TELKONET INC
Form 10-K/A
March 03, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-K/A
(Amendment No. 1)

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number: 001-31972

TELKONET, INC.
(Exact name of registrant as specified in its charter)

Utah (State or other jurisdiction of incorporation or organization)	87-0627421 (IRS Employee Identification No.)

20374 Seneca Meadows Parkway
Germantown, MD 20876
(Address of principal executive offices)

(240) 912-1800
(Issuer's telephone number)

Securities Registered pursuant to section 12(g) of the Act: None

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

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

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

Check if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained in this form, and no disclosure will be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See the definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

___ Large Accelerated Filer X Accelerated Filer ___ Non-Accelerated Filer

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

Aggregate market value of the voting stock held by non-affiliates of the registrant as of March 1, 2007: $136,993,170.
Number of outstanding shares of the registrant’s par value $0.001 common stock as of March 1, 2007: 57,002,301.

TELKONET, INC.
FORM 10-K/A
INDEX

		Page
	Explanatory Note	3
Part I		
Item 1.	Description of Business	4
Item 1A.	Risk Factors	13
Item 1B.	Unresolved Staff Comments	18
Item 2.	Description of Property	18
Item 3.	Legal Proceedings	19
Item 4.	Submission of Matters to a Vote of Security Holders	19
Part II		
Item 5.	Market for Registrant's Common Equity, Related Stockholder Matters and Registrant's Purchases of Securities	20
Item 6.	Selected Financial Data	21
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations	21
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk.	33
Item 8.	Financial Statements	33
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	34
Item 9A.	Controls and Procedures	34
Item 9B.	Other Information	36
Part III		
Item 10.	Directors and Executive Officers of the Registrant	36
Item 11.	Executive Compensation	39
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	48

Item 13. Certain Relationships and Related Transactions 49

Item 14. Principal Accounting Fees and Services 50

Part IV

Item 15. Exhibits and Financial Statement Schedules 50

EXPLANATORY NOTE

This Amendment No. 1 on Form 10-K/A (the "Amendment") amends our annual report on Form 10-K for the fiscal year ended December 31, 2006 as filed with the Securities and Exchange Commission on March 16, 2007 (the "Original Report"). The Company is filing this Amendment in response to comments received from the SEC. This Amendment corrects errors and provides additional disclosure information in Item 7, Note B Acquisition of Subsidiary, Note H Convertible Promissory Note Payable, and Note K Stock Options and Warrants, of the audited financial statements for the year-ended December 31, 2006 included in Item 8 of Part II, and Item 15 of Part IV as permitted by the rules and regulations of the SEC. The amendment did not have any material impact on our financial results.

For convenience and ease of reference, we are filing the annual report in its entirety with the applicable changes. Except for the amendments above and the updated certifications, this Amendment continues to speak as of the date of our Original Report, and we have not updated the disclosures contained herein to reflect any events that have occurred thereafter. For a discussion of events and developments thereafter, please see our reports filed with the Securities and Exchange Commission since March 16, 2007.

PART I

ITEM 1. DESCRIPTION OF BUSINESS.

GENERAL

Business

Telkonet, Inc., formed in 1999, develops and markets technology for the transmission of high-speed voice, video and data communications over the existing electrical wiring within a building. Telkonet has made definitive inroads into the Powerline communication (PLC) market and established the "leading" position for in-building commercial communication solutions.

Through the Company's majority-owned subsidiary Microwave Satellite Technologies (MST), the Company is able to offer quadruple play ("Quad-Play") services to multi-tenant unit ("MTU") and multi-dwelling unit ("MDU") residential, hospitality and commercial properties. These Quad- Play services include video, voice, high-speed internet and wireless fidelity ("Wi-Fi") access.

The Company's recent acquisition of Ethostream, LLC, a leading high speed wireless internet and technology provider for the hospitality industry (as described in greater detail below under "Segment Reporting"), will enable Telkonet to provide installation and support for PLC products and third party applications to customers across North America. The Company's new operating division represented by the assets acquired from Smart Systems International, a leading provider of energy management products and solutions (as described in greater detail below under "Segment Reporting") will permit the Company to offer new energy management products and solutions to its customers in the United States and Canada.

As a result of Telkonet's acquisition of Smart Systems International and EthoStream, the Company can now provide hospitality owners with a greater return on investment on technology investments. Hotel owners can leverage the Telkonet iWire System™ platform to support wired and wireless Internet access and, in the future, to support a networked energy management system. With the synergy of Ethostream, LLC's centralized remote monitoring and management platform extending over HSIA, digital video surveillance and energy management, hospitality owners will have a complete technology offering based on Telkonet's core PLC system as the infrastructure backbone, demonstrating true technology convergence.

The Company's offices are located at 20374 Seneca Meadows Parkway, Germantown, Maryland 20876. The reports that the Company files pursuant to the Securities Exchange Act of 1934 can be found at the Company's web site at www.telkonet.com.

Segment Reporting

We classify our operations in two reportable segments: the Telkonet Segment and the MST Segment

Telkonet Segment ("Telkonet")

Through the revolutionary Telkonet iWire System™ , Telkonet utilizes proven PLC technology to deliver commercial high-speed Broadband access from an IP "platform" that is easy to deploy, reliable and cost-effective by leveraging a building's existing electrical infrastructure. The building's existing electrical wiring becomes the backbone of the local area network, which converts virtually every electrical outlet into a high-speed data port without the costly installation of additional wiring or major disruption of business activity.

The Telkonet iWire System™ offers a viable and cost-effective alternative to the challenges of hardwiring and wireless local area networks (LANs). Telkonet's products are designed for use in commercial and residential applications, including multi-dwelling units and the hospitality and government markets. Applications supported by the Telkonet "platform" include, but are not limited to, VoIP telephones, internet connectivity, local area networking, video conferencing, closed circuit security surveillance and a host of other information services.

Telkonet's Product has been installed in all present target market segments. Government and regulatory certifications have been obtained to sell the product internationally. Telkonet has been shipping PLC products since 2003, initially targeting the multi-hospitality unit (MHU) market followed by the multi-dwelling unit (MDU) market as well as the Government and Public Sector markets. Telkonet employs both direct and indirect sales model to distribute and support product on a worldwide basis.

On March 9, 2007, the Company acquired substantially all of the assets of Smart Systems International (SSI), a leading provider of energy management products and solutions to customers in the United States and Canada for cash and Company common stock having an aggregate value of $7,000,000. The purchase price was comprised of $875,000 in cash and 2,227,273 shares of the Company's common stock. The Company is obligated to register the stock portion of the purchase price on or before May 15, 2007 and 1,090,000 shares are being held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase agreement may be satisfied. The aggregate number of shares held in escrow is subject to adjustment upward or downward depending upon the trading price of the Company's common stock during the one year period following the closing date.

On March 15, 2007, the Company acquired 100% of the outstanding membership units of Ethostream, LLC, a network solutions integration company that offers installation, sales and service to the hospitality industry. The Ethostream, LLC acquisition will enable Telkonet to provide installation and support for PLC products and third party applications to customers across North America. The purchase price of $11,756,097 was comprised of $2.0 million in cash and 3,459,609 shares of the Company's common stock. The entire stock portion of the purchase price is being held in escrow to satisfy certain potential indemnification obligations of the sellers under the purchase agreement. The shares held in escrow are distributable over the three years following the closing. The aggregate number of shares issuable to the sellers is subject to downward adjustment in the event the Company's common stock trades at or above a price of $4.50 per share for twenty consecutive trading days during the one year period following the closing.

Competition

Telkonet is a member of the HomePlug(TM) Powerline Alliance, an industry trade group that engages in marketing and educational initiatives and sets standards and specifications for products in the powerline communications industry.

The HomePlug(TM) Powerline Alliance has grown over the past year and now includes many well recognized brands in the networking and communications industries. These include Linksys (a Cisco company), Intel, GE, Motorola, Netgear, Sony and Samsung. With the exception of Motorola, who recently introduced a commercial product, these companies do not presently represent a direct competitive threat to Telkonet since they only market and sell their products in the residential sector.

There can be no assurance that other companies will not develop PLC products that compete with Telkonet's products in the future. They all have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources than Telkonet. These potential competitors may, among other things, undertake more extensive marketing campaigns, adopt more aggressive pricing policies, obtain more favorable pricing from suppliers and manufacturers and exert more influence on the sales channel than Telkonet can. As a result, Telkonet may not be able to compete successfully with these potential competitors and these potential competitors may develop or market technologies and products that are more widely accepted than those being developed by Telkonet or that would render Telkonet's products obsolete or noncompetitive.

Management has focused its sales and marketing efforts primarily on the commercial sector, which includes office buildings, hotels, schools, shopping malls, commercial buildings, multi-dwelling units, government facilities, and any other commercial facilities that have a need for Internet access and network connectivity. Telkonet has also focused on

establishing relationships with value added resellers. Telkonet continues to examine, select and approach entities with existing distribution channels that will be enhanced by Telkonet's offerings. Telkonet also intends to focus future sales and marketing efforts in Europe, South America, Asia and the Pacific Rim.

Raw Materials

Telkonet has not experienced any significant or unusual problems in the purchase of raw materials or commodities. While Telkonet is dependent, in certain situations, on a limited number of vendors to provide certain raw materials and components, it has not experienced significant problems or issues purchasing any essential materials, parts or components. Telkonet obtains the majority of its raw materials from the following suppliers: Avnet Electronics Marketing, Digi-Key Corporation, Intellon Corporation, and Parkview Metal Products. In addition, Superior Manufacturing Services, a U.S. based company, provides substantially all the manufacturing and assembly requirements for Telkonet.

Customers

Telkonet is neither limited to, nor reliant upon, a single or narrowly segmented consumer base from which it derives its revenues. Presently, Telkonet is not dependent on any particular customer under contract. However, Telkonet's sale of certain rental contract agreements to Hospitality Leasing Corporation represented approximately 18.0% of total revenues in each of 2005 and 2006. Telkonet's primary focus is in the commercial, government and international markets.

Intellectual Property

Telkonet has applied for patents that cover the unique technology integrated into the Telkonet iWire SystemTM product suite. Telkonet also continues to identify, design and develop enhancements to its core technologies that will provide additional functionality, diversification of application and desirability for current and future users of the Telkonet iWire SystemTM product suite.

In January 2003, Telkonet received Federal Communications Commission (FCC) approval to market the Telkonet iWire SystemTM product suite. FCC rules permit the operation of unlicensed digital devices that radiate radio frequency emissions if the manufacturer complies with certain equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements. An independent, FCC-certified testing lab has verified the Company's Gateway complies with the FCC technical requirements for Class A digital devices. No further testing of this device is required and the device may be manufactured and marketed for commercial use.

In December 2003, Telkonet received approval from the U.S. Patent and Trademark Office for its "Method and Apparatus for Providing Telephonic Communication Services" Patent No.: 6,668,058. This invention covers the utilization of an electrical power grid, for a concentration of electrical power consumers, and use of existing consumer power lines to provide for a worldwide voice and data telephony exchange

In March 2005, Telkonet received final certification of its Telkonet iWire SystemTM product suite from European Union (EU) authorities, which certification was required before Telkonet could sell and permanently install products in EU countries. As a result of the certification, Telkonet products that will be sold and installed in EU countries will bear the Conformite Europeene (CE) mark, a symbol that demonstrates that the product has met the EU's regulatory standards and is approved for sale within the EU. Telkonet now has satisfied the governmental requirements for product safety and certification in the EU and is free to sell and install the Telkonet iWire SystemTM product suite in the EU.

In June 2005, Telkonet received the National Institute of Standards and Technology (NIST) Federal Information Processing Standard (FIPS) 140-2 validation for the Gateway. In July 2005, Telkonet received FIPS 140-2 validation for the eXtender and iBridge. The U.S. federal government requires, as a condition to purchasing certain information processing applications, that such applications receive FIPS 140-2 validation. U.S. federal agencies use FIPS 140-2 compliant products for the protection of sensitive information. As a result of the foregoing validations, as of July 2005, all of Telkonet's powerline carrier products have satisfied all governmental requirements for security certification and are eligible for purchase by the U.S. federal government. In addition to the foregoing, Canadian provincial authorities use FIPS 140-2 compliant products for the protection of sensitive designate information. The Communications-Electronics Security Group (CESG) also has stated that FIPS 140-2 compliant products meet its security criteria for use in data traffic categorized as "Private." CESG is part of the United Kingdom's National Technical Authority for Information Assurance, which is a government agency responsible for validating the security of information processing applications for the government of the United Kingdom, financial institutions, healthcare organizations, and international governments, among others.

In November 2005, Telkonet received the Norma Official Mexicana (NOM) certification, enabling Telkonet to sell the iWire SystemTM product suite in Mexico. NOM certification is required for Telkonet's products to be sold in Mexico, and no further certifications are required to sell the Telkonet iWire SystemTM product suite in Mexico.

In December 2005, the United States Patent and Trademark Office issued Patent No: 6,975,212 titled "Method and Apparatus for Attaching Power Line Communications to Customer Premises". The patent covers the method and apparatus for modifying a three-phase power distribution network in a building in order to provide data communications by using a PLC signal to an electrical central location point of the power distribution system. Telkonet's Coupler technology enables the conversion of electrical outlets into high-speed data ports without costly installation, additional wiring, or significant disruption of business activity. The Coupler is an integral component of the Telkonet iWire SystemTM product suite.

6

In August 2006, the United States Patent and Trademark Office issued Patent No: 7,091,831, titled "Method and Apparatus for Attaching Power Line Communications to Customer Premises". The patented technology incorporates a safety disconnect circuit breaker into the Telkonet Coupler, creating a single streamlined unit. In doing so, installation of the Telkonet iWire System(TM) is faster, more efficient, and more economical than with separate disconnect switches, delivering optimal signal quality. The Telkonet Integrated Coupler Breaker patent covers the unique technique used for interfacing and coupling its communication devices onto the three-phase electrical systems that are predominant in commercial buildings.

In January 2007, the United States Patent and Trademark Office issued Patent No: 7,170,395 titled “Methods and Apparatus for Attaching Power Line Communications to Customer Premises” for Delta phase power distribution system applications, which are prevalent in the maritime industry, shipboard systems, along with that of heavy industrial plants and facilities.

Assumed through the acquisition of SSI, the United States Patent and Trademark Office issued Patent No: 5,395,042 in March 1995 titled “Apparatus and Method for automatic climate control” calculates and records the amount of time needed for the thermostat to return the room temperature to the occupant’s set point once a person re-enters the room

In addition Telkonet currently has multiple patent applications under examination, and intends to file additional patent applications covering a wide range of technologies including that of improved network topologies and techniques for imposing LANs over existing wired infrastructures.

Telkonet has also filed multiple Patent Cooperation Treaty (PCT) patent applications, which have been used to file national patent applications in foreign countries including the European Union, Japan, China, Russia, India and others.

Notwithstanding the issuance of these patents, there can be no assurance that any of Telkonet’s current or future patent applications will be granted, or, if granted, that such patents will provide necessary protection for the Company’s technology or its product offerings, or be of commercial benefit to the Company.

Government Regulation

We are subject to regulation in the United States by the FCC. FCC rules permit the operation of unlicensed digital devices that radiate radio frequency (RF) emissions if the manufacturer complies with certain equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements. An independent, FCC-certified testing lab has verified that the Company’s our PLC product line complies with the FCC technical requirements for Class B digital devices. No further testing of these devices is required and the devices may be manufactured and marketed for commercial and residential use.

In Europe and other overseas markets, Telkonet’s products are subject to safety and RF emissions regulations adopted by the European Union (EU) for Information Technology Equipment. In March 2005, the Company received final Conformite Europeene (CE) certification, which is required for the Company to freely market and sell its products within the EU. As a result of the certification, Telkonet’s products sold and installed in EU countries will bear the CE marking, a symbol that demonstrates that the product has met the EU’s regulatory standards and is approved for sale in the EU. The Restriction of Hazardous Substances Directive (RoHS) directive took effect in the EU on July 1, 2006. This directive restricts the use of six hazardous materials in the manufacture of various types of electronic and electrical equipment. It is closely linked with the Waste Electrical and Electronic Equipment Directive (WEEE) which sets collection, recycling and recovery targets for electrical goods and is part of a legislative initiative to solve the problem of huge amounts of toxic e-waste. Telkonet has taken the appropriate measures to be fully compliant with both of these directives.

Future products designed by the Company will require testing for compliance with FCC and CE regulations. Moreover, if in the future, the FCC or EU changes its technical requirements, further testing and/or modifications may be necessary.

Research and Development

During the years ended December 31, 2006, 2005 and 2004, Telkonet spent $1,925,746, $2,096,104, and $1,852,309, respectively, on research and development activities. In 2006, research and development activities were focused on the development of Telkonet’s next generation product. In 2005, research and development activities included (a) QoS for VoIP service for both commercial and FIPS 140-2 product applications, (b) design of the next generation high-speed development platform, (c) design, prototype & release of the Integrated Coupler Breaker product line, (d) design & development of the second generation automated test equipment for manufacturing, (e) automated SQA regression testing. In 2004, research and development activities included (a) development of a further cost-reduced (“G3”) iBridge/eXtender, (b) router software development, and (c) advanced encryption support.

Long Term Investments

Amperion, Inc.

On November 30, 2004, Telkonet entered into a Stock Purchase Agreement (“Agreement”) with Amperion, Inc. ("Amperion"), a privately held company. Amperion is engaged in the business of developing networking hardware and software that enables the delivery of high-speed broadband data over medium-voltage power lines. Pursuant to the Agreement, the Company invested $500,000 in Amperion in exchange for 11,013,215 shares of Series A Preferred Stock for an equity interest of approximately 4.7%. Telkonet accounted for this investment under the cost method, as the Company does not have the ability to exercise significant influence over operating and financial policies of the investee.

It is the policy of Telkonet to regularly review the assumptions underlying the operating performance and cash flow forecasts in assessing the carrying values of the investment. Telkonet identifies and records impairment losses on investments when events and circumstances indicate that such decline in fair value is other than temporary. Such indicators include, but are not limited to, limited capital resources, limited prospects of receiving additional financing, and limited prospects for liquidity of the related securities. Telkonet determined that its investment in Amperion was impaired based upon forecasted discounted cash flow. Accordingly, Telkonet wrote-off $92,000 and $400,000 of the carrying value of its investment through a charge to operations during the year-ended December 31, 2006 and 2005, respectively. The remaining value of Telkonet’s investment in Amperion is $8,000 and $100,000 at December 31, 2006 and 2005, respectively, and the amount at December 31, 2006, represents the current fair value.

BPL Global, Ltd.

On February 4, 2005, the Company’s Board of Directors approved an investment in BPL Global, Ltd. (“BPL Global”), a privately held company. Telkonet funded an aggregate of $131,000 as of December 31, 2005 and additional $44 during the year of 2006. This investment represents an equity interest of approximately 4.67% at December 31, 2006. BPL Global is engaged in the business of developing broadband services via power lines through joint ventures in the United States, Asia, Eastern Europe and the Middle East. Telkonet accounted for this investment under the cost method, as the Company does not have the ability to exercise significant influence over operating and financial policies of the investee. Telkonet reviewed the assumptions underlying the operating performance and cash flow forecasts in assessing the carrying values of the investment. The fair value of Telkonet's investment in BPL Global, Ltd. amounted $131,044 and $131,000 as of December 31, 2006 and 2005, respectively.

Backlog

As of March 1, 2007 and 2006, revenues to be recognized under non-cancelable leases and service contracts in the hospitality market of approximately $1,331,000 and $2,411,000, respectively. Additionally, Telkonet has a commitment to deploy the Telkonet iWire SystemTM at 50 properties for a major resort company which deployment represents revenue of approximately $1,100,000 over a 3 year term.

In conjunction with the acquisition of Smart Systems International on March 9, 2007, Telkonet assumed certain purchase orders relating to a major utilities energy management initiative provided through the two selected providers. The current order backlog amounts to approximately $500,000 and the estimated remaining program value amounts to $3,000,000 for products and services to be provided through 2008.

In conjunction with the acquisition of Ethostream, LLC on March 15, 2007, Telkonet acquired support contracts and monthly services for more than 1500 hotels which is expected to generate approximately $2,000,000 annual recurring support and internet advertising revenue.

MST Segment ("MST")

MST is a communications service provider offering quadruple play ("Quad-Play") services to multi-tenant unit ("MTU") and multi-dwelling unit ("MDU") residential, hospitality and commercial properties. These Quad-Play services include video, voice, high-speed internet and wireless fidelity ("Wi-Fi") access. In addition, MST currently offers or plans to offer a variety of next-generation telecommunications solutions and services including satellite installation, video conferencing, surveillance/security and energy management, and other complementary professional services.

NuVisions™

MST currently offers digital television service through DISH Network, a national satellite television provider, under its private label NuVisions™ brand of services. The NuVisions TV offering currently includes over 500 channels of video and audio programming, with a large high definition (more than 40 channels) and ethnic offering (over 100 channels from 17 countries) available in the market today. MST also offers its NuVisions Broadband high speed internet service and NuVisions Digital Voice telephone service to multi-family residences and commercial properties. MST delivers its broadband based services using terrestrial fiber optic links and in February 2005, began deployment in New York City of a proprietary wireless gigabit network that connects properties served in a redundant gigabit ring - a virtual fiber optic network in the air.

Wi-Fi Network

MST has constructed a large NuVisions Wi-Fi footprint in New York City intended to create a ubiquitous citywide Wi-Fi network. NuVisions Wi-Fi offers Internet access in the southern-half of Central Park, Riverside Park from 60th to 79th Streets, Dag Hammarskjold Plaza, and the United Nations Plaza. In addition, MST provides NuVisions Wi-Fi service in and around Trump Tower on Fifth Avenue, Trump World Tower on First Avenue, the Trump Place properties located on Riverside Boulevard, Trump Palace, Trump Parc, Trump Parc East as well as portions of Roosevelt Island surrounding the Octagon residential community. MST currently has plans to deploy additional Wi-Fi “Hot Zones” throughout New York City and continue to enlarge its Wi-Fi footprint as new properties are served.

Internet Protocol Television (“IPTV”)

In fourth quarter of 2006, MST invested in an IPTV platform to deploy in 2007. IPTV is a method of distributing television content over IP that enables a more user-defined, on-demand and interactive experience than traditional cable or satellite television. The IPTV service delivers traditional cable TV programming and enables subscribers to surf the Internet, receive on-demand content, and perform a host of Internet-based functions via their TV sets.

Competition

The home entertainment and video programming industry is competitive, and MST expects competition to intensify in the future. MST faces its most significant competition from the franchised cable operators. In addition, MST’s competition includes other satellite providers, telecom providers and off-air broadcasters.

Hardwired Franchised Cable System

Cable companies currently dominate the market in terms of subscriber penetration, the number of programming services available, audience ratings and expenditures on programming. However, satellite services are gaining market share which MST believes will provide it with the opportunity to acquire and consolidate a subscriber base by providing a high quality signal at a comparable or reduced price to many cable operators' current service.

Other Operators

MST’s next largest competitors are other operators who build and operate communications systems such as satellite master antenna television systems, commonly known as SMATV, or private cable headend systems, which generally serve condominiums, apartment and office complexes and residential developments. MST also competes with other national DBS operators such as EchoStar.

Off-Air Broadcasters

A majority of U.S. households that are not serviced by cable operators are serviced only by broadcast networks and local television stations (“off-air broadcasters”). Off-air broadcasters send signals through the air, which are received by traditional television antennas. Signals are accessible to anyone with an antenna and programming is funded by advertisers. Audio and video quality is limited and service can be adversely affected by weather or by buildings blocking a signal.

Traditional Telephone Companies

Traditional telephone companies such as Verizon and AT&T have recently diversified their service offerings to compete with traditional franchised cable companies in a triple-play market. Although their subscriber growth is currently smaller than franchise cable companies, these traditional phone companies are developing video offerings such as Verizon's FIOS product. These phone companies have in the past also been resellers of DIRECTV and EchoStar video programming, however, rarely in the multi-dwelling unit market. In the future, video offerings from traditional phone companies may become a significant competitor in the MDU market.

Customers/Strategy

MST's customer base and strategy is to target and cultivate a subscriber base that will demand high margin products including, video, IPTV, VoIP, high-speed Internet and Wi-Fi services.

