Dated: March 15, 2019	By: * Dennis G. Schmal Dennis G. Schmal, Director
Dated: March 15, 2019	By: * Gary C. Wallace Gary C. Wallace, Director
Dated: March 15, 2019	By: * Ann Marie Mehlum Ann Marie Mehlum, Director
Dated: March 15, 2019	By: * Gilbert E. Nathan Gilbert E. Nathan, Director

Dated: March 15, 2019	By:	* Benjamin Smeal
		Benjamin Smeal, Director
Dated: March 15, 2019	By:	* Steven D. Hovde
		Steven D. Hovde, Director
	*By:	/s/ Bryan H. Draper Bryan H. Draper, Attorney-in-fact

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