MST currently maintains service agreements with approximately 20 MDU and MTU properties. Generally, under the terms of a service agreement, MST provides either (i) "bulk services," which may include one or all of a bundle of products and services, at a fixed price per month to the owner of the MDU or MTU property, and contract with individual residents for enhanced services, such as premium cable channels, for a monthly fee or (ii) contract with individual residents of the MDU property for one or more basic or enhanced services for a monthly fee. These agreements typically include a revenue sharing arrangement with property owners, whereby the property owner is entitled to a share of the revenues derived from subscribers who reside at the MDU/MTU property. These revenue sharing arrangements are either based upon a fix amount per subscriber or based on a percentage, typically between 7-10%, of the monthly fees MST charges residents for its services. MST believes that its complementary products and services allows for future growth and as such are designed and integrated with scalability in mind.

Governmental Regulation

Federal Regulation

MST's systems do not use or traverse public rights-of-way and thus are exempt from the comprehensive regulation of cable systems under the Federal Communications Act of 1934, as amended (the "Communications Act"). Because its systems are subject to minimal federal regulation, MST has greater pricing freedom and is not required to serve any customer whom it does not choose to serve, and management believes that MST has significantly more competitive flexibility than do the franchised cable systems. Management believes that these regulatory advantages help to make MSTs' private systems competitive with larger franchised cable systems.

On October 5, 1992, Congress enacted the Cable Consumer Protection and Competition Act of 1992 (the "1992 Cable Act"), which imposed additional regulation on traditional franchised cable operators and permits regulation of rates in markets in which there is no "effective competition", as defined in the 1992 Cable Act, and directed the FCC to adopt comprehensive new federal standards for local regulation of certain rates charged by traditional franchised cable operators. Conversely, the legislation also provides for deregulation of traditional hardwire cable in a given market where effective competition is shown to exist. Rates charged by private cable operators, typically already lower than traditional franchise cable rates, are not subject to regulation under the 1992 Cable Act.

In February 1996, Congress passed the Telecommunications Act of 1996 (the "1996 Act"), which substantially amended the Communications Act. The 1996 Act contains provisions intended to increase competition in the telephone, radio, broadcast television, and hardwire and wireless cable television businesses. This legislation has altered, and management believes will continue to alter, federal, state, and local laws and regulations affecting the communications industry, including certain of the services MST provides.

Under the federal copyright laws, permission from the copyright holder generally must be secured before a video program may be retransmitted. Section 111 of the Copyright Act establishes the cable compulsory license pursuant to which certain “cable systems” are entitled to engage in the secondary transmission of broadcast programming without the prior permission of the holders of copyrights in the programming. In order to do so, a cable system must secure a compulsory copyright license. Such a license may be obtained upon the filing of certain reports with and the payment of certain licensing fees to the U.S. Copyright Office. Private cable operators, such as MST, may rely on the cable compulsory license with respect to the secondary transmission of broadcast programming. Management does not expect the licensing fees to have a material adverse effect on MST’s business.

Under the retransmission consent provisions of the 1992 Cable Act, multichannel video programming distributors, including, but not limited to, franchised and private cable operators, seeking to retransmit certain commercial television broadcast signals, notwithstanding the cable compulsory license, must first obtain the permission of the broadcast station in order to retransmit the station's signal. However, private cable systems, unlike franchised cable systems, are not required under the FCC's "must carry" rules to retransmit local television signals. Although there can be no assurances that MST will be able to obtain requisite broadcaster consents, management believes, in most cases, MST will be able to do so for little or no additional cost.

On November 29, 1999, Congress enacted the Satellite Home Viewer Improvement Act of 1999 ("SHVIA"), which amended the Satellite Home Viewer Act. SHVIA permits DBS operators to transmit local television signals into local markets. SHVIA generally seeks to place satellite operators on an equal footing with cable television operators in regards to the availability of television broadcast programming. SHVIA amends the Copyright Act and other applicable laws and regulations in order to clarify the terms and conditions under which a DBS operator may retransmit local and distant broadcast television stations to subscribers. The law was intended to promote the ability of satellite services to compete with cable television systems and to resolve disputes that had arisen between broadcasters and satellite carriers regarding the delivery of broadcast television station programming to satellite service subscribers. As a result of SHVIA, television stations are generally entitled to seek carriage on any DBS operator's system providing local service in their respective markets. SHVIA creates a statutory copyright license applicable to the retransmission of broadcast television stations to DBS subscribers located in their markets. Although there is no royalty payment obligation associated with this license, eligibility for the license is conditioned on the satellite carrier's compliance with applicable laws, regulations and FCC rules governing the retransmission of such "local" broadcast television stations to satellite service subscribers. Noncompliance with such laws, regulations and/or FCC requirements could subject a satellite carrier to liability for copyright infringement. SHVIA was extended and re-enacted by the Satellite Home Viewer Extension and Reauthorization Act ("SHVERA") in December of 2004.

MST is not directly subject to rate regulation or certification requirements by the FCC or state public utility commissions because its equipment installation and sales agent activities do not constitute the provision of common carrier or cable television services. As a private cable operator, MST is not subject to regulation as a DBS provider, but primarily relies upon its third-party programming aggregators to procure all necessary re-transmission consents and other programming rights under the Communications Act and the Copyright Act.

State and Local Cable System Regulation

MST does not anticipate that its deployment of video programming services will be subject to state or local franchise laws primarily due to the fact that its facilities do not use or traverse public rights-of-way. Although MST may be required to comply with state and local property tax, environmental laws and local zoning laws, management does not anticipate that compliance with these laws will have any material adverse impact on MST's business.

Preferential Access Right

MST generally negotiates exclusive rights to provide satellite services singularly or in competition with competing cable providers, and also negotiates, where possible, "rights-of-first-refusal" to match price and terms of third-party offers to provide other communication services in buildings where it has negotiated broadcast access rights. Management believes that these preferential rights of entry are generally enforceable under applicable law. However, current trends at the state and federal level suggest that the future enforceability of these provisions may be uncertain. The FCC has recently issued an order prohibiting telecommunications service providers from negotiating exclusive contracts with owners of commercial MDU properties, although it deferred determination in a pending rulemaking whether to render existing exclusive access agreements unenforceable, or to extend this prohibition to residential MDUs due to an inadequate administrative record. Although it is open to question whether the FCC has statutory and constitutional authority to compel mandatory access, there can be no assurance that it will not attempt to do so. Any

such action may undermine the exclusivity provisions of MST’s rights of entry on the one hand, but would also open up many other properties to which MST could provide a competing service. There can be no assurance that future state or federal laws or regulations will not restrict MST’s ability to offer access payments, limit MDU owners' ability to receive access payments or prohibit MDU owners from entering into exclusive agreements, any of which could have a material adverse effect on MST’s business.

Regulation of the High-Speed lnternet and Wi-Fi Business

ISPs, including Internet access providers, are largely unregulated by the FCC or state public utility commissions at this time (apart from federal, state and local laws and regulations applicable to business in general). However, there can be no assurance that this business will not become subject to regulatory restraints. Also, although the FCC has rejected proposals to impose additional costs and regulations on ISPs to the extent they use local exchange telephone network facilities, such change may affect demand for Internet related services. No assurance can be given that changes in current or future regulations adopted by the FCC or state regulators or other legislative or judicial initiatives relating to Internet services would not have a material adverse effect on MST’s business.

Regulation of the VoIP Business

IP-based voice services are currently exempt from the reporting and pricing restrictions placed on common carriers by the FCC. However, there are several state and federal regulatory proceedings further defining what specific service offerings qualify for this exemption. Due to the growing acceptance and deployment of VoIP services, the FCC and a number of state public service commissions are conducting regulatory proceedings that could affect the regulatory duties and rights of entities that provide IP-based voice applications. There is regulatory uncertainty as to the imposition of traditional retail, common carrier regulation on VoIP products and services.

Long Term Investments

MST maintains an investment in Interactivewifi.com, LLC a privately held company. This investment represents an equity interest of approximately 50% at December 31, 2006. Interactivewifi.com is engaged in providing internet and related services to customers throughout metropolitan New York, including the Nuvisions internet services. MST accounted for this investment under the cost method, as MST does not have the ability to exercise significant influence over operating and financial policies of the investee. Telkonet reviewed the assumptions underlying the operating performance and cash flow forecasts in assessing the carrying values of the investment. The fair value of MST's investment in Interactivewifi.com amounted to approximately $55,000 as of December 31, 2006.

Backlog

The MST subscriber portfolio includes approximately 20 MDU properties with bulk service agreements and/or access licenses to service the individual subscribers in metropolitan New York. The remaining terms of the access agreements provide MST access rights from 7 to 15 years with the final agreement expiring in 2016 and the revenues to be recognized under non-cancelable bulk agreements provide a minimum of $1,800,000 in revenue through 2013.

Other information

Employees

As of March 1, 2007, the Company had 104 full time employees comprised of 69 full time employees of Telkonet and 27 employees of MST. The Company anticipates that it will hire additional key staff throughout 2007 in the areas of business development, sales and marketing, and engineering.

Following the acquisition of SSI and Ethostream, LLC on March 9, 2007 and March 15, 2007, respectively, the Company had 177 full time employees.

Environmental Matters

The Company does not anticipate any material effect on its capital expenditures, earnings or competitive position due to compliance with government regulations involving environmental matters.

Financial Information About Geographic Areas

To date, the majority of the Company's revenue has been derived in the United States, although the Company continues to expand a growing portion of our revenue from international sales. International sales as a percentage of total revenue represented 19% and 25% in 2006 and 2005, respectively. Our international sales are concentrated in Canada, Latin America and Western Europe and we continue to expand into other markets worldwide. The table below sets forth our net revenue by major geographic region.

	Year Ended December 31,				
	2006	Percentage Change	2005	Percentage Change	2004
United States	$ 4,508,478	141%	$ 1,871,241	197%	$ 630,957
Worldwide	672,850	9%	617,082	812%	67,695
Total	$ 5,181,328	108%	$ 2,488,323	256%	$ 698,652

ITEM 1A. RISK FACTORS.

The Company's results of operations, financial condition and cash flows can be adversely affected by various risks. These risks include, but are not limited to, the principal factors listed below and the other matters set forth in this annual report on Form 10-K. You should carefully consider all of these risks.

The Company has a history of operating losses and an accumulated deficit and expects to continue to incur losses for the foreseeable future.

Since inception through December 31, 2006, the Company has incurred cumulative losses of $70,424,669 and has never generated enough funds through operations to support its business. Additional capital may be required in order to provide working capital requirements for the next twelve months. The Company's losses to date have resulted principally from:

· research and development costs relating to the development of the Telkonet iWire SystemTM product suite;

· costs and expenses associated with manufacturing, distribution and marketing of the Company's products;

· general and administrative costs relating to the Company's operations; and

· interest expense related to the Company's indebtedness.

The Company is currently unprofitable and may never become profitable. Since inception, the Company has funded its research and development activities primarily from private placements of equity and debt securities, a bank loan and short term loans from certain of its executive officers. As a result of its substantial research and development expenditures and limited product revenues, the Company has incurred substantial net losses. The Company's ability to achieve profitability will depend primarily on its ability to successfully commercialize the Telkonet iWire SystemTM product suite. If the Company is not successful in generating sufficient liquidity from operations or in raising sufficient capital resources on terms acceptable to the Company, this could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition.

Potential fluctuations in operating results could have a negative effect on the price of the Company's common stock.

The Company's operating results may fluctuate significantly in the future as a result of a variety of factors, most of which are outside the Company's control, including:

· the level of use of the Internet;

· the demand for high-tech goods;

- the amount and timing of capital expenditures and other costs relating to the expansion of the Company's operations;

- price competition or pricing changes in the industry;

· technical difficulties or system downtime;

· economic conditions specific to the internet and communications industry; and

· general economic conditions.

The Company's quarterly results may also be significantly impacted by certain accounting treatment of acquisitions, financing transactions or other matters. Such accounting treatment could have a material impact on the Company's results of operations and have a negative impact on the price of the Company's common stock.

The Company's directors and executive officers own a substantial percentage of the Company's issued and outstanding common stock. Their ownership could allow them to exercise significant control over corporate decisions.

As of March 1, 2007, the Company's officers and directors owned 17.8% of the Company's issued and outstanding common stock. This means that the Company's officers and directors, as a group, exercise significant control over matters upon which the Company's stockholders may vote, including the selection of the Board of Directors, mergers, acquisitions and other significant corporate transactions.

Further issuances of equity securities may be dilutive to current stockholders.

Although the funds that were raised in the Company's debenture offerings, the note offerings and the private placement of common stock are being used for general working capital purposes, it is likely that the Company will be required to seek additional capital in the future. This capital funding could involve one or more types of equity securities, including convertible debt, common or convertible preferred stock and warrants to acquire common or preferred stock. Such equity securities could be issued at or below the then-prevailing market price for the Company's common stock. Any issuance of additional shares of the Company's common stock will be dilutive to existing stockholders and could adversely affect the market price of the Company's common stock.

The exercise of options and warrants outstanding and available for issuance may adversely affect the market price of the Company's common stock.

As of December 31, 2006, the Company had outstanding employee options to purchase a total of 8,520,929 shares of common stock at exercise prices ranging from $1.00 to $5.97 per share, with a weighted average exercise price of $2.06. As of December 31, 2006, the Company had outstanding non-employee options to purchase a total of 1,815,937 shares of common stock at an exercise price of $1.00 per share. As of December 31, 2006, the Company had warrants outstanding to purchase a total of 4,557,850 shares of common stock at exercise prices ranging from $2.59 to $4.87 per share, with a weighted average exercise price of $4.20. The exercise of outstanding options and warrants and the sale in the public market of the shares purchased upon such exercise will be dilutive to existing stockholders and could adversely affect the market price of the Company's common stock.

The powerline communications industry is intensely competitive and rapidly evolving.

The Company operates in a highly competitive, quickly changing environment, and the Company's future success will depend on its ability to develop and introduce new products and product enhancements that achieve broad market acceptance in commercial and governmental sectors. The Company will also need to respond effectively to new product announcements by its competitors by quickly introducing competitive products.

Delays in product development and introduction could result in:

· loss of or delay in revenue and loss of market share;

- negative publicity and damage to the Company’s reputation and brand; and
- decline in the average selling price of the Company’s products.

The communication industry is intensely competitive and rapidly evolving.

The Company operates in a highly competitive, quickly changing environment, and our future success will depend on our ability to develop and introduce new services and service enhancements that achieve broad market acceptance in MDU and commercial sectors. The Company will also need to respond effectively to new product announcements by our competitors by quickly introducing competitive products.

Delays in product development and introduction could result in:

· loss of or delay in revenue and loss of market share;

· negative publicity and damage to our reputation and brand; and

· decline in the selling price of our products and services.

Additionally, new companies are constantly entering the market, thus increasing the competition. This could also have a negative impact on our ability to obtain additional capital from investors. Larger companies who have been engaged in our industry business for substantially longer periods of time may have access to greater resources. These companies may have greater success in the recruitment and retention of qualified employees, as well as in conducting their operations, which may give them a competitive advantage. In addition, actual or potential competitors may be strengthened through the acquisition of additional assets and interests. If the Company is unable to compete effectively or adequately respond to competitive pressures, this may materially adversely affect our results of operation and financial condition. Large companies including Direct TV, EchoStar, Time Warner, Cablevision and Verizon are active in our markets in the provision and distribution of communications services and we will also have to compete with such companies.

The Company is not large enough to negotiate cable television programming contracts as favorable as some of our larger competitors.

Programming costs are generally directly related to the number of subscribers to which the programming is provided, with discounts available to large traditional cable operatores and direct broadcast satallite (DBS) providers based on their high subscriber levels. As a result, larger cable and DBS systems generally pay lower per subscriber programming costs. The Company has attempted to obtain volume discounts from our suppliers. Despite these efforts, we believe that our per subscriber programming costs are significantly higher than large cable operatores and DBS providers with which we compete in some of our markets. This may put us at a competitive disadvantage in terms of maintaining our operating results while remaining competitive with prices offered by these providers. In addition, as programming agreements come up for renewal, the Company cannot assure you that we will be able to renew these agreements on comparable or favorable terms. To the extent that we are unable to reach agreement with a programmer on terms that we believe are reasonable, we may be forced to remove programming from our line-up, which could result in a loss of customers.

Government regulation of the Company's products could impair the Company's ability to sell such products in certain markets.

FCC rules permit the operation of unlicensed digital devices that radiate radio frequency emissions if the manufacturer complies with certain equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements. Differing technical requirements apply to "Class A" devices intended for use in commercial settings, and "Class B" devices intended for residential use to which more stringent standards apply. An independent, FCC-certified testing lab has verified that the Company's Telkonet's iWire SystemTM product suite complies with the FCC technical requirements for Class A and Class B digital devices. No further testing of these devices is required

and the devices may be manufactured and marketed for commercial and residential use. Additional devices designed by the Company for commercial and residential use will be subject to the FCC rules for unlicensed digital devices. Moreover, if in the future, the FCC changes its technical requirements for unlicensed digital devices, further testing and/or modifications of devices may be necessary. Failure to comply with any FCC technical requirements could impair the Company's ability to sell its products in certain markets and could have a negative impact on its business and results of operations.

Products sold by the Company’s competitors could become more popular than the Company’s products or render the Company’s products obsolete.

The market for powerline communications products is highly competitive. The HomePlug(TM) Powerline Alliance has grown over the past year and now includes many well recognized brands in the networking and communications industries. These include Linksys (a Cisco company), Intel, GE, Motorola, Netgear, Sony and Samsung. With the exception of Motorola, who recently introduced a commercial product, these companies do not presently represent a direct competitive threat to the Company since they only market and sell their products in the residential sector. There can be no assurance that other companies will not develop PLC products that compete with the Company’s products in the future. Some of these potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources. These potential competitors may, among other things, undertake more extensive marketing campaigns, adopt more aggressive pricing policies, obtain more favorable pricing from suppliers and manufacturers and exert more influence on the sales channel than the Company can. As a result, the Company may not be able to compete successfully with these potential competitors and these potential competitors may develop or market technologies and products that are more widely accepted than those being developed by the Company or that would render the Company’s products obsolete or noncompetitive. The Company anticipates that potential competitors will also intensify their efforts to penetrate the Company’s target markets. These potential competitors may have more advanced technology, more extensive distribution channels, stronger brand names, bigger promotional budgets and larger customer bases than the Company does. These companies could devote more capital resources to develop, manufacture and market competing products than the Company could. If any of these companies are successful in competing against the Company, its sales could decline, its margins could be negatively impacted, and the Company could lose market share, any of which could seriously harm the Company’s business and results of operations.

The failure of the internet to continue as an accepted medium for business commerce could have a negative impact on the Company’s results of operations.

The Company’s long-term viability is substantially dependent upon the continued widespread acceptance and use of the Internet as a medium for business commerce. The Internet has experienced, and is expected to continue to experience, significant growth in the number of users. There can be no assurance that the Internet infrastructure will continue to be able to support the demands placed on it by this continued growth. In addition, delays in the development or adoption of new standards and protocols to handle increased levels of Internet activity or increased governmental regulation could slow or stop the growth of the Internet as a viable medium for business commerce. Moreover, critical issues concerning the commercial use of the Internet (including security, reliability, accessibility and quality of service) remain unresolved and may adversely affect the growth of Internet use or the attractiveness of its use for business commerce. The failure of the necessary infrastructure to further develop in a timely manner or the failure of the Internet to continue to develop rapidly as a valid medium for business would have a negative impact on the Company’s results of operations.

The Company may not be able to obtain patents, which could have a material adverse effect on its business.

The Company’s ability to compete effectively in the powerline technology industry will depend on its success in acquiring suitable patent protection. The Company currently has several patents pending. The Company also intends to file additional patent applications that it deems to be economically beneficial. If the Company is not successful in obtaining patents, it will have limited protection against those who might copy its technology. As a result, the failure to obtain patents could negatively impact the Company’s business and results of operations.

Infringement by third parties on the Company’s proprietary technology and development of substantially equivalent proprietary technology by the Company’s competitors could negatively impact the Company’s business.

The Company's success depends partly on its ability to maintain patent and trade secret protection, to obtain future patents and licenses, and to operate without infringing on the proprietary rights of third parties. There can be no assurance that the measures the Company has taken to protect its intellectual property, including those integrated to its Telkonet iWire SystemTM product suite, will prevent misappropriation or circumvention. In addition, there can be no assurance that any patent application, when filed, will result in an issued patent, or that the Company's existing patents, or any patents that may be issued in the future, will provide the Company with significant protection against competitors. Moreover, there can be no assurance that any patents issued to, or licensed by, the Company will not be infringed upon or circumvented by others. Infringement by third parties on the Company's proprietary technology could negatively impact its business. Moreover, litigation to establish the validity of patents, to assert infringement claims against others, and to defend against patent infringement claims can be expensive and time-consuming, even if the outcome is in the Company's favor. The Company also relies to a lesser extent on unpatented proprietary technology, and no assurance can be given that others will not independently develop substantially equivalent proprietary information, techniques or processes or that the Company can meaningfully protect its rights to such unpatented proprietary technology. Development of substantially equivalent technology by the Company's competitors could negatively impact its business.

The Company depends on a small team of senior management, and it may have difficulty attracting and retaining additional personnel.

The Company's future success will depend in large part upon the continued services and performance of senior management and other key personnel. If the Company loses the services of any member of its senior management team, its overall operations could be materially and adversely affected. In addition, the Company's future success will depend on its ability to identify, attract, hire, train, retain and motivate other highly skilled technical, managerial, marketing, purchasing and customer service personnel when they are needed. Competition for these individuals is intense. The Company cannot ensure that it will be able to successfully attract, integrate or retain sufficiently qualified personnel when the need arises. Any failure to attract and retain the necessary technical, managerial, marketing, purchasing and customer service personnel could have a negative effect on the Company's financial condition and results of operations.

Any acquisitions we make could result in difficulties in successfully managing our business and consequently harm our financial condition.

We may seek to expand by acquiring competing businesses in our current or other geographic markets, including as a means to acquire spectrum. We cannot accurately predict the timing, size and success of our acquisition efforts and the associated capital commitments that might be required. We expect to face competition for acquisition candidates, which may limit the number of acquisition opportunities available to us and may lead to higher acquisition prices. There can be no assurance that we will be able to identify, acquire or profitably manage additional businesses or successfully integrate acquired businesses, if any, without substantial costs, delays or other operational or financial difficulties. In addition, acquisitions involve a number of other risks, including:

- failure of the acquired businesses to achieve expected results;
- diversion of management's attention and resources to acquisitions;
- failure to retain key customers or personnel of the acquired businesses;
- disappointing quality or functionality of acquired equipment and people: and
- risks associated with unanticipated events, liabilities or contingencies.

Client dissatisfaction or performance problems at a single acquired business could negatively affect our reputation. The inability to acquire businesses on reasonable terms or successfully integrate and manage acquired companies, or the occurrence of performance problems at acquired companies, could result in dilution, unfavorable accounting treatment or one-time charges and difficulties in successfully managing our business.

Our inability to obtain capital, use internally generated cash or debt, or use shares of our common stock to finance future acquisitions could impair the growth and expansion of our business.

Reliance on internally generated cash or debt to finance our operations or complete acquisitions could substantially limit our operational and financial flexibility. The extent to which we will be able or willing to use shares of our common stock to consummate acquisitions will depend on our market value which will vary, and liquidity. Using shares of our common stock for this purpose also may result in significant dilution to our then existing stockholders. To the extent that we are unable to use our common stock to make future acquisitions, our ability to grow through acquisitions may be limited by the extent to which we are able to raise capital through debt or additional equity financings. No assurance can be given that we will be able to obtain the necessary capital to finance any acquisitions or our other cash needs. If we are unable to obtain additional capital on acceptable terms, we may be required to

reduce the scope of any expansion or redirect resources committed to internal purposes. In addition to requiring funding for acquisitions, we may need additional funds to implement our internal growth and operating strategies or to finance other aspects of our operations. Our failure to: (i) obtain additional capital on acceptable terms; (ii) use internally generated cash or debt to complete acquisitions because it significantly limits our operational or financial flexibility; or (iii) use shares of our common stock to make future acquisitions, may hinder our ability to actively pursue our acquisition program.

We rely on a limited number of third party suppliers. If these companies fail to perform or experience delays, shortages, or increased demand for their products or services, we may face shortages, increased costs, and may be required to suspend deployment of our products and services.

We depend on a limited number of third party suppliers to provide the components and the equipment required to deliver our solutions. If these providers fail to perform their obligations under our agreements with them or we are unable to renew these agreements, we may be forced to suspend the sale and deployment of our products and services and enrollment of new customers, which would have an adverse effect on our business, prospects, financial condition and operating results.

Our management and operational systems might be inadequate to handle our potential growth.

We may experience growth that could place a significant strain upon our management and operational systems and resources. Failure to manage our growth effectively could have a material adverse effect upon our business, results of operations and financial condition. Our ability to compete effectively as a provider of PLC technology and a provider of digital satellite television and high-speed Internet products and services and to manage future growth will require us to continue to improve our operational systems, organization and financial and management controls, reporting systems and procedures. We may fail to make these improvements effectively. Additionally, our efforts to make these improvements may divert the focus of our personnel. We must integrate our key executives into a cohesive management team to expand our business. If new hires perform poorly, or if we are unsuccessful in hiring, training and integrating these new employees, or if we are not successful in retaining our existing employees, our business may be harmed. To manage the growth we will need to increase our operational and financial systems, procedures and controls. Our current and planned personnel, systems, procedures and controls may not be adequate to support our future operations. We may not be able to effectively manage such growth, and failure to do so could have a material adverse effect on our business, financial condition and results of operations

We may be affected if the United States participates in wars or military or other action or by international terrorism.

Involvement in a war or other military action or acts of terrorism may cause significant disruption to commerce throughout the world. To the extent that such disruptions result in (i) delays or cancellations of customer orders, (ii) a general decrease in consumer spending on information technology, (iii) our inability to effectively market and distribute our services or products or (iv) our inability to access capital markets, our business and results of operations could be materially and adversely affected. We are unable to predict whether the involvement in a war or other military action will result in any long-term commercial disruptions or if such involvement or responses will have any long-term material adverse effect on its business, results of operations, or financial condition.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

ITEM 2. PROPERTIES.

The Company presently leases 11,600 square feet of commercial office space in Germantown, Maryland for its corporate headquarters. The Germantown lease expires in November 2010. The Company is currently planning to increase the office space of its Germantown headquarters by approximately 6,000 square feet in April 2007 in conjunction with a corporate initiative to consolidate office space.

The Company also leases 1,800 square feet of office space in White Marsh, Maryland, where it operates a portion of its sales and marketing activities. The White Marsh lease expires in May 2007.

In March 2005, the Company entered into a lease agreement for 6,742 square feet of commercial office space in Crystal City, Virginia. The Crystal City lease expires in March 2008. In February 2007, the Company executed a sublease for this space commencing in April 2007 through the expiration of the lease in March 2008.

In conjunction with the January 2006 acquisition of MST, the Company presently leases 12,600 square feet of commercial office space in Hawthorne, New Jersey for its office and warehouse spaces. This lease expires in April 2010 with an option to extend the lease an additional five years.

Following the acquisitions of SSI and Ethostream the Company assumed leases on 9,000 square feet of office space in Las Vegas, NV for the SSI office and warehouse space on a month to month basis and 4,100 square feet of office space in Milwaukee, WI for Ethostream and this lease expires in May 2011.

ITEM 3. LEGAL PROCEEDINGS.

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

On December 8, 2006, the Company held its annual meeting of stockholders at which the Company's stockholders elected seven (7) directors to serve on the Company's Board of Directors and ratified the appointment of the Company's independent accountants for 2006. The following directors were elected at the annual meeting based on the number of votes indicated below. Each director was elected to serve until the next annual meeting of stockholders or until his successor is elected and qualified.

Director Name	For	Against	Abstain	Broker Non-votes
Warren V. Musser	45,352,150	0	1,520,291	0
Ronald W. Pickett	45,343,879	0	1,526,562	0
Stephen L. Sadle	45,399,903	0	1,472,538	0
Thomas C. Lynch	46,385,473	0	486,968	0
James L. Peeler	46,376,673	0	495,768	0
Thomas M. Hall	46,423,873	0	448,568	0
Seth D. Blumenfeld	45,392,739	0	1,479,702	0

The other matters presented at the meeting were approved by the Company's stockholders as follows:

Matter Voted Upon	For	Against	Abstain	Broker Non-votes
Ratification of Telkonet's Amended and Restated Stock Incentive Plan	12,119,456	2,641,084	222,197	31,889,704
Ratification of Independent Accountants	46,555,175	142,308	174,958	0

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

On January 24, 2004, the Company's common stock was listed for trading on the American Stock Exchange (AMEX) under the ticker symbol "TKO." Prior to January 24, 2004, the Company's common stock was quoted on the OTC Bulletin Board under the symbol "TLKO.OB." As of March 1, 2007, the Company had 216 stockholders of record and 57,002,301 shares of its common stock issued and outstanding.

The following table documents the high and low sales prices for the Company's common stock on the AMEX for the period beginning January 1, 2005 through December 31, 2006. The information provided for the periods listed below was obtained from the Yahoo! Finance web site.

	High	Low
Year Ended December 31, 2006		
First Quarter	$ 4.51	$ 3.35
Second Quarter	$ 4.49	$ 2.46
Third Quarter	$ 3.50	$ 1.65
Fourth Quarter	$ 3.27	$ 2.32
Year Ended December 31, 2005		
First Quarter	$ 6.85	$ 3.66
Second Quarter	$ 5.34	$ 2.61
Third Quarter	$ 5.60	$ 3.11
Fourth Quarter	$ 5.23	$ 3.51

The Company has never paid dividends on its common stock and does not anticipate paying dividends in the foreseeable future.

Performance Graph

Set forth below is a line graph comparing the cumulative total return on Telkonet's common stock against the cumulative total return of the Market Index for the American Stock Exchange (U.S.) ("AMEX") and for the peer group "Communications Services, within the Standard Industrial Classification Code category, (SIC) Code 4899", for the period beginning August 15, 2002 and each fiscal year ending December 31 thereafter through the fiscal year ended December 31, 2006. Because Telkonet's common stock was not widely traded prior to August 15, 2002, the graph does not show the total return on Telkonet's common stock prior to August 15, 2002. The total returns assume $100 invested on August 15, 2002 with reinvestment of dividends.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected financial data for the last 5 years. This selected financial data should be read in conjunction with the consolidated financial statements and related notes included in Item 15 of this Form 10-K.

	Year Ended December 31,				
(in thousands, except per share amounts)	2006	2005	2004	2003	2002
Total revenues	$ 5,181	$ 2,488	$ 698	$ 94	$ —
Operating loss	(17,563)	(15,307)	(13,112)	(6,564)	(3,155)
Net loss	(27,437)	(15,778)	(13,093)	(7,657)	(3,778)
Loss per share - basic	(0.54)	(0.35)	(0.32)	(0.37)	(.22)
Loss per share - diluted	(0.54)	(0.35)	(0.32)	(0.37)	(.22)
Basic weighted average common shares outstanding	50,824	44,743	41,384	20,702	17,120
Diluted weighted average common shares outstanding	50,824	44,743	41,384	20,702	17,120
Working capital	(531)	12,061	12,672	5,296	(894)
Total assets	12,517	23,291	15,493	6,176	295
Short-term borrowings and current portion of long-term debt	—	6,350	—	15	310
Long-term debt, net of current portion	—	9,617	588	3,132	863
Stockholders' equity (deficiency)	8,135	5,315	13,646	2,388	(1,527)

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

The following discussion and analysis of the Company's financial condition and results of operations should be read in conjunction with the accompanying financial statements and related notes thereto.

The Company reports financial results for the following operating business segments:

Telkonet

Through the revolutionary Telkonet iWire System™ , Telkonet utilizes proven PLC technology to deliver commercial high-speed Broadband access from an IP "platform" that is easy to deploy, reliable and cost-effective by leveraging a building's existing electrical infrastructure. The building's existing electrical wiring becomes the backbone of the local area network, which converts virtually every electrical outlet into a high-speed data port, without the costly installation of additional wiring or major disruption of business activity. The segment's net sales in 2006 were $3,425,525, representing 66% of the Company's consolidated net sales.

MST

MST is a communications service provider offering Quad-Play services to MTU and MDU residential, hospitality and commercial properties. These Quad-Play services include video, voice, high-speed internet and wireless fidelity ("Wi-Fi") access. In addition, MST currently offers or plans to offer a variety of next-generation telecommunications solutions and services, including satellite installation, video conferencing, surveillance/security and energy management, and other complementary professional services. The segments' net sales upon acquisition for the period February 1 through December 31, 2006 were $1,755,803, representing 34% of the Company's consolidated net sales.

21

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. On an ongoing basis, we evaluate significant estimates used in preparing our financial statements, including those related to revenue recognition, guarantees and product warranties and stock based compensation. We base our estimates on historical experience, underlying run rates and various other assumptions that we believe to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results could differ from these estimates. The following are critical judgments, assumptions, and estimates used in the preparation of the consolidated financial statements.

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, Revenue Recognition ("SAB104"), which superceded Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements ("SAB101"). SAB 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectibility of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The Company defers any revenue for which the product has not been delivered or is subject to refund until such time that the Company and the customer jointly determine that the product has been delivered or no refund will be required. SAB 104 incorporates Emerging Issues Task Force 00-21 ("EITF 00-21"), Multiple-Deliverable Revenue Arrangements. EITF 00-21 addresses accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

For equipment under lease, revenue is recognized over the lease term for operating lease and rental contracts. All of the Company's leases are accounted for as operating leases. At the inception of the lease, no lease revenue is recognized and the leased equipment and installation costs are capitalized and appear on the balance sheet as "Equipment Under Operating Leases." The capitalized cost of this equipment is depreciated from two to three years, on a straight-line basis down to the Company's original estimate of the projected value of the equipment at the end of the scheduled lease term. Monthly lease payments are recognized as rental income.

MST accounts for the revenue, costs and expense related to residential cable services as the related services are performed in accordance with SFAS No. 51, Financial Reporting by Cable Television Companies. Installation revenue for residential cable services is recognized to the extent of direct selling costs incurred. Direct selling costs have exceeded installation revenue in all reported periods. Generally, credit risk is managed by disconnecting services to customers who are delinquent.

Management identifies a delinquent customer based upon the delinquent payments status of an outstanding invoice, generally greater than 30 days past the due date. The delinquent account designation does not trigger an accounting transaction until such time the account is deemed uncollectible. The allowance for doubtful accounts is determined by examining the reserve history and any outstanding invoices that are over 30 days past due as of the end of the reporting period. Accounts are deemed uncollectible on a case-by-case basis, at management's discretion based upon an examination of the communication with the delinquent customer and payment history. Typically, accounts are only escalated to "uncollectible" status after multiple attempts have been made to communicate with the customer both orally and in writing, by the billing department and management.

Guarantees and Product Warranties

FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others” (“FIN 45”), requires that upon issuance of a guarantee, the guarantor must disclose and recognize a liability for the fair value of the obligation it assumes under that guarantee.

The Company’s guarantees issued subject to the recognition and disclosure requirements of FIN 45 as of December 31, 2006 and 2005 were not material. The Company records a liability for potential warranty claims. The amount of the liability is based on the trend in the historical ratio of claims to sales, the historical length of time between the sale and resulting warranty claim, new product introductions and other factors. The products sold are generally covered by a warranty for a period of one year. In the event the Company determines that its current or future product repair and replacement costs exceed its estimates, an adjustment to these reserves would be charged to earnings in the period such determination is made. During the year ended December 31, 2006, the Company experienced approximately 3% percent of units returned. Using this experience factor a reserve of $23,300 was accrued. Prior to the fiscal year of 2005, the Company had not established historical ratio of claims, and the cost of replacing defective products and product returns were immaterial and within management's expectations, accordingly there were no warranties provided with the purchase of the Company's products during the year ended December 31, 2004.

Stock Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company's fiscal year 2006. The Company's Consolidated Financial Statements as of and for the year ended December 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the year ended December 31, 2006 was $1,080,895, net of tax effect.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Consolidated Statement of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company's Consolidated Statement of Operations because the exercise price of the Company's stock options granted to employees and directors approximated or exceeded the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company's Consolidated Statement of Operations for the year ended December 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company's pro forma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

Upon adoption of SFAS 123(R), the Company is using the Black-Scholes option-pricing model as its method of valuation for share-based awards granted beginning in fiscal 2006, which was also previously used for the Company's pro forma information required under SFAS 123. The Company's determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the Company's expected stock price volatility over the term of the awards, and certain other market variables such as the risk free interest rate.

Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

Revenues

The Company’s revenue consists of direct product sales and a recurring (lease) model in the commercial, government and international markets of the Telkonet Segment. Additionally, the MST Segment consists of eleven months of revenue from date of acquisition through December 31, 2006 providing certain Quad-Play services. The table below outlines product versus recurring (lease) revenues for comparable periods:

23

Revenue:	Year ended December 31, 2006		2005		V
Product	$ 3,092,967	60%	$ 1,769,727	71%	$ 1,323
Rental (lease)	2,088,361	40%	718,596	29%	1,369

We could be adversely affected if we or any of our officers or directors fail to comply with bank or other laws and regulations.

As a bank holding company, we are subject to extensive regulation by U.S. federal and state regulatory agencies and face risks associated with investigations and proceedings by regulatory agencies, including those that we may believe to be immaterial. Like any company, we are also subject to risk arising from potential employee misconduct, including noncompliance with our internal policies. Any interventions by authorities may result in adverse judgments, settlements, fines, penalties, injunctions, suspension or expulsion of our officers or directors from the banking industry or other relief. In addition to the potential monetary consequences, these measures could, for example, impact our ability to engage in, or impose limitations on, certain aspects of our businesses. The number of these investigations and proceedings, as well as the amount of penalties and fines sought, has increased substantially in recent years with respect to many banks in the industry. Significant regulatory action against us or our officers or directors could materially and adversely affect our business, financial condition or results of operations or cause us significant reputational harm, which in turn could seriously harm our business.

Table of Contents

Changes in tax law may adversely affect our net income, effective tax rate and our overall results of operations and financial condition.

Our financial performance is impacted by federal and state tax laws. The enactment of new tax legislation, or changes in the interpretation of existing law, including provisions impacting tax rates, apportionment, consolidation or combination, income, expenses, and credits, may have a material adverse effect on our financial condition and results of operations.

Our internal controls and procedures may not be adequate or may fail or be circumvented.

Management regularly reviews and updates our internal controls, disclosure controls and procedures, and corporate governance policies and procedures are based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system will be met. Any failure or circumvention of our controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on our business, results of operations, cash flows and financial condition.

We are exposed to risk of environmental liabilities with respect to properties to which we take title.

A significant portion of our loan portfolio is secured by real property. In the course of our business, we may own or foreclose on and take title to properties securing certain loans and could be subject to environmental liabilities with respect to these properties. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation costs and clean-up costs incurred by these parties in connection with the environmental contamination, or we may be required to investigate or clean up the hazardous or toxic substances. The costs associated with investigation or remediation activities could be substantial. Further, the discovery or presence of hazardous or toxic substances may materially reduce the affected property s value or limit our ability to use or sell the affected property. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our business, financial condition, cash flows, liquidity and results of operations could be materially and adversely affected.

We are subject to a variety of operational risks, including reputational risk, legal risk and compliance risk, and the risk of fraud or theft by employees or outsiders, which may adversely affect our business and results of operations.

We are exposed to many types of operational risks, including reputational risk, legal and compliance risk, the risk of fraud or theft by employees or outsiders, and the risk of unauthorized transactions or operational errors by employees, including clerical or record-keeping errors or errors resulting from faulty or disabled computer or telecommunications systems.

Because the nature of the financial services business involves a high volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully rectified. Our necessary dependence upon automated systems to record and process transactions and our large transaction volume may further increase the risk that technical flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. We also may be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control (for example, computer viruses or electrical or telecommunications outages, or natural disasters, disease pandemics or other damage to property or physical assets), which may give rise to disruption of service to customers and to financial loss or liability. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as we are) and to the risk that we (or our vendors) business continuity and data security systems prove to be inadequate. The occurrence of any of these risks could diminish our ability to operate our business (for example, by requiring us to expend significant resources to correct the defect), as well as result in potential liability to clients, reputational damage and regulatory intervention, which in turn could materially and adversely affect our business, financial condition and results of operations.

Table of Contents

We are subject to security, transactional and operational risks relating to the use of technology that could damage our reputation and our business.

We rely heavily on communications and information systems to conduct our business, serving both internal and customer constituencies. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures, security applications and fraud mitigation applications designed to prevent or limit the effect of a failure, interruption or security breach of, or a fraud attack on, our information systems, there can be no assurance that any such failures, interruptions, fraud attacks or security breaches will not occur or, if they do occur, that they will be adequately addressed. Additionally, we outsource our data processing to a third party. If our third party provider encounters difficulties or if we have difficulty in communicating with the third party, it will significantly impair our ability to adequately process and account for customer transactions, which would significantly affect our business operations. Furthermore, breaches of the third party provider s technology may also cause reimbursable loss to our consumer and business customers through no fault of our own. Fraud attacks targeting customer-controlled devices, plastic payment card terminals and merchant data collection points provide another source of potential loss, again which would be through no fault of our own. The occurrence of any failures, interruptions or security breaches of, or fraud attacks on, information systems used to process customer transactions could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition, results of operations and cash flows.

Unauthorized disclosure of sensitive or confidential customer information, whether through a cyber-attack, other breach of our computer systems or otherwise, could severely harm our business.

In the normal course of our business, we collect, process and retain sensitive and confidential customer information. Despite the security measures we have in place, our facilities and systems may be vulnerable to cyber-attacks, security breaches, acts of vandalism, computer viruses, misplaced or lost data, programming or human errors, and other similar events.

Information security risks for financial institutions such as us have increased recently in part because of new technologies, the use of the Internet and telecommunications technologies, including mobile devices, to conduct financial and other business transactions and the increased sophistication and activities of organized crime, perpetrators of fraud, hackers, terrorists and others. In addition to cyber-attacks or other security breaches involving the theft of sensitive and confidential information, hackers have engaged in attacks against financial institutions designed to disrupt key business services such as customer-facing web sites. We are not able to anticipate or implement effective preventive measures against all security breaches of these types. Although we employ detection and response mechanisms designed to contain and mitigate security incidents, early detection may be thwarted by sophisticated attacks and malware designed to avoid detection.

We also face risks related to cyber-attacks and other security breaches in connection with debit card transactions that typically involve the transmission of sensitive information regarding our customers through various third parties. Some of these parties have in the past been the target of security breaches and cyber-attacks, and because the transactions involve third parties and environments that we do not control or secure, future security breaches or cyber-attacks affecting any of these third parties could impact us through no fault of our own, and in some cases we may have exposure and suffer losses for breaches or attacks relating to them. We also rely on external vendors to conduct other aspects of our business operations and face similar risks relating to them. Irrespective of how much diligence we may conduct with respect to these external vendors, we cannot be sure that their information security protocols are sufficient to withstand a cyber-attack or other security breach.

Any cyber-attack or other security breach involving the misappropriation, loss or other unauthorized disclosure of confidential customer information could severely damage our reputation, erode confidence in the security our systems, products and services, expose us to the risk of litigation and liability, disrupt our operations and have a material adverse effect our business.

Table of Contents

We continually encounter technological change.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success depends, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on our business and, in turn, our financial condition, results of operations and cash flows.

TERMS OF THE OFFERING

General

We are offering up to 1,365,656 shares of our common stock, par value $0.01 per share. We are offering the shares first to certain of our existing stockholders on a subscription rights basis and pursuant to a related over-subscription privilege. The purchase price in both cases is $7.25 per share. Stockholders must own at least two shares as of the record date to be eligible to participate in the rights portion of the offering. There is no minimum purchase requirement. Once you subscribe, your subscription is irrevocable.

Stockholders may subscribe for any number of shares being offered hereby, as described more fully below.

With respect to the over-subscription privilege, we reserve the right to reject any subscription, in whole or in part, in our sole discretion. In determining which over-subscriptions to accept, in whole or in part, we may take into account a subscriber s potential to do business with, or to direct customers to, Solera National Bank, and the order in which such subscriptions are received.

In the event we reject all or a portion of a requested over-subscription, we will refund to the subscriber all, or the appropriate portion, of the amount remitted with the subscription agreement, without interest or deduction. We will decide which over-subscriptions to accept, and will mail all

appropriate refunds, no later than 30 days after the expiration of the offering, when and as extended, or the partial closing of the offering relating to the period during which such subscription is received.

Stockholder subscription rights will expire if not exercised by 5:00 p.m., Mountain Time, on May 31, 2018 unless it is terminated earlier or either date is extended without notice to subscribers. Except in connection with subscription rights, we may, in our sole discretion, reject any subscriptions, in whole or in part, for any reason whatsoever. With respect to subscription rights exercised by rights holders and received by us no later than 5:00 p.m., Mountain Time, on May 31, 2018, we agree not to reject any such subscriptions unless we elect to withdraw the offering in its entirety, in which case payments received from holders in connection with the exercise of their subscription rights will be returned in full without interest or deduction.

We may cancel this offering at any time, and accepted subscriptions are subject to cancellation in the event that we elect to terminate the offering. With respect to the over-subscription privilege, we reserve the right to reject any subscription, in whole or in part, in our sole discretion.

Plan of Distribution

We are offering these shares on a best efforts basis through our Chief Financial Officer, Melissa Larkin, who will not be compensated in connection with her procurement of subscriptions, but who will be reimbursed for any reasonable out-of-pocket expenses incurred in connection with the offering, if any. We believe that because this offering is a rights offering that is only being marketed to certain of its existing stockholders, the expenses to be reimbursed, if any, will be nominal. We do not intend to travel to meet with stockholders to discuss the offering. As of the date of this offering circular, we do not believe that the Company will have any expenses to be reimbursed to Ms. Larkin. However, if any out-of-pocket expenses are incurred by Ms. Larkin, the Company believes that they would be limited to reasonable travel expenses and other reasonable expenses associated with meeting with stockholders to discuss the offering. The Company has agreed to limit the aggregate amount of any out-of-pocket expenses to be reimbursed to Ms. Larkin to $2,000.00 for the offering. We do not presently intend to engage an underwriter or placement agent in connection with this offering. We are offering the shares to certain existing stockholders on a subscription rights basis. See Plan of Distribution for further details.

Table of Contents

Subscription Procedure

For Registered Stockholders

If you wish to exercise your subscription rights in this offering, and you are a registered stockholder, i.e., you hold your shares directly in certificate form, you must complete the following steps before May 31, 2018:

- Login to the website using the credentials included on your Notice of Rights Offering and electronically complete and sign the stockholder subscription agreement (a sample of which accompanies this offering circular);

- Make full payment of the entire purchase price for the shares subscribed for in U.S. currency by ACH, wire transfer, or check payable to Solera National Bancorp, Inc. Stock Offering Account.

- Wire Transfer Instructions:

Solera National Bank

ABA# 107007281

319 S. Sheridan Blvd

Lakewood, CO 80226

For Credit To: Solera National Bancorp Account No. 2012368, Attention: [INSERT YOUR NAME HERE] Stock Purchase

- ACH Instructions:

Bank Name: Solera National Bank

Routing No.: 107007281

Account Name: [INSERT YOUR NAME HERE] Stock Purchase

Account No.: 2012368

The number of shares covered by each stockholder s subscription rights and the aggregate purchase price for the full exercise of such subscription rights are set forth on each stockholder s subscription agreement. To exercise your subscription rights, your completed agreement and payment must be received by us by May 31, 2018, unless such date is extended. If you wish to subscribe for additional shares pursuant to your over-subscription privilege please so indicate on your subscription agreement.

Important: The full subscription price for the shares must be remitted with the stockholder subscription agreement in order to be valid. Failure to include the full purchase price will give us the right to reject the subscription. If we do not receive your stockholder subscription agreement and payment in full by 5:00 p.m., Mountain Time, on May 31, 2018, your subscription rights in this offering will be waived, unless such date is extended.

The subscription price will be deemed to have been received by us only upon: (i) receipt by us of any certified check or cashier s check or money order; or (ii) receipt of ACH or wired funds in the stock offering account designated above.

Please note that all stockholders who currently own their shares in certificate form will automatically receive a statement for book-entry shares for the new shares they purchase, unless they specifically request a stock certificate instead.

If you have other questions regarding the Company, the Bank or the stock offering, please contact Melissa Larkin, EVP and Chief Financial Officer, at (303) 937-6423.

For Street Name Stockholders

If you do not hold your shares directly in certificate form, but hold them instead through a custodian bank, broker, dealer or other nominee, then your nominee is the record holder of the shares you own. If you are not contacted by your nominee, you should contact your nominee as soon as possible. Your nominee must exercise the subscription rights on your behalf for the shares of common stock you wish to purchase. You will not receive a stockholder

Table of Contents

subscription agreement. Please follow the instructions of your nominee. Your nominee may establish a deadline that may be before the May 31, 2018 expiration date that we have established for the rights offering.

If you have other questions regarding the Company, the Bank or the stock offering, please contact Melissa Larkin, EVP and Chief Financial Officer, at (303) 937-6423.

Expiration Date

The subscription rights granted to stockholders of record as of January 29, 2018 will expire if not validly exercised by 5:00 p.m., Mountain Time, on May 31, 2018, unless extended. We may also extend the expiration date without notice to subscribers. Any such extension shall not affect the rights of those who have already subscribed.

Closings and Issuance of Shares

The offering will close on May 31, 2018, which date may be extended in our sole discretion. In addition, we reserve the right to have multiple closings of the offering should we determine this to be advisable in our sole discretion.

If you currently hold your stock directly in certificate form, we will send, via electronic mail, information about how to login to your account to view your statement of ownership for your new book-entry shares. This information will be provided as soon as practicable after the close of the applicable portion of the offering. You may specifically request a stock certificate instead of a book-entry statement of ownership. If your shares as of January 29, 2018 were held by a custodian bank, broker, dealer or other nominee, you will not receive stock certificates or statements of ownership from us for your new shares. Instead, your nominee will be credited with the shares of common stock you purchase, according to the same timeframe as described above with respect to stock certificates or book-entry shares.

Determination of the Offering Price

Prior to this offering there has been a very limited trading market in our common stock. See MARKET INFORMATION AND DIVIDEND POLICY AND RELATED MATTERS Trading History. We determined the offering price after analyzing and taking into consideration several factors including, but not limited to, our current financial condition, recent trading prices and volumes of our common stock, book value per share, management s analysis of our growth potential, the prices of shares of common stock of similarly situated independent banks, and our market position in the geographical areas in which we operate. The offering price will not necessarily reflect the market price of our common stock after this offering.

No Board Recommendation

An investment in the common stock must be made pursuant to each investor s evaluation of such security. Accordingly, neither our board of directors nor management makes any recommendation to potential investors regarding whether they should subscribe for or purchase any shares.

USE OF PROCEEDS

The net proceeds to us from the sale of the common stock offered in the offering are expected to be approximately $9,831,000, net of offering expenses, assuming the sale of all shares offered hereby. The actual net proceeds to be raised in the offering will depend upon the number of shares sold in the offering and the actual amount of offering expenses incurred, which may differ from the foregoing estimate.

We intend to use the net proceeds from this offering for general and corporate working capital purposes, including funding for loans and to support future growth, and enabling our subsidiary, the Bank, to continue to meet applicable capital requirements. Some of these funds may be used to pay the salaries of our officers and employees in the ordinary course of business. The amount and timing of the use of proceeds from this offering will depend on our capital needs and local loan demand, and we reserve the right to modify the use of proceeds accordingly. No

Table of Contents

assurance can be given that any new branches will be established in the future or, if established, that the resulting impact on our financial condition will be favorable.

PLAN OF DISTRIBUTION

General

We are offering these shares on a best efforts basis through our Chief Financial Officer, Melissa Larkin, who will not be entitled to receive any discounts or commissions for selling any shares, but may be reimbursed for any reasonable out-of-pocket expenses incurred in connection with the offering, if any. We believe that because this offering is a rights offering that is only being marketed to certain of its existing stockholders, the expenses to be reimbursed, if any, will be nominal. We do not intend to travel to meet with stockholders to discuss the offering. As of the date of this offering circular, we do not believe that the Company will have any expenses to be reimbursed to Ms. Larkin. However, if any out-of-pocket expenses are incurred by Ms. Larkin, the Company believes that they would be limited to reasonable travel expenses and other reasonable expenses associated with meeting with stockholders to discuss the offering. The Company has agreed to limit the aggregate amount of any out-of-pocket expenses to be reimbursed to Ms. Larkin to $2,000.00 for the offering. The offering is not underwritten and we do not presently intend to engage an underwriter or placement agent in connection with this offering.

Distribution to Stockholders

Holders of record of our common stock as of the close of business on January 29, 2018 are being given non-transferable subscription rights in this offering. Such stockholders will have subscription rights to purchase one share for every two shares owned of record on that date, at a purchase price of $7.25 per share, and an over-subscription privilege whereby they may subscribe for additional shares of our common stock unclaimed by other holders of rights in this offering at the same subscription price up to the number of shares owned as of the record date.

We believe that it is in our best interests and those of our stockholders to give these subscription rights, although our common stock does not carry any preemptive rights and such subscription rights are therefore not legally required. These subscription rights will enable stockholders to eliminate the

potential dilution of their respective percentage ownership of our stock which may occur through this offering.

The number of shares for which each stockholder is entitled to subscribe by virtue of these subscription rights, along with the aggregate price required for full exercise of these subscription rights, are set forth in the stockholder subscription agreement accompanying this offering circular. If any stockholder loses or misplaces his or her subscription agreement, the number of shares for which each stockholder is entitled to subscribe can be calculated by dividing by two the number of shares owned of record by such stockholder as of January 29, 2018. If the resulting number contains a fraction, the fraction should be rounded down to the nearest whole number.

If you have other questions regarding the Company, the Bank or the stock offering, please contact Melissa K. Larkin, EVP and Chief Financial Officer, at (303) 937-6423.

MARKET INFORMATION AND DIVIDEND POLICY AND RELATED MATTERS

Trading History

Shares of our common stock are not listed on any exchange or quoted by the Nasdaq Stock Market, although they are quoted on the OTC-Pink under the ticker symbol SLRK. Trades may also occur in unreported private transactions. The OTC-Pink is an electronic, screen-based market maintained and operated by the OTC Markets Group, which imposes considerably less stringent listing standards than the Nasdaq. The OTC-Pink is a regulated quotation service that displays real-time quotes, last-sale prices and volume information in over-the-counter equity securities.

Trading volume in the Company s stock has not been extensive and such trades cannot be characterized as constituting an active trading market. There can be no assurance that a more active trading market will develop in the future, or if developed, that it will be maintained. Management is aware of the following securities dealers which make a market in the Company s common stock: Raymond James and PCS Community Banking Group, Wedbush Securities.

Table of Contents

The information in the following table indicates the high and low sales prices and approximate trading volume for our common stock for each quarterly period since January 1, 2015, and is based upon information provided by S&P Global Market Intelligence. The information does not include transactions for which no public records are available.

	Sales Prices				Approximate Number of
Calendar Quarter Ended		**High**		**Low**	**Shares Traded**
March 31, 2015	$	4.75	$	4.30	94,841
June 30, 2015	$	5.75	$	4.70	81,272
September 30, 2015	$	5.80	$	5.50	113,122
December 31, 2015	$	5.85	$	5.41	80,112
March 31, 2016	$	5.41	$	4.80	83,116
June 30, 2016	$	6.00	$	5.15	123,088
September 31, 2016	$	6.36	$	5.85	71,352
December 31, 2016	$	7.50	$	6.15	136,819
March 31, 2017	$	7.65	$	7.15	92,637
June 30, 2017	$	7.80	$	7.40	57,066
September 30, 2017	$	8.15	$	7.65	41,159
December 31, 2017	$	8.50	$	8.00	145,200

Holders

As of January 25, 2018 there were approximately 730 stockholders of our common stock, including approximately 560 registered holders, and approximately 170 beneficial owners whose shares were held in street name.

Dividends

The Company has never declared or paid dividends on its common stock. In addition, the Company expects to retain future earnings, if any, for use in the operation and expansion of the Bank s business and does not anticipate paying any cash dividends in the foreseeable future. Any determination to pay dividends in the future will be at the discretion of the Board of Directors and will, among other factors, depend upon regulatory requirements and restrictions, the Company s results of operations, its financial condition and capital requirements.

Because it is a holding company, the Company conducts no material activities at this time other than holding the common stock of the Bank and its ability to pay dividends depends on the receipt of dividends from the Bank. The Board of Directors of the Bank intends to retain earnings to promote growth and build capital and to recover any losses incurred in prior periods. Accordingly, the

Company does not expect to receive dividends from the Bank in the foreseeable future. In addition, banks and bank holding companies are both subject to certain regulatory restrictions on the payment of cash dividends. In the case of the holding company, for example, cash to pay dividends to stockholders of the holding company, is substantially dependent on the earnings of the Bank and the payment of dividends by the Bank to the holding company, as the Bank s sole stockholder.

Stockholders are entitled to receive dividends only when and if declared by our board of directors. To date, we have not received cash dividends from the Bank. No assurance can be given that our earnings will permit the payment of dividends of any kind in the future.

The Bank s ability to pay cash dividends to us is also subject to certain legal limitations under federal laws and regulations. No national bank may, pursuant to 12 U.S.C. Section 56, pay dividends from its capital; all dividends must be paid out of net profits then on hand, after deducting for expenses including losses and bad debts. The payment of dividends out of net profits of a national bank is further limited by 12 U.S.C. Section 60(a) which prohibits a bank from declaring a dividend on its shares of common stock until the surplus fund equals the amount of capital stock, or if the surplus fund does not equal the amount of capital stock, until one-tenth of the Bank s net profits of the preceding half-year in the case of quarterly or semiannual dividends, or the preceding two consecutive half-year periods are transferred to the surplus fund before each dividend is declared.

Pursuant to 12 U.S.C. Section 60(b), the approval of the OCC is required if the total of all dividends declared by the Bank in any calendar year exceed the total of the Bank s net profits for that year combined with its net profits for the

Table of Contents

two preceding years, less any required transfers to surplus or a fund for the retirement of any preferred stock. The OCC has adopted guidelines which set forth factors which are to be considered by a national bank in determining the payment of dividends. A national bank, in assessing the payment of dividends, is to evaluate the bank s capital position, its maintenance of an adequate allowance for loan losses, and the need to review or develop a comprehensive capital plan, complete with financial projections, budgets and dividend guidelines. Therefore, the payment of dividends by the Bank is also governed by its ability to maintain minimum required capital levels and an adequate allowance for loan and lease losses. Additionally, pursuant to 12 U.S.C. Section 1818(b), the OCC may prohibit the payment of any dividend which would constitute an unsafe and unsound banking practice.

We are incorporated in Delaware and are governed by the Delaware General Corporation Law. Delaware law allows a corporation to pay dividends only out of surplus, as determined under Delaware law or, if there is no surplus, out of net profits for the fiscal year in which the dividend was declared and for the preceding fiscal year. Under Delaware law, however, we cannot pay dividends out of net profits if, after we pay the dividend, our capital would be less than the capital represented by the outstanding stock of all classes having a preference upon the distribution of assets.

CAPITALIZATION

The following table shows the Company s regulatory capital ratios (unaudited) as of September 30, 2017 on a historical basis, and on an as adjusted basis to reflect the sale of the Maximum Offering Amount in this offering. You should read the following table with the consolidated financial statements and notes that are included elsewhere in this document.

	(Unaudited) September 30, 2017	
	Actual	As adjusted for the offering(2)
	(Dollars in thousands)	
Stockholders Equity		
Common stock: par value $0.01 per share, 10 million share authorized; 2,751,588 shares issued and outstanding actual, and 4,117,244 total shares issued and outstanding as adjusted for this offering (1)	27	41
Additional paid-in capital	$ 27,197	$ 37,084
Retained earnings (accumulated deficit)	(2,755)	(2,755)
Accumulated other comprehensive income (loss)	(175)	(175)
Treasury stock, at cost	(156)	(156)
Total Stockholders Equity	$ 24,138	$ 34,039
Company s Regulatory Capital Ratios: (2)		
Total risk-based capital ratio	19.27%	25.08%

Common Equity Tier 1 capital ratio	18.02%	23.93%
Tier 1 risk-based capital ratio	18.02%	23.93%
Tier 1 leverage ratio	13.90%	18.76%

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(1) For purposes of the table above, it is assumed that the Maximum Offering Amount will be sold and issued in this offering. The shares issued and outstanding includes 25,776 shares of treasury stock, which is excluded from the total number of shares outstanding when calculating earnings per share.

(2) Assumes estimated net proceeds of $9,837,000 from the sale of the Maximum Offering Amount of Common Stock. Assumes entire amount is invested in the Bank. The Company s capital ratios are those of the Bank s.

The following table provides the average, volume-weighted price of the Company s common stock, assuming that the offering is fully subscribed.

Estimated Share Price			
2,726,813	$	8.25	prior to offering
1,363,406	$	7.25	offering
4,090,219	$	7.92	post offering

Table of Contents

BUSINESS

The Company and the Bank

Solera National Bancorp, Inc. is a bank holding company headquartered in Lakewood, Colorado. As illustrated in the organizational chart set forth below, Solera National Bank has been our wholly owned subsidiary since our formation. Our principal offices are located at 319 South Sheridan Boulevard, Lakewood, Colorado 80226. Our telephone number is (303) 209-8600, and our website address is www.solerabank.com.

Solera National Bancorp, Inc.

319 S Sheridan Blvd

Lakewood, CO 80226

Incorporated in Delaware

100%

Solera National Bank

319 S Sheridan Blvd

Lakewood, CO 80226

National Association

Solera National Bancorp, Inc. was incorporated in 2006 to organize and serve as the holding company for Solera National Bank which opened for business on September 10, 2007. Solera National Bank is a traditional, community, commercial bank focused on serving the diverse local market. Solera National Bank currently operates one service location in Lakewood, Colorado.

We offer a broad range of commercial and consumer banking services to small and medium-sized businesses, licensed professionals and individuals who are particularly responsive to the personalized service that the Bank provides to its customers. We believe that one location with the entire management team working side-by-side every day allows the Bank to serve customers efficiently and effectively. The Bank competes on the basis of providing a personalized banking experience combined with a broad range of services, customized and tailored to fit the individual needs of its clients. The Company remains focused on executing its strategy since its inception of delivering prudent and controlled growth to efficiently leverage the Company s capital and expense base with the goal of achieving sustained profitability.

The Company s ultimate objective is to create stockholder value through its recognition as the premier community bank in Colorado. We are committed to running a lean and efficient organization that can execute on business decisions quickly. Additionally, the Company believes in providing transparent financial reporting to our stakeholders through publication of quarterly earnings releases and annual audited financial statements. The Company s common stock is traded over-the-counter under the ticker symbol SLRK.

As a community-oriented bank, we offer a wide array of personal, consumer and commercial services generally offered by a locally-managed, independently-operated bank. We provide a broad range of deposit instruments and general banking services, including checking, savings accounts (including money market demand accounts), certificates of deposit for both business and personal accounts; internet banking services, such as cash management and Bill Pay; telebanking (banking by phone); courier services and mobile banking.

Since we operate in Colorado, our operating results are significantly influenced by economic conditions in Colorado, particularly the health of the real estate market. Additionally, we are subject to competition from other financial institutions and are impacted by fiscal and regulatory policies of the federal government as well as regulatory oversight by the Office of the Comptroller of the Currency, (the **OCC**).

Recent Accounting Pronouncements

Information on recent accounting pronouncements is contained in Note A to the 2016 consolidated financial statements included herein.

Market Area and Competition

The banking business in Colorado tends to be highly competitive, including in our specific market areas. Continued consolidation within the banking industry has contributed to the competitive environment in recent periods, following on the heels of a relatively large number of FDIC-assisted

takeovers of failed banks and other acquisitions of troubled financial institutions in the aftermath of the Great Recession. There are also a number of unregulated companies competing for business in our markets with financial products targeted at profitable customer segments. These companies include non-bank mortgage originators, private equity funds, and online lenders. These businesses offer, among other products, mortgages, construction loans and other loan products and deposit and investment products. Many of those companies are able to compete across geographic boundaries and provide meaningful alternatives to significant banking products and services. These competitive trends are likely to continue.

With respect to commercial bank competitors, the business is dominated by a relatively small number of major banks that operate a large number of offices within our geographic footprint. These banks have, among other

Table of Contents

advantages, the ability to finance businesses and geographic area with effective advertising campaigns and to allocate their investment resources to regions of highest yield and demand. By virtue of their greater total capitalization, such banks also have substantially higher lending limits than the Company.

In addition to other banks, our competitors include savings institutions, credit unions, and numerous non-banking institutions such as finance companies, leasing companies, insurance companies, brokerage firms, asset management groups, mortgage banking firms and internet-based companies. Technological innovations have lowered traditional barriers of entry and enabled many of these companies to offer services that previously were considered traditional banking products, and we have witnessed increased competition from specialized companies, including those that circumvent the banking system by facilitating payments via the internet, wireless devices, prepaid cards, or other means.

Strong competition for deposits and loans among financial institutions and non-banks alike affects interest rates and other terms on which financial products are offered to customers. Mergers between financial institutions have created additional pressures within the financial services industry to streamline operations, reduce expenses, and increase revenues in order to remain competitive. Competition is also impacted by federal and state interstate banking laws which permit banking organizations to expand into other states.

In an effort to compete effectively, the Company provides quality, personalized service with prompt, local decision-making, which cannot always be matched by major banks. The Company relies on local promotional activities, personal relationships established by the Company s officers, directors, and employees with the Company s customers, and specialized services tailored to meet the needs of the Company s primary service area.

The Company competes in its service area by using to the fullest extent possible the flexibility that its independent status and strong community ties permit. This status includes an emphasis on specialized services, local promotional activity, and personal contacts by the Company s officers, directors, organizers and employees. Programs have and will continue to be developed which are specifically addressed to the needs of small businesses, professionals and consumers. If our customers loan demands exceed the Company s lending limit, the Company is able to arrange for such loans on a participation basis with other financial institutions and intermediaries. The Company can also assist those customers requiring other services not offered by the Company to obtain such services from its correspondent banks.

Employees

As of September 30, 2017, the Bank had 20 full-time equivalent employees.

Properties

The Bank s main office and administrative headquarters as well as the Company s principal offices are located at 319 South Sheridan Boulevard, Lakewood, Colorado 80226. The Company leased the property until purchased on April 30, 2015 at a purchase price of $1.4 million. The building consists of approximately 6,100 square feet of space. The office has a vault, teller windows, customer parking and one automated teller machine located on the exterior of the building.

Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

At a meeting on May 11, 2016, the Audit Committee dismissed Fortner, Bayens, Levkulich & Garrison, P.C. as the Company s principal independent auditors. The Audit Committee did not have any disagreement with its independent auditors, but rather elected to change independent auditors for business reasons. At the same meeting, the Audit Committee selected the accounting firm of Eide Bailly LLP as the independent auditors for the Company s 2016 fiscal year.

Fortner, Bayens, Levkulich & Garrison, P.C. audited the Company s consolidated financial statements for the fiscal years ended December 31, 2015 and 2014. Fortner, Bayens, Levkulich & Garrison, P.C. s report on the Company s financial statements for 2015 and 2014 did not contain an adverse opinion or disclaimer of opinion, nor were such reports qualified or modified as to uncertainty, audit scope or accounting principles.

Table of Contents

During the subsequent interim period from January 1, 2016 through December 2016 and for the fiscal years ended December 31, 2015 and 2014, there were no disagreements between Fortner, Bayens, Levkulich & Garrison, P.C. and the Company on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of Fortner, Bayens, Levkulich & Garrison, P.C., would have caused it to make reference to the subject matter of the disagreements in connection with its reports.

Legal Proceedings

From time to time, the Company and the Bank may be involved in litigation relating to claims arising out of its normal course of business. As of the date of this offering circular, we did not have any material pending legal matters or litigation for either entity. During 2016, the Company was involved in a legal proceeding with its former Chief Executive Officer, Mr. John Carmichael. In September 2016, the case went to trial. The jury in the trial found the Company breached an employment agreement with Mr. Carmichael. The jury awarded Mr. Carmichael approximately $515,000 as salary and interest due by the Company for breach of contract. This cost, as well as the $138,000 in legal fees incurred were recorded to expense in 2016.

Supervision and Regulation

Banks and bank holding companies are heavily regulated by federal and state laws and regulations. Most banking regulations are intended primarily for the protection of depositors and the deposit insurance fund and not for the benefit of stockholders. The following is a summary of certain statutes, regulations and regulatory guidance affecting the Company and the Bank. This summary is not intended to be a complete explanation of such statutes, regulations and guidance, all of which are subject to change in the future, nor does it fully address their effects and potential effects on the Company and the Bank.

The Company s activities are governed by the Bank Holding Company Act of 1956, as amended (BHCA). We are subject to regulation, supervision and examination by the Board of Governors of the Federal Reserve System (the Federal Reserve) pursuant to the BHCA. We file quarterly reports and other information with the Federal Reserve. Shares of our common stock are quoted on the OTC-Pink under the ticker symbol SLRK.

The Bank is organized as a national banking association under the National Bank Act, and is subject to regulation, supervision and examination by the Office of the Comptroller of the Currency (the OCC) and the FDIC as well as being subject to regulation by certain other federal and state agencies. The OCC has primary supervisory responsibility for the Bank and performs examinations concerning safety and soundness, the quality of management and directors, information technology and compliance with applicable laws and regulations. The Bank files quarterly reports of condition and income with the FDIC, which provides insurance for certain of the Bank s deposits. In addition, Consumer Financial Protection Bureau (CFPB) regulations and guidance apply to all financial

institutions, including the Bank, although only banks with $10 billion or more in assets are subject to examination by the CFPB. Banks with less than $10 billion in assets, including the Bank, are examined for compliance by their primary federal banking agency.

Bank Holding Company Regulation. The BHCA limits our business to banking, managing or controlling banks and other activities that the Federal Reserve has determined to be closely related to banking. We, through the Bank, engage in traditional banking activities that are deemed financial in nature. In order for us to undertake new activities permitted by the BHCA, we and the Bank must be considered well capitalized (as discussed below) and well managed, the Bank must have received a rating of at least satisfactory in its most recent examination under the Community Reinvestment Act and we would be required to notify the Federal Reserve within 30 days of engaging in the new activity.

Under Federal Reserve policy, now codified by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Company is expected to act as a source of financial and managerial strength to the Bank and to commit resources to its support. Such support may be required at times when, absent this Federal Reserve policy, a holding company may not be inclined to provide it. The Company could in certain circumstances be required to guarantee the capital plan of the Bank if it became undercapitalized.

With certain limited exceptions, the BHCA prohibits a person or company or a group of persons deemed to be acting in concert from, directly or indirectly, acquiring more than 10% (5% if the acquirer is a bank holding company) of any class of our voting stock or obtaining the ability to control in any manner the election of a majority

Table of Contents

of our directors or otherwise direct the management or policies of our company without prior notice or application to and the approval of the Federal Reserve.

If, in the opinion of the applicable federal bank regulatory authorities, a depository institution or holding company is engaged in or is about to engage in an unsafe or unsound practice (which could include the payment of dividends), such authority may require, generally after notice and hearing, that such institution or holding company cease and desist such practice. The federal banking agencies have indicated that paying dividends that deplete a depository institution s or holding company s capital base to an inadequate level would be such an unsafe or unsound banking practice. Moreover, the Federal Reserve and the FDIC have issued policy statements providing that financial holding companies and insured depository institutions generally should only pay dividends out of current operating earnings.

Regulation of the Bank by the OCC. National banks are subject to regulation, supervision and examination by the OCC. The OCC regulates or monitors all areas of a national bank s operations, including security devices and procedures, adequacy of capitalization and loss reserves, accounting treatment and impact on capital determinations, loans, investments, borrowings, deposits, liquidity, mergers, issuances of securities, payment of dividends, interest rate risk management, establishment of branches, corporate reorganizations, maintenance of books and records, and adequacy of staff training to carry on safe and sound lending and deposit gathering practices. The OCC requires national banks to maintain specified capital ratios and imposes limitations on their aggregate investment in real estate, bank premises and furniture and fixtures. National banks are required by the OCC to file quarterly reports of their financial condition and results of operations and to obtain an annual audit of their financial statements in compliance with minimum standards and procedures prescribed by the OCC.

Capital Adequacy Requirements. Federal banking regulators have adopted a system using risk-based capital guidelines to evaluate the capital adequacy of banks and bank holding companies that is based upon the 1988 capital accord of the Bank for International Settlements Committee on Banking Supervision (the Basel Committee), a committee of central banks and bank regulators from the major industrialized countries that coordinates international standards for bank regulation. Under the guidelines, specific categories of assets and off-balance-sheet activities such as letters of credit are assigned risk weights, based generally on the perceived credit or other risks associated with the asset. Off-balance-sheet activities are assigned a credit conversion factor based on the perceived likelihood that they will become on-balance-sheet assets. These risk weights are multiplied by corresponding asset balances to determine a risk weighted asset base which is then measured against various measures of capital to produce capital ratios.

An organization s capital is classified in one of two tiers, Core Capital, or Tier 1, and Supplementary Capital, or Tier 2. Tier 1 capital includes common stock, retained earnings, qualifying non-cumulative perpetual preferred stock, minority interests in the equity of consolidated subsidiaries, a limited amount of qualifying trust preferred securities and qualifying cumulative perpetual preferred stock at the holding company level, less goodwill and most intangible assets. Tier 2 capital includes perpetual preferred stock and trust preferred securities not meeting the Tier 1 definition, mandatory convertible debt securities, subordinated debt, and allowances for loan and lease losses. Each category is subject to a number of regulatory definitional and qualifying requirements.

The Basel Committee in 2010 released a set of recommendations for strengthening international capital and liquidity regulation of banking organizations, known as Basel III. In July 2013, the Federal Reserve published final rules for the adoption of the Basel III regulatory capital framework (the Basel III Capital Rules). The Basel III Capital Rules became effective for many financial institutions on January 1, 2015, with certain transition provisions phasing in over a period ending on January 1, 2019.

The Basel III Capital Rules, among other things, (i) specify a capital measure called Common Equity Tier 1 (CET1), (ii) specify that Tier 1 capital consists of CET1 and Additional Tier 1 capital instruments meeting specified requirements, (iii) require that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) define the scope of the deductions/adjustments to the capital measures.

The Basel III Capital Rules set risk-based capital requirements and the total risk-based requirements to a minimum of 6.0% and 8.0%, respectively, plus a capital conservation buffer of 2.5% producing targeted ratios of 8.5% and 10.5%, respectively. The leverage ratio requirement under the Basel III Capital Rules is 5.0%. In order to be well

Table of Contents

capitalized under the rules now in effect, banks must maintain a CET1 capital ratio, Tier 1 capital ratio and total capital ratio that is equal to or greater than 6.5%, 8.0% and 10.0%, respectively.

Additionally, the Basel III Capital Rules specify a capital conservation buffer with respect to each of the CET1, Tier 1 and total capital to risk-weighted assets ratios, which provides for capital levels that exceed the minimum risk-based capital adequacy requirements. The capital conservation buffer is subject to a three year phase-in period that began on January 1, 2016 and will be fully phased-in on January 1, 2019 at 2.5%. The required phase-in capital conservation buffer during 2016 was 0.625%. A financial institution with a conservation buffer of less than the required amount is subject to limitations on capital distributions, including dividend payments and stock repurchases, and certain discretionary bonus payments to executive officers.

The Company is currently subject to the Federal Reserve s Small Bank Holding Company Policy Statement (the **Policy Statement**). The Policy Statement provides that the Basel III capital rules and reporting requirements will not apply to a bank holding company with under $1 billion in assets that: (a) is not engaged in significant non-bank activities; (b) has no significant off-balance sheet activities conducted through a non-bank subsidiary; and (c) subject to certain limited exceptions, has no material amount of SEC-registered debt or equity securities outstanding. As of September 30, 2017, the Company had $167.6 million in consolidated assets and satisfied the other criteria described above, and so the Holding Company is not subject to the Basel III capital rules and reporting requirements, however; the Bank is subject to Basel III capital rules.

Regulators may change capital and liquidity requirements, including previous interpretations of practices related to risk weights, which could require an increase to the allocation of capital to assets held by the Bank. Regulators could also require us to make retroactive adjustments to financial statements to reflect such changes. A regulatory capital ratio or category may not constitute an accurate representation of the Bank s overall financial condition or prospects. Our regulatory capital status is addressed in more detail under the heading *Capital Resources* within *Management s Discussion and Analysis of Financial Condition and Results of Operations* and in Note U in the accompanying notes to the consolidated financial statements included elsewhere in this offering circular.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) sets forth five capital categories for insured depository institutions under the prompt corrective action regulations:

- Well capitalized-equals or exceeds a 10% total risk-based capital ratio, 8% Tier 1 risk-based capital ratio, and 5% leverage ratio and is not subject to any written agreement, order or directive requiring it to maintain a specific level for any capital measure;

- Adequately capitalized-equals or exceeds an 8% total risk-based capital ratio, 6% Tier 1 risk-based capital ratio, and 4% leverage ratio;

- Undercapitalized-total risk-based capital ratio of less than 8%, or a Tier 1 risk-based ratio of less than 6%, or a leverage ratio of less than 4%;

- Significantly undercapitalized-total risk-based capital ratio of less than 6%, or a Tier 1 risk-based capital ratio of less than 4%, or a leverage ratio of less than 3%; and

- Critically undercapitalized-a ratio of tangible equity to total assets equal to or less than 2%.

Federal bank regulatory agencies are required to implement arrangements for prompt corrective action for institutions failing to meet minimum requirements to be at least adequately capitalized. FDICIA imposes an increasingly stringent array of restrictions, requirements and prohibitions as an organization s capital levels deteriorate. An adequately capitalized institution may not accept or roll over brokered deposits without an FDIC waiver. A significantly undercapitalized institution is subject to mandated capital raising activities, restrictions on interest rates paid and transactions with affiliates, removal of management and other restrictions. The OCC has only very limited discretion in dealing with a critically undercapitalized institution and is virtually required to appoint a receiver or conservator (the FDIC) if the capital deficiency is not corrected promptly.

Under the Federal Deposit Insurance Act (FDIA), critically undercapitalized banks may not, beginning 60 days after becoming critically undercapitalized, make any payment of principal or interest on their subordinated debt (subject to certain limited exceptions). In addition, under Section 18(i) of the FDIA, banks are required to obtain the advance consent of the FDIC to retire any part of their subordinated notes. Under the FDIA, a bank may not pay

Table of Contents

interest on its subordinated notes if such interest is required to be paid only out of net profits, or distribute any of its capital assets, while it remains in default on any assessment due to the FDIC.

Federal bank regulators may set capital requirements for a particular banking organization that are higher than the minimum ratios when circumstances warrant. Federal Reserve and OCC guidelines provide that banking organizations experiencing significant growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets. Concentration of credit risks arising from non-traditional activities, as well as an institution s ability to manage these risks, are important factors taken into account by regulatory agencies in assessing an organization s overall capital adequacy.

The OCC and the Federal Reserve also use a leverage ratio as an additional tool to evaluate the capital adequacy of banking organizations. The leverage ratio is a company s Tier 1 capital divided by its average total consolidated assets. A minimum leverage ratio of 3.0% is required for banks and bank holding companies that either have the highest supervisory rating or have implemented the appropriate federal regulatory authority s risk-adjusted measure for market risk. All other banks and bank holding companies are required to maintain a minimum leverage ratio of 4.0%, unless a different minimum is specified by an appropriate regulatory authority. In order to be considered well capitalized the leverage ratio must be at least 5.0%.

The Bank s leverage ratio was 13.90% at September 30, 2017 and, as a result, it is currently classified as well capitalized for purposes of the OCC s prompt corrective action regulations.

The risk-based and leverage capital ratios established by federal banking regulators are minimum supervisory ratios generally applicable to banking organizations that meet specified criteria, assuming that they otherwise have received the highest regulatory ratings in their most recent examinations. Banking organizations not meeting these criteria are expected to operate with capital positions in excess of the minimum ratios. Regulators can, from time to time, change their policies or interpretations of banking practices to require changes in risk weights, which may require the Bank to obtain additional capital to support future growth or reduce asset balances in order to meet minimum acceptable capital ratios.

Gramm-Leach-Bliley Financial Modernization Act of 1999 (Gramm-Leach-Bliley Act). The Gramm-Leach-Bliley Act:

- allows bank holding companies meeting management, capital and Community Reinvestment Act standards to engage in a substantially broader range of non-banking activities than was permissible prior to enactment, including insurance underwriting and making merchant banking investments in commercial

and financial companies;

- allows insurers and other financial services companies to acquire banks;

- removes various restrictions that applied to bank holding company ownership of securities firms and mutual fund advisory companies; and

- establishes the overall regulatory structure applicable to bank holding companies that also engage in insurance and securities operations.

The Gramm-Leach-Bliley Act also modified other financial laws, including laws related to financial privacy. The financial privacy provisions generally prohibit financial institutions, including us, from disclosing non-public personal financial information to non-affiliated third parties unless customers have the opportunity to opt out of the disclosure.

Community Reinvestment Act. The Community Reinvestment Act of 1977 (CRA) requires depository institutions to assist in meeting the credit needs of their market areas consistent with safe and sound banking practice. Under the CRA, each depository institution is required to help meet the credit needs of its market areas by, among other things, providing credit to low- and moderate-income individuals and communities. Depository institutions are periodically examined for compliance with the CRA and are assigned ratings. In order for a financial holding company to commence new activity permitted by the BHCA, each insured depository institution subsidiary

Table of Contents

of the financial holding company must have received a rating of at least satisfactory in its most recent examination under the CRA.

The USA Patriot Act, the International Money Laundering Abatement and Financial Anti-Terrorism Act and the Bank Secrecy Act. A major focus of U.S. government policy regarding financial institutions in recent years has been combating money laundering, terrorist financing and other illegal payments. The USA Patriot Act of 2001 and the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 substantially broadened the scope of United States anti-money laundering laws and penalties, specifically related to the Bank Secrecy Act of 1970, and expanded the extra-territorial jurisdiction of the U.S. government in this area. Regulations issued under these laws impose obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing and to verify the identity of their customers. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with relevant laws or regulations, could have serious legal, reputational and financial consequences for the institution. Because of the significance of regulatory emphasis on these requirements, we will continue to expend significant staffing, technology and financial resources to maintain programs designed to ensure compliance with applicable laws and regulations and an effective audit function for testing our compliance with the Bank Secrecy Act on an ongoing basis.

Safe and Sound Banking Practices; Enforcement. Banks and bank holding companies are prohibited from engaging in unsafe and unsound banking practices. Bank regulators have broad authority to prohibit and penalize activities of bank holding companies and their subsidiaries which represent unsafe and unsound banking practices or which constitute violations of laws, regulations or written directives of or agreements with regulators. Regulators have considerable discretion in identifying what they deem to be unsafe and unsound practices and in pursuing enforcement actions in response to them.

Enforcement actions against us, the Bank and our officers and directors may include the issuance of a written directive, the issuance of a cease-and-desist order that can be judicially enforced, the imposition of civil money penalties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the issuance of removal and prohibition orders against institution-affiliated parties, the imposition of restrictions and sanctions under prompt corrective action provisions, the termination of deposit insurance (in the case of the Bank) and the appointment of a conservator or receiver for the Bank. Civil money penalties can be as high as $1.0 million for each day a violation continues.

Transactions with Affiliates and Insiders. The Bank is subject to Section 23A of the Federal Reserve Act which places limits on, among other covered transactions, the amount of loans or extensions of credit to affiliates that may be made by the Bank. Extensions of credit to affiliates must be adequately collateralized by specified amounts and types of collateral. Section 23A also limits the amount of loans or advances by the Bank to third party borrowers which are collateralized by our securities or obligations or those of our subsidiaries. The Bank also is subject to Section 23B of the Federal Reserve Act, which, among other things, prohibits an institution from engaging in transactions with affiliates unless the transactions are on terms substantially the same, or at least as favorable to such institution or its subsidiaries, as those prevailing at the time for comparable transactions with non-affiliates.

We are subject to restrictions on extensions of credit to executive officers, directors, principal stockholders and their related interests. These restrictions are contained in the Federal Reserve Act and Federal Reserve Regulation O and apply to all insured institutions as well as their subsidiaries and holding companies. These restrictions include limits on loans to one borrower and conditions that must be met before such loans can be made. There is also an aggregate limitation on all loans to insiders and their related interests, which cannot exceed the institution s total unimpaired capital and surplus, unless the FDIC determines that a lesser amount is appropriate. Insiders are subject to enforcement actions for knowingly accepting loans in violation of applicable restrictions. Additional restrictions on transactions with affiliates and insiders are discussed in the Dodd-Frank Act section below.

Restrictions on Dividends and Repurchases. The primary source of funding of the Company s financial obligations has been dividends paid by the Bank. The Bank is subject to statutory dividend restrictions. Under such restrictions, national banks may not, without the prior approval of the OCC, declare dividends in excess of the sum of the current year s net profits plus the retained net profits from the prior two years, less any required transfers to surplus. Capital rules further limit the amount of dividends that may be paid by the Bank. In addition, under the

FDICIA, the Bank may not pay any dividend if it is undercapitalized or if payment would cause it to become undercapitalized.

Limits on Compensation. The Federal Reserve, OCC and FDIC in 2010 issued comprehensive final guidance on incentive compensation policies for executive management of banks and bank holding companies. This guidance was intended to ensure that the incentive compensation policies of banking organizations do not undermine their safety and soundness by encouraging excessive risk-taking. The objective of the guidance is to assure that incentive compensation arrangements (i) provide incentives that do not encourage excessive risk-taking, (ii) are compatible with effective internal controls and risk management and (iii) are supported by strong corporate governance, including oversight by the board of directors.

In 2016, the U.S. financial regulators proposed revised rules on incentive-based payment arrangements at specified regulated entities having at least $1 billion in total assets. The proposed revised rules would establish general requirements applicable to all covered entities, which would include: (i) prohibiting incentive arrangements that encourage inappropriate risks by providing excessive compensation; (ii) prohibiting incentive arrangements that encourage inappropriate risks that could lead to a material financial loss; (iii) establishing requirements for performance measures to appropriately balance risk and reward; (iv) requiring board of director oversight of incentive arrangements; and (v) mandating appropriate record-keeping. Under the proposed rule, larger financial institutions with total average consolidated assets of at least $50 billion would also be subject to additional requirements applicable to such institutions senior executive officers and significant risk-takers . These rules would not be directly applicable to the Company, which currently has less than $1 billion in assets.

The Dodd-Frank Act. The Dodd-Frank Act became law in 2010 and has had a broad impact on the financial services industry, imposing significant regulatory and compliance changes. A significant volume of financial services regulations required by the Dodd-Frank Act have not yet been finalized by banking regulators, Congress continues to consider legislation that would make significant changes to the law and courts are addressing significant litigation arising under the Act, making it difficult to predict the ultimate effect of the Dodd-Frank Act on our business. The following discussion provides a brief summary of certain provisions of the Dodd-Frank Act that may have an effect on us.

The Dodd-Frank Act significantly reduced the ability of national banks to rely upon federal preemption of state consumer financial laws. Although the OCC, as the primary regulator of national banks, has the ability to make preemption determinations where certain conditions are met, the broad rollback of federal preemption has the potential to create a patchwork of federal and state compliance obligations and enforcement. This could, in turn, result in significant new regulatory requirements

applicable to us and certain of our lending activities, with potentially significant changes in our operations and increases in our compliance costs.

The Dodd-Frank Act made permanent the general $250,000 deposit insurance limit for insured deposits. Amendments to the FDIA also revised the assessment base against which an insured depository institution s deposit insurance premiums paid to the FDIC s deposit insurance fund (DIF) are calculated. The assessment base now consists of average consolidated total assets less average tangible equity. Additionally, the Dodd-Frank Act made changes to the minimum designated reserve ratio of the DIF, increasing the minimum from 1.15% to 1.35% of the estimated amount of total insured deposits, and eliminating the requirement that the FDIC pay dividends to depository institutions when the reserve ratio exceeds certain thresholds. These changes contributed to an increase in the FDIC deposit insurance premiums paid by us in 2015 and 2016 and may contribute to increasing and less predictable deposit insurance expense in future years.

The Dodd-Frank Act generally enhances the restrictions on transactions with affiliates under Sections 23A and 23B of the Federal Reserve Act, including an expansion of the definition of covered transactions and an increase in the amount of time for which collateral requirements regarding covered credit transactions must be satisfied. Insider transaction limitations are expanded through the strengthening of restrictions on loans to insiders and the expansion of the types of transactions subject to the various limits, including derivatives transactions, repurchase agreements, reverse repurchase agreements and securities lending or borrowing transactions. Restrictions are also placed on certain asset sales to and from an insider to an institution, including requirements that such sales be on market terms and, in certain circumstances, approved by the institution s board of directors.

Table of Contents

The Dodd-Frank Act increases the risk of secondary actor liability for lenders such as the Bank that provide financing or other services to customers offering financial products or services to consumers. The Act can impose liability on a service provider for knowingly or recklessly providing substantial assistance to a customer found to have engaged in unfair, deceptive or abusive practices that injure a consumer. This exposure contributes to increased compliance and other costs in connection with administration of credit extended to entities engaged in activities covered by the Dodd-Frank Act.

The Dodd-Frank Act may continue to impact the profitability of our business activities, require further changes to certain of our business practices, impose upon us more stringent compliance, capital, liquidity and leverage requirements or otherwise adversely affect our business. These developments may also require us to invest significant management attention and resources to evaluate and make changes to our business as necessary to comply with changing statutory and regulatory requirements.

The Volcker Rule. The Dodd-Frank Act amended the BHCA to require the federal financial regulatory agencies to adopt rules that prohibit banks and their affiliates from engaging in proprietary trading in designated types of financial instruments and from investing in and sponsoring certain hedge funds and private equity funds. The final rule became effective in July 2015. It is highly complex, and many aspects of its application remain uncertain. We do not currently anticipate that the Volcker Rule will have a material effect on our operations since we do not engage in the businesses prohibited by the Volcker Rule. Unanticipated effects of the Volcker Rule s provisions or future interpretations may have an adverse effect on our business or services provided to the Bank by other financial institutions.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our consolidated financial statements and the related notes thereto included elsewhere in this offering circular. Our future operating results may be affected by various trends and factors that are beyond our control. These include the factors set forth in Risk Factors and Cautionary Statement Regarding Forward-Looking Information. Accordingly, past results and trends may not be reliable indicators of future results or trends. With the exception of historical information, the matters discussed below include forward-looking statements that involve risks and uncertainties. We caution readers that a number of important factors discussed below could affect our actual results and cause actual results to differ materially from those in the forward-looking statements.

Overview

We are a community bank offering full-service banking through our single branch location.

At September 30, 2017, our total consolidated assets were $167.6 million, representing an $11.5 million increase since December 31, 2016. At September 30, 2017, our total net loans were $114.7 million and our total deposits were $134.8 million compared to total net loans of $103.4 million and total deposits of $126.3 million at December 31, 2016.

Our net income for the year ended December 31, 2016 was $3.1 million compared to net income of $1.8 million for the year ended December 31, 2015, representing an increase of $1.3 million. The 2016 results included a full reversal of our deferred tax asset valuation allowance resulting in a one-time tax benefit of $2.2 million. Partially offsetting this one-time income tax benefit was a loss contingency of $515,000 as a result of a jury verdict awarding a severance payment and related interest to our former CEO. Our net income for the nine months ended September 30, 2017 was $788,000 compared to net income of $1.0 million for the nine months ended September 30, 2016. 2016 results were bolstered by a $125,000 gain earned on the sale of the guaranteed portion of an SBA loan and net gains realized on the sale of investment securities totaling $157,000. Additionally, there was no income tax expense recorded in the nine months ended September 30, 2016 compared to $412,000 recorded during the nine months ended September 30, 2017.

Significant Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. While we base our estimates on historical experience, current information and other factors deemed to be relevant, actual results could differ from those estimates.

Table of Contents

We consider accounting estimates to be critical to our reported financial results if: (a) the accounting estimate requires management to make assumptions about matters that are highly uncertain; and (b) different estimates that our management reasonably could have used for the accounting estimate in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on our financial statements. Accounting policies related to allowance for loan losses and loss contingencies are considered to be critical as these policies involve considerable subjective judgment and estimation by our management.

Significant accounting policies, and our procedures related to these policies, are described at Note A, Summary of Significant Accounting Policies in the notes to our consolidated financial statements included elsewhere in this offering circular.

Recent Financial Trends

Key Financial Measures and Results. The following tables set forth certain key financial measures and results for the Company for the periods indicated.

	For the year ended and as of December 31,		Change Favorable
(derived from audited statements)	**2016**	**2015**	**(Unfavorable)**
	(Dollars in thousands, except per share)		
Income Statement Data:			
Net Income	$ 3,127	$ 1,778	$ 1,349
Earnings per share	$ 1.15	$ 0.65	$ 0.50
End of Period Balance Sheet Data:			
Total assets	$ 156,091	$ 146,073	$ 10,018
Gross loans, net of unearned fees	104,983	82,109	22,874
Net loans	103,384	80,591	22,793
Deposits	126,325	120,839	5,486
Stockholders equity	23,072	19,837	3,235
Performance Ratios:			
Net interest margin	2.99%	3.13%	(0.14)%
Efficiency ratio (1)	83.25%	66.94%	(16.31)%
Return on average assets	2.12%	1.25%	0.87%
Return on average common equity	14.42%	9.12%	5.30%

(1) Efficiency measures the ratio of noninterest expense to the sum of net interest income and noninterest income, excluding gain (loss) on sale of securities.

Table of Contents

(unaudited)	For the nine months ended and as of September 30, 2017	2016	Change Favorable (Unfavorable)
	(Dollars in thousands, except per share)		
Income Statement Data:			
Net Income	$ 788	$ 1,042	$ (254)
Earnings per share	$ 0.29	$ 0.38	$ (0.09)
End of Period Balance Sheet Data:			
Total assets	$ 167,634	$ 149,277	$ 18,357
Gross loans, net of unearned fees	116,257	100,066	16,191
Net loans	114,671	98,482	16,189
Deposits	134,775	122,126	12,649
Stockholders equity	24,138	21,492	2,646
Performance Ratios:			
Net interest margin	3.07%	2.98%	0.09%
Efficiency ratio (1)	67.21%	73.79%	6.58%
Return on average assets	0.64%	0.96%	(0.32)%
Return on average common equity	4.42%	6.55%	(2.13)%

(1) Efficiency measures the ratio of noninterest expense to the sum of net interest income and noninterest income, excluding gain (loss) on sale of securities.

(derived from audited statements)	As of December 31, 2016	2015	Percent Increase (Decrease)
Selected Balance Sheet Ratios(1) :			
Total risk based capital to risk weighted assets	20.00%	20.00%	%
Tier 1 capital to average assets	13.98%	13.19%	0.79%
Gross loans, net of unearned fees, to deposits	83.10%	67.94%	15.16%
Selected Asset Quality Ratios:			
Non-performing loans (NPLs) to gross loans	%	0.16%	(0.16)%
Non-performing assets to total assets	%	0.09%	(0.09)%
Allowance for loan losses to gross loans	1.52%	1.85%	(0.33)%
Criticized assets to total assets	3.92%	3.36%	0.56%

(1) Capital ratios are presented for the bank only. Capital ratios are not presented on a consolidated basis, as they are only applicable for bank holding companies with consolidated assets of $500 million or more, or for those bank holding companies that are engaged in significant nonbanking activities.

Table of Contents

(unaudited)	As of September 30, 2017	2016	Percent Increase (Decrease)
Selected Balance Sheet Ratios(1):			
Total risk based capital to risk weighted assets	19.27%	20.40%	(1.13)%
Tier 1 capital to average assets	13.90%	13.19%	0.71%
Gross loans, net of unearned fees, to deposits	86.26%	81.94%	4.32%
Selected Asset Quality Ratios:			
Non-performing loans (NPLs) to gross loans	%	%	%
Non-performing assets to total assets	%	%	%
Allowance for loan losses to gross loans	1.36%	1.58%	(0.22)%
Criticized assets to total assets	2.83%	4.36%	(1.53)%

(1) Capital ratios are presented for the bank only. Capital ratios are not presented on a consolidated basis, as they are only applicable for bank holding companies with consolidated assets of $500 million or more, or for those bank holding companies that are engaged in significant nonbanking activities.

Return on Average Common Equity. Given the Company s single class of common stock, all net income is net income available to stockholders. Net income for the year ended December 31, 2016 was $3.1 million compared to net income of $1.8 million for the year ended December 31, 2015. Return on average common equity for the year ended December 31, 2016 was 14.42% as compared to 9.12% for the year ended December 31, 2015, based on average common equity amounts of $21.7 million and $19.5 million, respectively. The increase in net income for 2016 was due to a full reversal of the Company s deferred tax asset valuation allowance resulting in a one-time tax benefit of $2.2 million. Partially offsetting this one-time income tax benefit was a loss contingency of $515,000 as a result of a jury verdict awarding a severance payment and related interest to our former CEO.

Net income for the nine months ended September 30, 2017 was $788,000 compared to net income of $1.0 million for the nine months ended September 30, 2016. Return on average common equity for the nine months ended September 30, 2017 was 4.42% as compared to 6.55% for the nine months ended September 30, 2016, based on average common equity amounts of $23.8 million and $21.2 million, respectively. 2016 results were bolstered by a $125,000 gain on the sale of the guaranteed portion of an SBA 7(a) loan as well as $157,000 in gains on the sale of investment securities and no income tax expense. During the first nine months of 2017, the Company did not recognize any gains from the sale of loans or investment securities and recorded $412,000 of income tax expense.

Return on Average Assets (ROAA). ROAA for the year ended December 31, 2016 was 2.12% as compared to 1.25% for the year ended December 31, 2015, based on average total asset amounts of $147.2 million and $142.3 million, respectively.

ROAA for the nine months ended September 30, 2017 was 0.64%, as compared to 0.96% for the nine months ended September 30, 2016, based on average total asset amounts of $162.9 million and $144.2 million, respectively.

Net Interest Margin. Net interest margin decreased from 3.13% for the year ended December 31, 2015 to 2.99% for the year ended December 31, 2016 primarily due to increased interest expense on time deposits given increases in both the average rate (up 8 basis points) and the average balance, up 18%, in 2016. This negative impact on net interest margin was mitigated by an increase in interest income on loans, due to increased volumes. Average loans increased $8.7 million, or 10%, in 2016. However, the average yield on loans decreased 32 basis points, or 6%, due to the mix of the loan portfolio. In 2016, the Company purchased an interest in a pool of rehabilitated student loans. These loans earn at a rate substantially below the rest of the loan portfolio, but they also have a lower risk of loss as approximately 98% of the balance is government guaranteed.

Net interest margin increased from 2.98% for the nine months ended September 30, 2016 to 3.08% for the nine months ended September 30, 2017 primarily due to a shift in earning assets from lower yielding investment securities to high yielding loans which . increased the yield on interest-earning assets by10 basis points. During this same period,

Table of Contents

the cost of interest-bearing liabilities increased 5 basis points from 1.07% for the nine months ended September 30, 2016 to 1.12% for the nine months ended September 30, 2017. This was primarily driven by increases in the federal funds rate which raised the cost of deposits. The Federal Reserve raised the target federal funds rate four times since December 2015 when the target federal funds rate was 0.00% - 0.25%. As of September 30, 2017, the target federal funds rate is 1.00% - 1.25%. The Federal Reserve increased rates by 25 basis points in December 2015, December 2016, March 2017 and June 2017. The impact of the increased cost of interest-bearing liabilities was mitigated by the increase in noninterest-bearing deposits which increased $7.0 million on average from an average balance of $4.2 million for the nine months ended September 30, 2016 to an average balance of $11.2 million for the nine months ended September 30, 2017.

Asset Quality. For banks, asset quality plays a significant role in the overall financial condition of the institution and results of operations. The Company defines a non-performing loan as a loan past due 90 days or more and still accruing and nonaccrual loans. The Company does not include government guaranteed loans past due 90 days or more and still accruing as non-performing loans, as most of the principal and accrued interest will be recovered on these loans. Net charge-offs are calculated as the difference between charged-off loans and recovery payments received on previously charged-off loans. The Company had no non-performing loans, no other real estate owned (OREO) nor any foreclosed assets as of December 31, 2016, September 30, 2016 and September 30, 2017. As of December 31, 2015, the Company had one non-performing loan totaling $131,000 and no OREO or other foreclosed assets.

As of December 31, 2016, non-performing assets were $0 compared to $131,000 at December 31, 2015. Non-performing assets as a percentage of total assets were 0% as of December 31, 2016 compared to 0.09% as of December 31, 2015. For the year ended December 31, 2016, the Company recorded net recoveries of approximately, $81,000 or 0.08% recoveries as a percentage of average gross loans, net of unearned fees, compared to net charge-offs of $32,000 or 0.03% for the year ended December 31, 2015.

The Company had no non-performing assets as of September 30, 2017 or 2016. For the nine months ended September 30, 2017, the Company recorded net charge-offs of $13,000 compared to net recoveries of $66,000 for the nine months ended September 30, 2016.

The tables below present information regarding our provision and allowance for loan losses for the periods indicated:

(derived from audited statements)	**At December 31, 2016**	**2015**
	(Dollars in thousands)	
Beginning allowance for loan losses	$ 1,518	$ 1,600

Provision (reversal of) for loan losses				(50)
Loan charge-offs		(1)		(117)
Recoveries		82		85
Net recoveries (charge-offs)		81		(32)
Ending allowance for loan losses	$	1,599	$	1,518
ALLL to gross loans, net of unearned fees		1.52%		1.84%
ALLL to non-performing loans		%		%
Net (recoveries) charge-offs to average gross loans, net of unearned fees		(0.08)%		0.04%

Table of Contents

(unaudited)	At September 30, 2017	2016
	(Dollars in thousands)	
Beginning allowance for loan losses	$ 1,599	$ 1,518
Provision for loan losses		
Loan charge-offs	(64)	(1)
Recoveries	51	67
Net (charge-offs) recoveries	(13)	66
Ending allowance for loan losses	$ 1,586	$ 1,584
ALLL to gross loans, net of unearned fees	1.36%	1.58%
ALLL to non-performing loans	%	%
Net charge-offs (recoveries) to average gross loans, net of unearned fees	0.01%	(0.07)%

The ratio of our allowance for loan and lease losses (ALLL) to gross loans, net of unearned fees, declined from 1.84% on December 31, 2015 to 1.52% on December 31, 2016 and from 1.58% on September 30, 2016 to 1.36% on September 30, 2017. The decline is partially due to the continued improvement in the credit quality of the loan portfolio and partially due to the volume of government guaranteed student loans within the loan portfolio as these loans have a substantially lower risk of loss than the remainder of the portfolio. As of December 31, 2015, the Bank had no government guaranteed student loans compared to balances of $14.5 million, $14.3 million and $11.7 million as of September 30, 2016, December 31, 2016 and September 30, 2017, respectively.

Asset and Deposit Growth. The ability to produce loans and generate deposits is fundamental to our growth. Our assets and liabilities are comprised primarily of loans and deposits, respectively. Total assets were $156.1 million at December 31, 2016, an increase of $10.0 million from $146.1 million at December 31, 2015. Total net loans increased $22.8 million, or 28%, to $103.4 million at December 31, 2016 from $80.6 million at December 31, 2015. Total deposits increased by $5.5 million to $126.3 million at December 31, 2016 from $120.8 million at December 31, 2015.

Total assets were $167.6 million at September 30, 2017, an increase of $18.4 million from $149.3 million at September 30, 2016. Total net loans increased to $114.7 million at September 30, 2017 from $98.5 million at September 30, 2016. Total deposits increased by $12.6 million to $134.8 million at September 30, 2017 from $122.1 million at September 30, 2016.

Loan Mix. At September 30, 2017, real estate-secured loans represented our largest concentration of loans by collateral type. Real estate loans were primarily comprised of commercial real estate loans, representing 55% of total gross loans.

Construction and land development loans represented 2%, and loans secured by one-to-four family properties were 24%. Commercial and industrial loans represented 8% of total gross loans. Consumer-related loans, including government-guaranteed student loans represented 11% of total loans.

Deposit Mix. We are focused on maintaining and increasing core deposits to improve net interest margin. Noninterest-bearing demand deposit accounts increased from 4.7% of total deposits at December 31, 2016 to 15.2% of total deposits at September 30, 2017.

Operating Efficiency. Operating efficiency is measured in terms of how efficiently income before income taxes is generated as a percentage of revenue. Our efficiency ratio (noninterest expenses divided by the sum of net interest income and noninterest income, excluding gain (loss) on sale of securities) was 83.25% for the year ended December 31, 2016 as compared to 66.94% for the year ended December 31, 2015. The negative change in the 2016 efficiency ratio was primarily driven by increased noninterest expenses associated with a lawsuit between the Company and a former President and Chief Executive Officer which resulted in increased legal costs as well as a $515,000 expense as a result of a jury verdict awarding a severance payment and related interest to this former executive. Additionally, the efficiency ratio for 2015 was bolstered by a one-time bank owned life insurance benefit of $293,000.

The Company s efficiency ratio for the nine months ended September 30, 2017 was 67.21% compared to 73.79% for the nine months ended September 30, 2016. The efficiency ratio for 2016 was bolstered by a $125,000 gain on the sale of the guaranteed portion of an SBA loan.

Asset Sensitive. Management uses various modeling strategies to manage the repricing characteristics of our assets and liabilities. These models contain a number of assumptions and cannot take into account all the various factors that influence the sensitivities of our assets and liabilities. Despite these limitations, based on our most recent analysis, our models indicate that our balance sheet is slightly liability sensitive. A company is considered to be

Table of Contents

liability sensitive if the amount of its interest earning assets maturing or repricing within a certain time period are less than the amount of its interest-bearing liabilities also maturing or repricing within the same period. Being liability sensitive means generally that in times of rising interest rates, a company s net interest income will decrease, and in times of falling interest rates, net interest income will increase.

Results of Operations

Our results of operations depend substantially on net interest income, which is the difference between interest income on interest-earning assets, consisting primarily of loans receivable, securities and other short-term investments, and interest expense on interest-bearing liabilities, consisting primarily of deposits and borrowings. Our results of operations are also dependent upon our generation of noninterest income, consisting of income from banking, deposit, and other service fees. Other factors contributing to our results of operations include our provisions for loan losses, gains or losses on sales of securities and income taxes, as well as the level of our noninterest expenses, such as compensation and benefits, occupancy and equipment and other miscellaneous operating expenses.

Year Ended December 31, 2016 Compared to Year Ended December 31, 2015

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

(derived from audited statements)	2016	2015	Change Favorable (Unfavorable) 2016 v 2015
	(Dollars in thousands)		
Results of Operations:			
Interest income	$ 5,477	$ 5,342	$ 135
Interest expense	1,300	1,135	(165)
Net interest income	4,177	4,207	(30)
Provision (reversal of) for loan losses		(50)	(50)
Net interest income after provision for loan losses	4,177	4,257	(80)
Noninterest income	522	745	(223)
Noninterest expense	3,781	3,224	(557)
Income before income taxes	918	1,778	(860)
Income tax (expense) benefit	2,209		2,209

Net income	$ 3,127	$ 1,778	$ 1,349
Earnings per share	$ 1.15	$ 0.65	$ 0.50
Weighted-average common shares outstanding, basic	2,723,062	2,722,473	589
Return on average assets	2.12%	1.25%	0.87%
Return on average equity	14.42%	9.12%	5.30%
Average equity to average assets	13.32%	12.57%	0.76%

Table of Contents

Net income for the year ended December 31, 2016 was $3.1 million compared to net income of $1.8 million for the year ended December 31, 2015. The 2016 results included a full reversal of our deferred tax asset valuation allowance resulting in a one-time tax benefit of $2.2 million. Partially offsetting this one-time income tax benefit was a loss contingency of $515,000 as a result of a jury verdict awarding a severance payment and related interest to our former CEO. Our net interest income after provision for loan and lease losses decreased by $80,000 for the year ended December 31, 2016 compared to the year ended December 31, 2015. The Company recorded no provision for loan and lease losses in 2016 compared to a $50,000 credit to the provision for loan and lease losses in 2015. Our noninterest income decreased by $223,000 in 2016. This decline was due to a one-time bank owned life insurance benefit of $293,000 along with a higher gain on the sale of available-for-sale securities in 2015, partially offset by a gain on loans sold of $125,000 in 2016. Our noninterest expense increased by $557,000 as a result of the loss contingency and related legal expenses incurred to defend the lawsuit with our former CEO.

Net Interest Income and Net Interest Margin

Net interest income, which is our primary source of income, represents the difference between interest earned on assets and interest paid on liabilities. The interest rate spread is the difference between the yield on our interest-bearing assets and liabilities. Net interest margin is net interest income expressed as a percentage of average interest-earning assets.

The following table sets forth daily average balances, interest income and expense amounts, and average yields and cost of funds for our significant classes of interest-earning assets and interest-bearing liabilities for the periods indicated. The table also presents net interest income, net interest margin and net interest spread for the periods indicated. With respect to loans, average balances include loans which are on nonaccrual status.

	Year Ended December 31,					
	2016			**2015**		
(Dollars in thousands) (derived from audited statements)	**Average Balance**	**Interest Income/ Expense**	**Average Yield/ Cost**	**Average Balance**	**Interest Income/ Expense**	**Average Yield/ Cost**
ASSETS:						
Interest earning assets:						
Gross loans, net of unearned fees(1)	$ 91,891	$ 4,383	4.77%	$ 83,231	$ 4,237	5.09%
Investment securities	45,335	1,036	2.29	48,633	1,044	2.15
Federal funds sold	982	5	0.51	635	2	0.31
Other interest-earning assets	1,340	53	3.96	1,731	59	3.41
Total interest earning assets	139,548	$ 5,477	3.92%	134,230	$ 5,342	3.98%
Non-earning assets:						
Cash and due from banks	687			802		
Other assets	5,872			5,706		
Total assets	**$ 146,107**			**$ 140,738**		
LIABILITIES AND STOCKHOLDERS EQUITY:						

Interest-bearing liabilities:						
Deposits						
NOW	$ 7,937	$ 60	0.76%	$ 7,388	$ 55	0.74%
Money market	19,035	82	0.43	18,502	68	0.37
Savings	21,528	116	0.54	27,738	139	0.50
Time deposits	67,633	971	1.44	57,247	779	1.36
Total interest-bearing deposits	116,133	1,230	1.06	110,875	1,041	0.94
Fed funds purchased	3		1.01	18		0.79
Federal home loan bank advances	5,641	71	1.26	7,369	94	1.28
Other borrowed funds	47		0.29	55		0.30
Total interest bearing liabilities	$ 121,824	$ 1,300	1.07%	$ 118,317	$ 1,135	0.96%
Noninterest bearing liabilities:						
Demand deposits	4,490			4,413		
Other liabilities	325			324		
Total liabilities	126,639			123,054		
Stockholders equity	19,468			17,684		
Total liabilities and stockholders equity	**$ 146,107**			**$ 140,738**		
Net interest income/ margin(2)		$ 4,177	2.99%		$ 4,207	3.13%
Net interest spread(3)			2.86%			3.02%
Ratio of average interest-earning assets to average interest-bearing liabilities			114.55%			113.45%

51

Table of Contents

(1) Average loans include nonaccrual loans of $11,000 and $163,000 in 2016 and 2015, respectively.

(2) Net interest margin is computed by dividing net interest income by total average earning assets.

(3) Net interest spread represents average yield earned on interest-earning assets less the average rate paid on interest-bearing liabilities.

Net interest income decreased $30,000 to $4.2 million in 2016. Net interest margin decreased to 2.99% for 2016 from 3.13% for 2015.

The yield on our average interest-earning assets was 3.92% for the year ended December 31, 2016, compared to 3.98% for the year ended December 31, 2015. The yields on our average loan balances and securities portfolio were 4.77% and 2.29%, respectively, for the year ended December 31, 2016, compared to 5.09% and 2.15%, respectively, for the year ended December 31, 2015. The decreased yield on loans was primarily due to the mix of the loan portfolio. In 2016, the Company purchased an interest in a pool of rehabilitated government-guaranteed student loans, which have earned an average rate of 2.86% during 2016. Additionally, the Company s local environment is intensely competitive, which has driven down yields on high-quality loans. The increased yield on the investment portfolio is primarily due to the Company investing in longer, fixed rate bonds and reducing its concentration in lower-yielding residential agency mortgage-backed securities.

The cost of funds on our average interest-bearing liabilities was 1.07% for the year ended December 31, 2016, compared to 0.96% for the year ended December 31, 2015. The increase in cost of funds was primarily the impact of two Federal Reserve rate increases and an increase in both the volume and rate of time deposits. The Company is committed to increasing non-interest bearing deposits to help reduce the Company s cost of funds. Progress has been made in this area during 2017.

	Year ended December 31, 2016 Compared to Year ended December 31, 2015 Increase (Decrease) due to		
(derived from audited statements)	**Volume**	**Rate**	**Total**
	(Dollars in thousands)		
Interest income:			
Gross loans, net of unearned fees	$ 370	$ (224)	$ 146
Investment securities	(165)	157	(8)
Federal funds	1	2	3
Other interest-earning assets	(21)	15	(6)
Total increase (decrease) in interest income	$ 185	$ (50)	$ 135
Interest expense:			
Deposits:			

NOW	$	4	$	1	$	5
Money market		2		12		14
Savings		(35)		12		(23)
Time deposits		147		45		192
Federal funds purchased						
Other borrowed funds		(22)		(1)		(23)
Total increase (decrease) in interest expense		96		69		165
Increase (decrease) in net interest income	$	120	$	(150)	$	(30)

Table of Contents

Nine Months Ended September 30, 2017 Compared to Nine Months Ended September 30, 2016

The following tables set forth summaries of our results of operations for the periods indicated:

(unaudited)	**Nine Months Ended September 30, 2017**	**2016**	**Change Favorable (Unfavorable)**
	(Dollars in thousands)		
Results of Operations:			
Interest income	$ 4,549	$ 4,035	$ 514
Interest expense	1,057	965	(92)
Net interest income	3,492	3,070	422
Provision for loan losses			
Net interest income after provision for loan losses	3,492	3,070	422
Noninterest income	168	464	(296)
Noninterest expense	2,460	2,492	32
Income before income taxes	1,200	1,042	158
Income tax (expense) benefit	(412)		(412)
Net income	$ 788	$ 1,042	(254)
Earnings per share	$ 0.29	$ 0.38	$ (0.09)
Weighted-average common shares outstanding	2,724,080	2,723,063	
Return on average assets	0.64%	0.96%	(0.32)%
Return on average equity	4.42%	6.55%	(2.13)%
Average equity to average assets	13.97%	13.40%	0.57%

Net income for the nine months ended September 30, 2017 was $788,000 compared to net income of $1.0 million for the nine months ended September 30, 2016. The decline was primarily due to income tax expense of $412,000 recorded during 2017 compared to no income tax in 2016. Noninterest income decreased due to gains on loans sold and gains on sale of available-for sale securities recorded in 2016 of $125,000 and $157,000, respectively, compared to no activity in 2017.

The following table sets forth daily average balances, interest income and expense amounts, and average yields and cost of funds for our significant classes of interest-earning assets and interest-bearing liabilities for the nine months ended September 30, 2017 as compared to the nine months ended September 30, 2016. The table also presents net interest income, net interest margin and net interest spread for the periods indicated. With respect to loans, average balances include loans which are on nonaccrual status.

Table of Contents

(unaudited)	Nine Months Ended September 30, 2017 Average Balance	Interest Income/ Expense	Average Yield/ Cost	2016 Average Balance	Interest Income/ Expense	Average Yield/ Cost
	(Dollars in thousands)					
ASSETS:						
Interest earning assets:						
Gross loans, net of unearned fees(1)	$ 108,732	$ 3,738	4.60%	$ 88,742	$ 3,208	4.83%
Investment securities	40,250	760	2.52	46,468	783	2.25
Federal funds sold	1,188	9	1.01	1,202	4	0.44
Other interest-earning assets	1,456	42	3.86	1,340	40	3.99
Total interest earning assets	151,626	$ 4,549	4.01%	137,752	$ 4,035	3.91%
Non-earning assets:						
Cash and due from banks	926			672		
Other assets	7,508			5,857		
Total assets	**$ 160,060**			**$ 144,281**		
LIABILITIES AND STOCKHOLDERS EQUITY:						
Interest-bearing liabilities:						
Deposits						
NOW	$ 7,953	$ 48	0.81%	$ 8,250	$ 47	0.76%
Money market	27,657	139	0.67	17,757	52	0.39
Savings	19,982	94	0.63	22,055	88	0.53
Time deposits	65,489	722	1.47	66,768	720	1.44
Total interest-bearing deposits	121,081	1,003	1.11	114,830	907	1.06
Fed funds purchased	5		1.48	4		1.02
Federal Home Loan Bank advances	4,974	54	1.45	5,552	58	1.37
Other borrowed funds				55		0.30
Total interest bearing liabilities	$ 126,060	$ 1,057	1.12%	$ 120,441	$ 965	1.07%
Noninterest bearing liabilities:						
Demand deposits	11,194			4,202		
Other liabilities	450			311		
Total liabilities	137,704			124,954		
Stockholders equity	22,356			19,327		
Total liabilities and stockholders equity	**$ 160,060**			**$ 144,281**		
Net interest income / margin(2)		$ 3,492	3.08%		$ 3,070	2.98%
Net interest spread(3)			2.89%			2.84%
Ratio of average interest-earning assets to average interest-bearing liabilities			120.28%			114.37%

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(1) Average loans include nonaccrual loans of $0 and $14,000 for the nine months ended September 30, 2017 and 2016, respectively.

(2) Net interest margin is computed by dividing net interest income by total average earning assets.

(3) Net interest spread represents average yield earned on interest-earning assets less the average rate paid on interest-bearing liabilities.

Net interest margin increased from 2.98% for the nine-month ended September 30, 2016 to 3.08% for the same period of 2017. Net interest income increased to $3.5 million for the nine months ended September 30, 2017 as compared to $3.1 million for the nine months ended September 30, 2016. This increase was primarily attributable to an increased volume of loans for the nine months of 2017 as compared to the same period in 2016. This positive change was partially offset by an increase in the cost of interest-bearing deposits during the nine months ended September 30, 2017 due primarily to increases in short-term interest rates.

The table below demonstrates the relative impact on net interest income of changes in the volume of interest-earning assets and interest-bearing liabilities and changes in rates earned and paid by us on those assets and liabilities. Information is provided for each category of interest-earning assets and interest-bearing liabilities with respect to: (a) changes attributable to changes in volume (*i.e.*, changes in average balances multiplied by the prior-period average rate); and (b) changes attributable to rate (*i.e.*, changes in average rate multiplied by current-period average balances). For purposes of these tables, changes attributable to both rate and volume, which cannot be segregated, have been allocated proportionately to the change due to volume and the change due to rate.

Table of Contents

(unaudited)	Nine Months Ended September 30, 2017 Compared to Nine Months Ended September 30, 2016 Increase (Decrease) due to		
	Volume	Rate	Total
	(Dollars in thousands)		
Interest income:			
Net loans	$ 672	$ (142)	$ 530
Investment securities	(223)	200	(23)
Federal funds		5	5
Other interest-earning assets	3	(1)	2
Total increase in interest income	$ 452	$ 62	$ 514
Interest expense:			
Deposits:			
NOW	$ (1)	$ 2	$ 1
Money market	38	49	87
Savings	(6)	12	6
Time deposits	(23)	25	2
Federal funds purchased			
Federal Home Loan Bank advances	(9)	5	(4)
Total increase (decrease) in interest expense	(1)	93	92
Increase (decrease) in net interest income	$ 453	$ (31)	$ 422

Provision for Loan Losses - The provision for loan losses in each period is reflected as a charge against earnings in that period. The provision is equal to the amount required to maintain the allowance for loan losses at a level that, in our judgment, is adequate to absorb probable loan losses inherent in the loan portfolio.

We had no provision for loan losses for 2016 and we reversed $50,000 of provision in 2015. The Company charged-off loans totaling $1,000 in 2016 and $117,000 in 2015. The 2015 charge-off pertained to one commercial loan.

For the nine months ended September 30, 2016 and 2017, no provision for loan losses was recognized. The Company recorded $64,000 in charge-offs during the first nine months of 2017 related to the unguaranteed portion of the purchased student loan pool. Comparatively, the Company recorded $1,000 of charges-offs in the first nine months of 2016.

For further discussion of the methodology and factors impacting our estimate of the allowance for loan losses, see Allowance for Loan Losses below. For a discussion of impaired loans and associated collateral values, see Non-performing Assets and Impaired Loans below.

Noninterest Income - We earn noninterest income primarily through the following:

- Service charges on deposit accounts, including overdraft and non-sufficient fund charges;
- ATM and debit card income, including usage surcharges and interchange income; and
- Referral fees generated on referral of non-deposit investment activity (in other noninterest income).

The following table presents, for the periods indicated, amounts earned in the major categories of noninterest income:

Table of Contents

(derived from audited statements)	For the Year Ended December 31, 2016	2015	Increase (Decrease)
	(Dollars in thousands)		
Noninterest income:			
Service charges and fees	$ 102	$ 110	$ (8)
Other income	138	449	(311)
Gain on loans sold	125		125
Gain on sale of available-for-sale securities, net	157	186	(29)
Total noninterest income	$ 522	$ 745	$ (223)

Noninterest income decreased by $223,000 in 2016 compared to 2015. This decline was due to a one-time bank owned life insurance benefit of $293,000 along with a higher gain on the sale of available-for-sale securities in 2015, partially offset by a gain on loans sold of $125,000 in 2016.

(unaudited) (Dollars in thousands)	For the Nine Months Ended September 30, 2017	2016	Increase (Decrease)
Noninterest income:			
Service charges and fees	$ 73	$ 76	$ (3)
Other income	95	106	(11)
Gain on loans sold		125	(125)
Gain on sale of available-for-sale securities, net		157	(157)
Total noninterest income	$ 168	$ 464	$ (296)

The decrease of $296,000 in noninterest income for the nine months ended September 30, 2017 as compared to the same period in 2016 was primarily due to gains on loans sold and gains on sale of available-for-sale securities recorded in 2016 of $125,000 and $157,000, respectively, compared to no activity in 2017.

Noninterest Expense - We incur noninterest expense primarily through the following:

- Salaries, wages and employee benefits;
- Expenses related to occupancy of our facilities and use of equipment;
- Data processing;
- Professional, accounting and legal fees;

- Regulatory and reporting fees; and
- FDIC insurance premiums.

The following table presents, for the periods indicated, amounts spent in the major categories of noninterest expense:

Table of Contents

(derived from audited statements) (Dollars in thousands)	For the Year ended December 31, 2016	2015	Increase (Decrease)
Noninterest Expense:			
Employee compensation and benefits	$ 1,617	1,581	$ 36
Occupancy and equipment	233	203	30
Data processing	515	524	(9)
Professional fees	280	205	75
Regulatory and reporting fees	127	115	12
FDIC insurance	133	159	(26)
Other general and administrative expenses	876	437	439
Total noninterest expense	$ 3,781	$ 3,224	$ 557

Noninterest expense increased by $557,000 when comparing 2016 to 2015. The primary reasons for the increase were the loss contingency of $515,000 recorded for the jury verdict awarding a severance payment and related interest to our former CEO and related legal expenses incurred to defend the lawsuit. All other expenses remained relatively stable between years.

(unaudited) (Dollars in thousands)	For the Nine Months Ended September 30, 2017	2016	Increase (Decrease)
Noninterest Expense:			
Employee compensation and benefits	$ 1,413	$ 1,192	$ 221
Occupancy and equipment	143	180	(37)
Data processing	370	383	(13)
Professional fees	120	231	(111)
Regulatory and reporting fees	87	97	(10)
FDIC insurance	41	139	(98)
Other general and administrative expenses	286	270	16
Total noninterest expense	$ 2,460	$ 2,492	$ (32)

Noninterest expense decreased by $32,000 when comparing the nine months ended September 30, 2017 to the nine months ended September 30, 2016. The decrease was largely attributed to lower professional fees, primarily due to the resolution of the lawsuit which increased professional fees during 2016. Additionally, FDIC insurance decreased as a result of the termination of the Formal Agreement with the Office of the Comptroller of the Currency (OCC), the Bank s primary regulator, during the first quarter of 2017. These decreases were offset by increased employee compensation and benefits expense during 2017, due primarily to an increase in the number of personnel on staff.

Income Taxes   During the twelve months ended December 31, 2016, the Company reversed the valuation allowance on its deferred tax asset. Realization of deferred tax assets is dependent upon the generation of sufficient future taxable income during the period that deductible temporary differences and carryforwards are

expected to be available to reduce taxable income. After nine consecutive quarters of earnings, the Company believed it was more likely than not that the Company would generate sufficient taxable income to utilize the $2.5 million net deferred tax asset.

During the period ended December 31, 2015, the Company had a full valuation allowance reducing its $2.5 million net deferred tax asset to $0. The valuation allowance was established because the Company had not reported earnings sufficient enough to support the recognition of the deferred tax assets. For further information regarding income taxes, see Note K, Income Taxes in the notes to our consolidated financial statements included elsewhere in this offering circular.

Table of Contents

Financial Condition

Total Assets

Our total assets as of December 31, 2016 and December 31, 2015 were $156.1 million and $146.1 million, respectively. The $10.0 million increase from December 31, 2015 to December 31, 2016 was due primarily to solid growth in gross loans of $23.1 million along with the release of the deferred tax asset valuation allowance, which recognized the Company s deferred tax asset of approximately $2.5 million. These increases were partially offset by a $12.2 million decrease in investment securities available for sale.

Loans

Our gross loans, net of unearned fees as of December 31, 2016 and December 31, 2015 were $105.0 million and $82.1 million, respectively. The $22.9 million increase from December 31, 2015 to December 31, 2016 was due primarily to organic commercial loan growth coupled with the purchase of government guaranteed student loans.

Net loans, after ALLL, were $103.4 million at December 31, 2016 compared to $80.6 million at December 31, 2015. Net loans increased $22.8 million for the twelve months ended 2016 from loan originations of $28.2 million, coupled with a $15.0 million purchased participation interest in a pool of rehabilitated student loans. These were partially offset by loan payoffs and pay downs totaling $20.4 million.

The following tables show the amounts of loans outstanding by type of loan at the dates indicated:

(derived from audited statements)	**At December 31,**	
(Dollars in thousands)	**2016**	**2015**
Commercial real estate (CRE)	$ 49,806	$ 42,395
Residential real estate	28,767	26,080
Commercial and industrial	9,065	10,046
Construction and land development	3,110	3,571
Consumer and other	14,495	31
Subtotal	105,243	82,123
Less:		
Allowance for loan losses	(1,599)	(1,518)
Net deferred loan fees	(260)	(15)
Loans, net	$ 103,384	$ 80,590

(unaudited) (Dollars in thousands)	At September 30, 2017	2016
Commercial real estate (CRE)	$ 63,430	$ 47,899
Residential real estate	27,451	27,147
Commercial and industrial	10,835	8,039
Construction and land development	2,903	2,495
Consumer and other	11,879	14,756
Subtotal	116,498	100,336
Less:		
Allowance for loan losses	(1,586)	(1,584)
Net deferred loan fees	(241)	(270)
Loans, net	$ 114,671	$ 98,482

Table of Contents

Loan Maturities. The following table shows the amounts of gross loans, net of unearned fees, outstanding at December 31, 2016, which, based on remaining scheduled repayments of principal, were due in one year or less, over one year through five years, and over five years. Demand or other loans having no stated maturity and no stated schedule of repayments are reported as due in one year or less. The table also presents, for loans with maturities over one year, the percentage of loans with a fixed interest rate versus the percentage of loans with a floating interest rate.

	Maturity				Rate structure for loans with maturities over one year	
(derived from audited statements)	One Year or Less	One Through Five Years	Over Five Years	Total	Fixed Rate	Floating Rate
	(Dollars in thousands)					
CRE owner occupied	$ 154	$ 5,762	$ 13,468	$ 19,384	42%	58%
CRE non-owner occupied	3,006	7,706	19,601	30,313	32%	68%
Residential real estate	1,933	6,181	20,671	28,785	23%	77%
Commercial and industrial	2,492	4,166	928	7,586	44%	56%
Construction and land development	1,228	1,878		3,106	100%	%
Consumer and other	5	0	17	22	100%	%
Government guaranteed	5	307	15,475	15,787	7%	93%
Total gross loans	$ 8,823	$ 26,000	$ 70,160	$ 104,983		

Loan Concentrations. Our loan portfolio includes credit exposure to the commercial real estate industry. Overall, however, our real estate-related loan portfolio is relatively diversified across a number of collateral types. As of December 31, 2016 and December 31, 2015, real estate-related loans comprised 78% and 88% of total gross loans, respectively. Generally, these loans are secured by liens with an initial loan-to-value ratio of generally no more than 80%.

One-to-four family residential real estate loans have a lower risk than commercial real estate and construction and land development loans due to lower loan balances to single borrowers. Our policy for requiring collateral to secure a loan is to require collateral whenever it is available or desirable, depending upon the degree of risk we are willing to accept. Repayment of loans is expected from the borrower s cash flows and/or from the sale proceeds of the collateral. Deterioration in the performance of the economy and real estate values in our primary market areas, in particular, could have had an adverse impact on collectability, and consequently have an adverse effect on our profitability. We have been executing a strategy which also focuses on serving the needs of commercial and industrial (C&I) customers and, in addition, we have been de-emphasizing our efforts in consumer lending. See Risk Factors .

Commercial Real Estate Concentrations. We have adopted the guidance set forth in the regulatory agencies final guidance entitled Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (December 6, 2006) and the Financial Institution Letter entitled Managing Commercial Real Estate Concentrations in a Challenging Environment (FIL-22-2008). In general, the guidelines establish two concentration levels. First, a concentration is deemed to exist if the institution s total outstanding construction, land development and other land loans represent 100% or more of total risk-based capital (**CRE 1 Concentration**). Second, a concentration will be deemed to exist if total outstanding loans for construction, land development and other land and loans secured by multifamily and non-owner occupied non-farm, non-residential properties (excluding loans secured by owner-occupied properties) represent 300% or more of total risk-based capital (**CRE 2 Concentration**) and the institution s commercial real estate loan portfolio has increased by 50% or more during the prior 36 month period. If an institution is deemed to have a concentration, management should employ heightened risk management practices, including board and management oversight and strategic planning, development of underwriting standards, risk assessment and monitoring through market analysis and portfolio stress testing. As of September 30, 2017, the Bank s CRE 1 Concentration level was 12% and its CRE 2 Concentration level was 193%. We have concluded that we did not have a concentration in commercial real estate lending under the foregoing standards at September 30, 2017.

Table of Contents

Non-Performing Assets. Non-performing assets include unguaranteed loans past due 90 days or more and still accruing interest, nonaccrual loans, and OREO. In general, loans are placed on nonaccrual status when we determine timely recognition of interest to be in doubt due to the borrower s financial condition and collection efforts. OREO results from loans where we have received physical possession of the borrower s assets. The Company had no OREO as of December 31, 2016 or 2015. Additionally, the Company had $0 and $131,000 in nonaccrual loans as of December 31, 2016 and 2015, respectively. The Company had no nonaccrual loans and no OREO as of September 30, 2017 or 2016.

Classified Assets. The quality of the Company s loan portfolio is assessed as a function of the levels of past due loans and impaired loans, and internal credit quality ratings which are updated quarterly by management. The ratings on the Company s internal credit scale are broadly grouped into the categories non-classified and classified. Non-classified loans are those loans with minimal identified credit risk, as well as loans with potential credit weaknesses which deserve management s attention but for which full collection of contractual principal and interest is not significantly at risk. Classified loans include loans internally graded as substandard , doubtful and loss and are those loans that have well-defined weakness that put full collection of contractual principal or interest at risk. Classified loans for which it is probable that the Company will not collect all contractual principal or interest are also considered impaired. The credit quality ratings are an important part of our overall credit risk management process and are considered in the determination of the allowance for loan losses. Classified assets include classified loans, classified investments, OREO and other foreclosed real estate. The following tables summarize information relating to our classified assets:

(unaudited) **(Dollars in thousands)**	**September 30, 2017**	**September 30, 2016**	**December 31, 2016**	**December 31, 2015**
Classified Loans	$ 3,660	$ 3,935	$ 4,364	$ 2,531
Classified Investments	591	596	595	1,140
OREO and other foreclosed assets				
Total classified assets	$ 4,251	$ 4,531	$ 4,959	$ 3,671
Classified assets to total assets	2.54%	3.04%	3.17%	2.51%
Classified assets to Tier 1 Capital and ALLL	17.29%	21.27%	21.42%	18.45%

Impaired Loans. Impaired loans are all specifically identified loans for which it is probable that the Company will not collect all amounts due according to the contractual terms of the loan agreement. Factors considered by management in

determining whether a loan is impaired include payment status, collateral value, the borrower s financial condition and overall loan quality as determined by our internal loan grading system. Included in impaired loans are all nonaccrual loans and all accruing troubled debt restructurings. Loans that experience insignificant payment delays or payment shortfalls generally are not considered impaired. For impaired loans for which repayment is expected solely from the collateral, impairment is measured based on the fair value of the collateral. For other impaired loans, impairment may be measured based on the fair value of the collateral or on the present value of expected future cash flows discounted at the loan s original effective interest rate. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through a valuation allowance.

As of September 30, 2017 and December 31, 2016, there were no loans classified as impaired.

Table of Contents

Allowance for Loan Losses

Like all financial institutions, we must maintain an adequate allowance for loan losses. The allowance for loan losses is a valuation allowance for probable incurred credit losses, and is established through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance consists of specific and general components. The specific component relates to loans that are considered impaired, and is comprised of valuation allowances calculated on a loan-by-loan basis. Impaired loans are all specifically identified loans for which it is probable that the Company will not collect all amounts due according to the contractual terms of the loan agreement (see Impaired Loans above). Due to the credit concentration of our loan portfolio in real estate secured loans, the value of collateral is heavily dependent on real estate values in Colorado.

The general component relates to non-impaired loans, and is based on historical loss experience segmented by loans with similar risk parameters and types, adjusted for the effects of qualitative factors that are likely to cause estimated credit losses as of the evaluation date to differ from the portfolio s historical loss experience. Qualitative factors include the following: economic and environmental conditions; portfolio concentrations; changes in lending policies and procedures; trends in the volume and terms of loans; the experience, ability and depth of lending staff; levels and trends in delinquencies and impaired loans; levels and trends in charge-off and recovery activity; and levels and trends of loan quality as determined by an internal loan grading system.

Although the allowance contains a specific component, the entire allowance is available for any loan that, in management s judgment, should be charged off.

The quality of the Company s loan portfolio is assessed as a function of the levels of past due loans and impaired loans, and internal credit quality ratings which are updated quarterly by management (see Classified Assets above). The credit quality ratings are an important part of our overall credit risk management process and are considered in the determination of the allowance for loan losses.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management s periodic review of the collectability of loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect borrowers ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as new information becomes available. In addition, regulators, as an integral part of their respective examination processes, periodically review our allowance for loan losses, and may require us to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

Table of Contents

The tables below present information regarding our provision and allowance for loan losses for the periods indicated:

(derived from audited statements)

Rollforward of Allowance for Loan and Lease Losses by Portfolio Segment
Twelve Months Ended December 31, 2016

(in thousands)	Commercial Real Estate	Residential Real Estate	Commercial and Industrial	Construction and Land Development	Consumer	Total
Balance at December 31, 2015	$ 866	$ 322	$ 206	$ 123	$ 1	$ 1,518
Provision for loan losses	84	(41)	7	(95)	45	
Charge-offs					(1)	(1)
Recoveries		35	3	44		82
Net (charge-offs) recoveries		35	3	44	(1)	81
Balance at December 31, 2016	$ 950	$ 316	$ 216	$ 72	$ 45	$ 1,599

The following tables detail the allocation of the allowance for loan losses to the various portfolio classes. The allocation is made for analytical purposes and it is not necessarily indicative of the portfolio classes in which future credit losses may occur. The allocations in the tables below were determined by a combination of the following factors: specific allocations made on loans considered impaired as determined by management and historical losses in each loan type category combined with a weighting of the current loan composition. While we have allocated the allowance to various portfolio classes for purposes of these tables, the allowance for loan losses is general and is available for the portfolio in its entirety.

	At December 31,			
	2016		2015	
(derived from audited statements)	Allocation Amount ($)	% of allocation to total	Allocation Amount ($)	% of allocation to total
	(Dollars in thousands)			
CRE owner occupied	$ 632	39.5%	$ 594	39.1%
CRE non-owner occupied	318	19.9%	272	17.9%
Residential real estate	316	19.8%	322	21.2%
Commercial and industrial	211	13.2%	188	12.4%
Construction and land development	72	4.5%	123	8.1%
Consumer and other		%		%
Government guaranteed	50	3.1%	19	1.3%

Total allowance for loan losses	$ 1,599	$ 1,518

Investment Securities

Securities are identified as either held-to-maturity or available-for-sale based upon various factors, including asset/liability management strategies, liquidity and profitability objectives, and regulatory requirements. Held-to-maturity securities are carried at cost, adjusted for amortization of premiums or accretion of discounts. Available-for-sale securities are securities that may be sold prior to maturity based upon asset/liability management decisions. Securities identified as available-for-sale are carried at fair value. Unrealized gains or losses on available-for-sale securities are recorded as accumulated other comprehensive income in stockholders equity. Amortization

Table of Contents

of premiums or accretion of discounts on mortgage-backed securities is periodically adjusted for estimated prepayments.

We use our investment securities portfolio to ensure liquidity for cash and pledging requirements, manage interest rate risk, provide a source of income and manage asset quality. At September 30, 2017, net unrealized losses in the available-for-sale portfolio were approximately $175,000. We evaluate our securities on a quarterly basis to determine whether or not any securities are subject to Other-Than-Temporary Impairment (OTTI). No securities were considered to be other-than-temporarily impaired as of September 30, 2017.

The following tables set forth the carrying values of our portfolio of investment securities at the dates indicated:

	At December 31,			
	2016		2015	
(derived from audited statements)	**Amount**	**% of total**	**Amount**	**% of total**
	(Dollars in thousands)			
Securities Available-for-Sale:				
Corporate	$ 9,949	27%	$ 6,524	14%
State and municipal	9,474	26%	13,541	28%
Residential agency MBS and CMOs	15,727	44%	26,292	54%
U.S. agency	983	3%	2,017	4%
Total securities available-for-sale	$ 36,133	100%	$ 48,374	100%
Securities Held-to-Maturity:				
Corporate	$ 4,500	100%	$ 4,500	100%
Total securities held-to-maturity	$ 4,500	100%	$ 4,500	100%

	At September 30,			
	2017		2016	
(unaudited)	**Amount**	**% of total**	**Amount**	**% of total**
	(Dollars in thousands)			
Securities Available-for-Sale:				
Corporate	$ 9,622	29%	$ 9,789	27%
State and municipal	8,474	25%	9,769	27%
Residential agency MBS and CMOs	14,318	43%	16,766	46%
U.S. agency	982	3%		%
Total securities available-for-sale	$ 33,396	100%	$ 36,324	100%
Securities Held-to-Maturity:				

Corporate	$	4,901	100%	$	4,500	100%
Total securities held-to-maturity	$	4,901	100%	$	4,500	100%

The following table shows the amortized cost of held to maturity securities and the fair value of available for sale securities, maturities and approximated weighted average yield based on estimated annual income divided by the amortized cost of our securities portfolio as of December 31, 2016.

Table of Contents

(derived from audited statements)	Within one year Amount	Within one year Yield	After one year but within five years Amount	After one year but within five years Yield	After five years but within ten years Amount	After five years but within ten years Yield	After ten years Amount	After ten years Yield
	(Dollars in thousands)							
Securities available-for-sale:								
Corporate	$ 500	2.46%	$ 3,181	2.52%	$ 5,154	3.05%	$ 1,114	3.68%
State and municipal	502	5.43%	1,769	3.01%	5,483	2.85%	1,720	2.57%
Residential agency MBS and CMOs					892	1.32%	14,835	1.46%
U.S. agency					983	2.02%		
Total securities available-for-sale	$ 1,002	3.93%	$ 4,950	2.70%	$ 12,512	2.76%	$ 17,669	1.72%
Securities Held to Maturity:								
Corporate	$		$		$ 2,750	3.50%	$ 1,750	4.02%
Total securities held to maturity	$		$		$ 2,750	3.50%	$ 1,750	4.02%

Deposits

As of September 30, 2017, total deposits were $134.8 million as compared to $126.3 million at December 31, 2016 and $120.8 million as of December 31, 2015. As of September 30, 2017, non-interest bearing deposits were $20.5 million, compared to $5.9 million as of December 31, 2016, and $4.0 million as of December 31, 2015. As of September 30, 2017, interest-bearing deposits were $114.2 million compared to $120.4 million as of December 31, 2016 and $116.8 million as of December 31, 2015. Interest-bearing deposits are comprised of NOW, savings, money market, and time deposit. Included in time deposits as of September 30, 2017 were $2.1 million in CDARS.

The following table presents average period-end balances, weighted average cost of funds and mix for major categories of deposits for the periods indicated:

(derived from audited statements)	2016 Average Balance	2016 Average Rate	2016 % of Total	2015 Average Balance	2015 Average Rate	2015 % of Total
	Year Ended December 31, (Dollars in thousands)					
Non-interest-bearing deposits	$ 4,490	%	4%	$ 4,413	%	4%
Interest-bearing deposits:						
NOW	7,937	0.76%	6%	7,388	0.74%	6%
Money market	19,035	0.43%	16%	18,502	0.37%	16%
Savings	21,528	0.54%	18%	27,738	0.50%	24%
Time deposits	67,633	1.44%	56%	57,247	1.36%	50%
Total interest-bearing deposits	116,133	1.06%	96%	110,875	0.94%	96%

Total deposits	$	120,623	1.02%	100%	$ 115,288	0.90%	100%

64

Table of Contents

(unaudited)	Nine Months Ended September 30, 2017 Average Balance	Average Rate	% of Total	2016 Average Balance	Average Rate	% of Total
	(Dollars in thousands)					
Non-interest-bearing deposits	$ 11,194		8%	$ 4,202		4%
Interest-bearing deposits:						
NOW	7,953	0.81%	6%	8,250	0.76%	7%
Money market	27,657	0.67%	21%	17,757	0.39%	15%
Savings	19,982	0.63%	15%	22,055	0.53%	18%
Time deposits	65,489	1.47%	50%	66,768	1.44%	56%
Total interest-bearing deposits	121,081	1.11%	92%	114,830	1.06%	96%
Total deposits	$ 132,275	1.01%	100%	$ 119,032	1.02%	100%

The following table shows the remaining maturities for certificates of deposits as of the dates indicated:

(unaudited)	December 31, 2016	As of December 31, 2015	September 30, 2017
		(Dollars in thousands)	
Remaining maturity:			
Three months or less	$ 5,220	$ 9,685	$ 6,156
Over three months through six months	7,609	5,149	7,602
Over six months through 12 months	14,225	10,432	11,346
Over 12 months	42,387	40,894	32,511
Total	$ 69,441	$ 66,160	$ 57,615

Capital Resources

Current risk-based regulatory capital standards generally require banks to maintain minimum capital ratios. Tier 1 risk-based capital ratio compares Tier 1 or core capital, which consists principally of common equity, and risk-weighted assets for a minimum ratio of at least 8.0% to be considered well capitalized. Common equity Tier 1 capital ratio, a new ratio requirement under Basel III, must be at least 6.5%, and leverage ratio must be at least 5.0%. Total risk-based capital ratio compares total capital, which consists of Tier 1 capital, certain forms of subordinated debt, a portion of the allowance for loan losses, and preferred stock, to risk-weighted assets for a minimum ratio of at least 10.0% to be considered well capitalized. Risk-weighted assets are calculated by multiplying the balance in each category of assets by a risk factor, which generally ranges from zero to 150%, but may go as high as 1,250% and adding the products together.

At September 30, 2017, the Company was categorized as well capitalized under the regulatory framework outlined above. See Note U Regulatory Matters in the notes to our consolidated financial statements included elsewhere in this Offering Circular.

Indebtedness

As of September 30, 2017, we had available lines of credit through the Federal Home Loan Bank of Topeka (**FHLB**). These lines of credit are secured by investment securities or mortgage loans, and our borrowing capacity under these lines of credit is based on the value of the assets that we pledge with respect to them. The Company has an advance, pledge and security agreement with the FHLB and had pledged qualifying loans and securities in the

Table of Contents

amount of $9.5 million at December 31, 2016 and $11.7 million at December 31, 2015. Information concerning borrowings on the FHLB line of credit is summarized below:

(derived from audited statements)	Year Ended December 31, 2016	2015
	(Dollars in thousands)	
Average daily balance during the year	$ 5,641	$ 7,369
Average interest rate during the year	1.26%	1.28%
Maximum month-end balance during the year	$ 9,035	$ 11,346
Balance at year-end	$ 5,815	$ 5,000

Contractual Obligations and Off-Balance Sheet Arrangements

We are party to credit-related financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit and stand-by letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. Our exposure to credit loss is represented by the contractual amount of these commitments. We follow the same credit policies in making commitments as we do for on-balance sheet instruments.

We had outstanding loan commitments associated with outstanding commitments to extend credit and undisbursed funds on recorded loans of $26.3 million as of September 30, 2017. Most of these commitments were associated with unfunded commitments outstanding commitments on loans secured by real estate.

We routinely enter into contracts for services in the conduct of ordinary business operations, which may require payment for services to be provided in the future and may contain penalty clauses for early termination of the contracts. We do not believe that these off-balance sheet arrangements have or are reasonably likely to have a material effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources. However, there can be no assurance that such arrangements will not have a future effect.

Liquidity

The ability to have readily available funds sufficient to repay fully maturing liabilities is of primary importance to depositors, creditors and regulators. Our liquidity, represented by cash and due from banks, federal funds sold and available-for-sale securities, is a result of our operating, investing and

financing activities and related cash flows. In order to ensure funds are available at all times, on at least a monthly basis, we project the amount of funds that will be required and maintain relationships with a diversified customer base so funds are accessible. Liquidity requirements can also be met through short-term borrowings or the disposition of short-term assets. As of September 30, 2017, we maintained cash on deposit with the Federal Reserve or other banks totaling approximately $3.7 million, which could be liquidated within 24 hours.

Table of Contents

DIRECTORS AND EXECUTIVE OFFICERS

The following table sets forth the name, age, and position of our executive officers and directors. Executive officers are elected annually by our Board of Directors. Each executive officer holds his office until he resigns, is removed by the Board, or his successor is elected and qualified. Directors are elected annually by our stockholders at the annual meeting. The Board of Directors currently includes five independent directors and the Company expects to maintain at least two independent directors on the Board of Directors.

Name	Age	Position(s) Held with Solera National Bancorp, Inc.	Position(s) Held with Solera National Bank	Director Since (2)
Robert J. Fenton(1)	60	Director	Director	2014
Melissa K. Larkin	39	Chief Financial Officer and Secretary; Director	Chief Financial Officer and Secretary; Director	2017
Martin P. May	53	Chief Executive Officer and Director	Chief Executive Officer and Director	2015
Rene Morin(1)	63	Director	Director	2014
Michael D. Quagliano	55	Chairman and Director	Chairman and Director	2014
Philip J. Randell(1)	61	Director	Director	2016
Richard M. Thorne(1)	51	Director	Director	2017
Alan D. Weel(1)	58	Director	Director	2015

(1) Independent director as defined in the Statement of Policy Regarding Corporate Securities Definitions.

(2) Each director holds his office until his successor is elected and qualified or his earlier resignation or removal.

Robert J. Fenton

Mr. Fenton joined the Company in January 2005 as a co-founder and organizer and then as a full-time consultant in April 2005. Mr. Fenton served as Executive Vice President, Chief Financial Officer and Secretary of the Company and as the Bank s Executive Vice President, Chief Financial Officer, Chief Operating Officer and Secretary from September 2007 until March 2014. Mr. Fenton was unemployed between April 2014 and June 2014. In July 2014, Mr. Fenton was named interim President and Chief Executive Officer, and was appointed to the Board of Directors. Mr. Fenton served as interim President and Chief Executive Officer until November 2015. Since November 2015, he has been serving on the

Company s and Bank s Boards of Directors and working to advance the mission of Wellspring Community, a 501(c)(3) non-profit organization dedicated to serving adults with developmental disabilities, which he and his wife co-founded in 2008. Prior to joining the Company, Mr. Fenton was the CFO of Visa Debit Processing Services, a division of Visa USA, from October 2002 through July 2004. Prior to joining Visa, Mr. Fenton was the CFO of E*TRADE Bank from January 2001 through October 2002. Before joining E*TRADE, Mr. Fenton held several leadership positions, domestically and internationally, during his 15 years with Citicorp/Citibank (now Citigroup). Mr. Fenton is a CPA (expired license) and has an MBA in Finance from Pace University and a Bachelor of Science in Accounting from Ithaca College in Ithaca, New York.

Melissa K. Larkin

Ms. Larkin joined Solera National Bank in September 2007 as Vice President, Controller. In July 2014, Ms. Larkin was promoted to Senior Vice President, Chief Financial Officer and Secretary of the Company and Solera National Bank. Currently, Ms. Larkin serves as the Company s and the Bank s Executive Vice President, Chief Financial Officer and Secretary. Prior to joining the bank, Ms. Larkin was a Regional Controller for WestStar Bank, a subsidiary of Vail Banks, Inc. from November 2004 to December 2006. Prior to that, Ms. Larkin was a Senior Auditor with KPMG in their Denver office. She also spent one year working as a post- graduate technical assistant for the Financial Accounting Standards Board after completing her Masters of Accountancy from the University of Denver in June 2001. Ms. Larkin currently serves on the Audit Committee of the Catholic Archdiocese of Denver. She obtained her Certified Public Accountant s license in October 2002.

Table of Contents

Martin P. May

Mr. May joined the Company in August 2015. He was named President and Chief Executive Officer of the Company and of the Bank in November 2015 and was appointed to the Board of Directors at that time. Prior to joining the Company, Mr. May served as the President of First Western Trust s Cherry Creek (Denver) Colorado office from January 2014 to August 2015. Prior to that, he was a Market President for Front Range Bank from March 2011 to December 2013. He also served in senior executive roles at American National Bank, Colorado Capital Bank, and Commercial Federal Bank. He has played an active role in the Denver area community where he serves on the non-profit Board of Directors of the Colorado Humane Society and Pet Aid Colorado. Mr. May has also served as a director for the Denver Dumb Friends League and was the former Treasurer for the Denver Sailing Association. Mr. May holds a certificate from the Graduate School of Banking at Colorado and a Bachelor s of Science in Applied Economics from the University of San Francisco.

Rene Morin

Mr. Morin joined the board of directors in July 2014. Mr. Morin is a petroleum engineer, a career he started after graduating college in 1978 and joining Chevron USA Inc. Currently, he is Vice President and Partner of RIM Operating, Inc., a company he helped form in 1991 to acquire oil and gas properties. He is also owner of Bluebonnet Energy Corporation which he started in 1985. Additionally, Mr. Morin is Vice President of RIM Offshore Inc. and General Partner of RIM LLLP and RIM Nominee Partnership. Mr. Morin was an original investor in the Company and is very involved in the Hispanic community in Denver. Although no longer serving on the Latin American Education Foundation (LAEF) Board of Directors, Mr. Morin was President of LAEF in 2014 and served on the Board from 2007 - 2015.

Michael D. Quagliano

Mr. Quagliano was appointed to the board of directors in June 2014. Since 1982, including the period between November 2012 to present, Mr. Quagliano has owned and operated various businesses and investments, including restaurant franchises and real estate investments. Such businesses are conducted under various names, including Best Buy of Hiram, Inc., Best Buy of Cedar Rapids, Inc., BBQ Too, Inc., Serendipitous, Inc., Rainmaker Management, Inc., A Shapiro, LLC, QHQ Partnership and in Mr. Quagliano s own name. Mr. Quagliano has been involved with the Company since its inception including serving on the Company s Board of Directors from December 2008 through May 2009 and continues to serve today after his appointment to the Board in June 2014.

Phillip J. Randell

Mr. Randell joined the Board of Directors in September 2016, after retiring from a lengthy banking career that began in 1978 with Illinois National Bank. Mr. Randell currently continues to manage his family farm operation located in East Central Illinois, as he has done since 2007, upon the death of his father. He also currently provides consulting services to businesses in a variety of areas. Mr. Randell s banking career most recently included Commercial Market President for CoreFirst Bank & Trust in Denver, Colorado, a position he held from April 2009 until his retirement in March 2016. Prior to that, Mr. Randell was Executive Vice President and Denver Regional President for Community Banks of Colorado from June 2006 to February 2008 where he started a commercial lending group that specialized in commercial and industrial loans for working capital, equipment, and owner-occupied real estate. Additionally, he also provided consulting services to the bank in the areas of renewable energy financing and conservation easements. While at Community Banks of Colorado, Mr. Randell and his team of lenders and bankers managed a portfolio of $300 million in loans and $350 million in deposits. Additionally, Mr. Randell was the State Commercial Banking Manager for Commercial Federal Bank in Denver, CO from November, 2001 to December, 2005, where Randell and his team of lenders and bankers managed a loan portfolio with over a billion dollars of loan commitments and over $800 million in loans outstanding. Mr. Randell holds a Bachelor of Science degree in Agribusiness from Illinois State University. He also completed the Graduate School of Banking in 1987 at Southern Methodist University in Dallas, Texas. Mr. Randell is a past member of the Economic Development Group with the South Denver Metro Chamber and has served as the Treasurer and Board Member for Bonfils Blood Center Foundation.

Richard M. Thorne

Mr. Thorne joined the Board of Directors in December 2017, after retiring from a career as a bank examiner. Mr. Thorne s career began with the Federal Deposit Insurance Corporation (FDIC) where he was a Commissioned Bank Examiner for seven years. From 1999 until his retirement in October 2017, he worked for the Federal Reserve Bank of Kansas City s Denver Branch where he was the Assistant Vice President Examinations and Inspections. Mr. Thorne was responsible for supervision and regulation of state member banks and bank holding companies loacated in Colorado, Wyoming and New Mexico. During his time with the Federal Reserve, Mr. Thorne developed a number of key initiatives including horizontal reviews of financial institutions with high concentrations in commercial real estate lending. Mr. Thorne has a Bachelor s of Science in Business Administration with a concentration in Finance from Southwest Texas State University.

Table of Contents

Alan D. Weel

Mr. Weel joined the Board of Directors in July 2015. Mr. Weel is currently Senior Vice President Commercial Real Estate for Wintrust Bank in Chicago ($1.6 billion in assets) which he joined in 2009. He manages a team of five individuals responsible for a $300+ million loan portfolio. Wintrust Bank is a charter of Wintrust Financial Corp, a $25 billion publicly-traded holding company headquartered in Rosemont, Illinois. Prior to joining Wintrust Bank, Mr. Weel was Senior Vice President Commercial Real Estate for MB Financial Bank from 2002 to 2009. Mr. Weel holds two Bachelor s degrees from MacMurray College in Jacksonville, IL, one in business administration and one in physical education.

EXECUTIVE OFFICER AND DIRECTOR COMPENSATION

Summary Executive Compensation Information

The following table sets forth certain summary compensation information with respect to the Company s Chief Executive Officer and its only other executive officers whose total compensation for the fiscal year ended December 31, 2016 exceeded $100,000 (the Named Executive Officers):

Name and Principal Position	Year	Salary ($)	Bonus ($)	Non-equity Incentive Plan Compensation ($)	All Other Compensation (1) ($)	Total ($)
Melissa K. Larkin, EVP, Chief Financial Officer	2016	124,038	10,000		3,902	137,940
Peter D. Lindquist, EVP, Chief Credit Officer	2016	135,000	5,000		3,427	143,427
Marty P. May, President and Chief Executive Officer	2016	129,721			3,892	133,612

(1) Represents employer contributions to the officer s 401(k) plan.

Employment Agreements

The Company does not enter into employment agreements. All employees, including executives, are at-will employees. Ms. Larkin and Mr. Lindquist are paid their annual salary and are entitled to a discretionary annual bonus based on their individual performance as well as the performance of the Bank. As long as Mr. May is employed as Chief Executive Officer, he will receive a 10% increase in salary on the first six anniversaries from his date of hire; the first of such increases occurred on August 10, 2016. There is no additional performance bonus above this 10% annual increase.
Mr. May was granted 250,000 non-qualified stock options on his date of hire at an exercise price of $7.00 per share. The options will vest 16.67% each year on the anniversary of hire. The options scheduled to vest over the first five years will expire five years and 30 days after the grant date. The options scheduled to vest in year six will expire six years and thirty days after the grant date. Currently, 83,333 stock options are vested. In September 2017, the Company and Mr. May entered into a written agreement evidencing the grant of options.

Compensation of Directors

In 2016, the Company granted 1,000 shares of performance-based restricted stock to Messrs. Fenton, Morin and Weel and one then-director who did not stand for re-election, and 750 shares of performance-based restricted stock to Mr. Randell as compensation for their service. On June 21, 2017, these shares vested for Messrs. Fenton, Weel and Randell. The shares granted to Mr. Morin and the then-director who did not stand for re-election did not vest as they did not meet the performance criteria. Beginning in June 2017, each independent director will earn $300 per Board meeting attended and $100 per committee meeting attended.

Table of Contents

Mr. Quagliano has elected not to receive compensation for his service and Mr. May and Ms. Larkin do not receive any additional compensation for their services as directors.

RELATED PARTY TRANSACTIONS

Certain of the Company s executive officers and directors and the companies with which they are associated have been customers of, and have had banking transactions with the Bank in the ordinary course of the Bank s business and the Bank expects to continue to have such banking transactions in the future. All loans and commitments to lend included in such transactions were made in the ordinary course of business and were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans with other persons not related to the Bank, and in the opinion of the Board of Directors, did not involve more than the normal risk of repayment or present any other unfavorable features. These transactions satisfy the criteria listed in Section IV.C. of the NASAA Statement of Policy Regarding Loans and Other Material Affiliated Transactions (the Policy), and the Company expects that all future transactions will also comply with Section IV.C of the Policy. In addition, (a) the Bank will make all future material affiliated transactions and enter into all future loans on terms that are no less favorable to the Bank than those that can be obtained from unaffiliated third parties; (2) a majority of the Bank s independent directors will approve all future material transactions and loans, and any forgiveness of loans, in accordance with Section VI of the Policy; and (3) the Bank s officers and directors will consider their due diligence and assure that there is a reasonable basis for these representations, and consider whether to embody the representations in the Bank s charter or bylaws. There have been no transactions in the last two fiscal years that exceeded, nor is there any currently proposed transactions between a related party and the Company or the Bank that would exceed $50,000.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information regarding the beneficial ownership of the Company s Common Stock as of January 25, 2018 for: (a) each of our directors; (b) each person known by us to own beneficially more than 5% of the Company s outstanding Common Stock; (c) each of our executive officers; and (d) such executive officers, directors and 5% stockholders as a group.

	Number of Shares Beneficially Owned				
Name and Address* of Beneficial Owners	**Common Stock**	**Stock Options(1)**	**Restricted Stock**	**Total**	**Percent of Class(2)**

Greater Than 5% Stockholder:				
Michael D. Quagliano (also a director)	854,165		854,165	31.3%
Directors and Named Executive Officers:				
Robert J. Fenton	35,225		35,225	1.3%
Melissa K. Larkin	2,000	3,500	5,500	(3)
Peter D. Lindquist				(3)
Martin P. May	9,900	83,333	93,233	3.3%
Rene Morin	20,000		20,000	(3)
Philip J. Randell	920		920	(3)
Richard M. Thorne(4)				(3)
Alan D. Weel	1,400		1,400	(3)
All directors and executive officers as a group (8 persons)	923,610	86,833	1,010,443	35.9%

* The address of each of our directors and named executive officers is c/o Solera National Bancorp, Inc., 319 South Sheridan Blvd., Lakewood, Colorado 80226.

(1) Includes all vested options and the number of unvested shares of common stock that the director/named executive will have the right to acquire within sixty days of January 25, 2018, pursuant to the scheduled vesting of stock options.

(2) Calculated based on 2,731,313 shares of common stock outstanding as of January 25, 2018 plus options and warrants exercisable within sixty days of January 25, 2018 for the individual or the group, as applicable.

(3) Less than 1%.

(4) Appointed to the Board of Directors of the Bank and the Company on December 12, 2017.

Table of Contents

DESCRIPTION OF CAPITAL STOCK

The following discussion summarizes some of the important rights of our stockholders. This discussion does not purport to be a complete description of these rights and may not contain all of the information regarding our common stock that is important to you. These rights can be determined in full only by reference to federal and state banking laws and regulations, the Delaware General Corporation Law and our certificate of incorporation and bylaws.

General

Our certificate of incorporation authorizes our Board of Directors, without stockholder approval, to issue up to 10,000,000 shares of common stock. In addition, we have reserved 760,734 shares of common stock for issuance under our stock incentive plans.

All shares of our common stock are entitled to share equally in dividends from legally available funds, when, as, and if declared by our board of directors. We have not historically and do not anticipate in the near future that we will pay any cash dividends on our common stock. If we were to voluntarily or involuntarily liquidate or dissolve, all shares of our common stock would be entitled to share equally in all of our remaining assets available for distribution to our stockholders. Each holder of common stock will be entitled to one vote for each share on all matters submitted to the stockholders. Holders of our common stock do not have any preemptive right to acquire any authorized but unissued shares of our capital stock. No cumulative voting, redemption, sinking fund or conversion rights or provisions apply to our common stock.

Authorized but Unissued Shares

The authorized but unissued shares of our common stock are available for future issuance without stockholder approval. These additional shares may be used for a variety of corporate purposes, including future public or private offerings to raise additional capital, corporate acquisitions, and employee benefit plans. The existence of authorized but unissued and unreserved shares of our common stock may enable our Board of Directors to issue shares to persons friendly to current management, which could render more difficult or discourage any attempt to obtain control of our corporation by means of a proxy contest, tender offer, merger or otherwise, and thereby protect the continuity of management and possibly deprive the stockholders of opportunities to sell their shares of common stock for prices higher than prevailing market prices.

Dividends

As a bank holding company, we conduct no material activities other than holding the common stock of Solera National Bank, and our ability to pay dividends depends on the receipt of dividends from the Bank. We expect that for the foreseeable future, the Bank will retain all of its earnings to support its operations and to expand its business. Additionally, Solera National Bancorp and Solera National Bank are subject to significant regulatory restrictions on the payment of cash dividends. The payment of future dividends and the dividend policies of Solera National Bancorp and Solera National Bank depends on our earnings, capital requirements and financial condition, as well as other factors that our respective Boards of Directors consider relevant. See *Supervision and Regulation* beginning on page 38 for additional discussion of legal and regulatory restrictions on the payment of dividends.

Selected Provisions of Our Certificate of Incorporation and Bylaws

Protective Provisions. Certain provisions of our certificate of incorporation and bylaws highlighted below may be deemed to have anti-takeover effects and may delay, prevent or make more difficult unsolicited tender offers or takeover attempts that a stockholder may consider to be in his or her best interest, including those attempts that might result in a premium over the market price for the shares held by stockholders. These provisions may also have the effect of making it more difficult for third parties to cause the replacement of our current management. These provisions include:

Table of Contents

- the availability of authorized but unissued shares for issuance from time to time at the discretion of our Board of Directors;

- bylaw provisions enabling our Board of Directors to increase, between annual meetings, the number of persons serving as Directors and to fill the vacancies created as a result of the increase by a majority vote of the Directors present at the meeting;

- bylaw provisions establishing an advance notice procedure with regard to business to be brought before an annual or special meeting of stockholders and with regard to the nomination of candidates for election as Directors, other than by or at the direction of the Board of Directors; and

- bylaw provisions allowing the Board of Directors, or the President of the company to call special meetings of shareholders of the Bank. A special meeting of shareholders may be called by the shareholders, provided that shareholders representing at least twenty-five percent (25%) of all of the votes entitled to be cast join in the request.

Although our bylaws do not give our Board of Directors any power to approve or disapprove stockholder nominations for the election of Directors or proposals for action, they may have the effect of precluding a contest for the election of Directors or the consideration of stockholder proposals if the established procedures are not followed, and of discouraging or deterring a third party from conducting a solicitation of proxies to elect its own slate of Directors or to approve its proposal without regard to whether consideration of the nominees or proposals might be harmful or beneficial to us and our stockholders.

Indemnification. Our certificate of incorporation provides generally that we shall indemnify and hold harmless each of our Directors and Executive Officers and may indemnify any other person acting on our behalf in connection with any actual or threatened action, proceeding or investigation, subject to limited exceptions. For example, we will not indemnify any person from or against expenses, liabilities, judgments, fines, penalties or other payments resulting from matters for which the person is determined to be liable for willful or intentional misconduct in the performance of his duty to the corporation, unless and only to the extent that a court shall determine indemnification to be fair despite the

adjudication of liability.

In addition, to the extent that indemnification for liabilities arising under the Securities Act of 1933 may be permitted to our Directors, officers and controlling persons, we have been advised that, in the opinion of the Commission, this indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable.

Limitation of Liability. Our certificate of incorporation limits the personal liability of our Directors and officers in actions brought on our behalf or on behalf of our stockholders for monetary damages as a result of a Director s or officer s acts or omissions while acting in a capacity as a Director or officer, with certain exceptions. Consistent with the Delaware General Corporation Law, as amended, our certificate of incorporation does not limit the personal liability of our Directors and officers in connection with:

- the breach of the Director s duty of loyalty to the corporation or its stockholders;

- any act or omission not in good faith or which involves intentional misconduct or knowing violation of law; or

- any transaction from which the Director derives an improper personal benefit.

Our certificate of incorporation also contains a provision that, in the event that Delaware law is amended in the future to authorize corporate action further eliminating or limiting the personal liability of Directors or eliminating or limiting the personal liability of officers, the liability of a Director or officer of the corporation will be eliminated or limited to the fullest extent permitted by law. Our certificate of incorporation does not eliminate or limit our right or the right of our stockholders to seek injunctive or other equitable relief not involving monetary damages.

Table of Contents

Shares Eligible for Future Sale

Assuming the sale of the maximum number of shares available in this offering, 1,365,656, upon completion of the offering, we will have 4,096,969 shares of common stock outstanding, excluding 25,776 shares of treasury stock. These shares of common stock will be freely tradable without restriction, except our affiliates must comply with the resale limitations of Rule 144 under the Securities Act. An affiliate is a person who directly or indirectly controls, is controlled by, or is under common control with, Solera National Bancorp. Inc. Affiliates of a company generally include its directors, executive officers and principal stockholders.

In general, under Rule 144, affiliates will be entitled to sell within any three-month period a number of shares that does not exceed the greater of the following:

- 1% of the outstanding shares of common stock; or
- the average weekly trading volume during the four calendar weeks preceding his or her sale.

Sales under Rule 144 are also subject to provisions regarding the manner of sale, notice requirements and the availability of current public information about us. Affiliates will not be subject to the volume restrictions and other limitations under Rule 144 beginning 90 days after their status as an affiliate ends.

Prior to the offering, the market for the common stock has not been active, and we cannot predict the effect, if any, that the sale of shares or the availability of shares for sale will have on the market price prevailing from time to time. Nevertheless, sales of substantial amounts of common stock in the public market could adversely affect prevailing market prices and our ability to raise equity capital in the future.

LEGAL MATTERS

Certain legal matters, including the validity of common shares offered hereby, have been passed upon for us by Shapiro Bieging Barber Otteson LLP.

EXPERTS

The consolidated financial statements of the Company as of December 31, 2016 included in this offering circular have been so included in reliance on the report of Eide Bailly LLP, an independent public accounting firm, given on the authority of such firm as experts in accounting and auditing. The consolidated financial statements of the Company as of December 31, 2015 included in this offering circular have been so included in reliance on the report of Fortner, Bayens, Levkulich & Garrison, P.C., an independent public accounting firm, given on the authority of such firm as experts in accounting and auditing.

Table of Contents

INDEX TO FINANCIAL STATEMENTS

	Page
Unaudited Interim Financial Statements	
Consolidated Balance Sheets	I-1
Consolidated Statements of Operations	I-2
Consolidated Statements of Changes in Stockholders Equity	I-3
Consolidated Statements of Cash Flows	I-4

	Page
Audited Consolidated Financial Statements of Solera National Bancorp, Inc. as of December 31, 2016 and 2015 and for the Two Years Ended December 31, 2016 and 2015	
Independent Auditor s Report	F-2
Consolidated Balance Sheets as of December 31, 2016 and 2015	F-4
Consolidated Statements of Comprehensive Income for the Years Ended December 31, 2016 and 2015	F-5
Consolidated Statement of Changes in Stockholders Equity for the Years Ended December 31, 2016 and 2015	F-6
Consolidated Statements of Cash Flows for the Years Ended December 31, 2016 and 2015	F-7
Notes to Consolidated Financial Statements	F-9
Supplemental Consolidating Schedules	F-42

	Page
Audited Consolidated Financial Statements of Solera National Bancorp, Inc. as of December 31, 2015 and 2014 and for the Two Years Ended December 31, 2015 and 2014	
Independent Auditor s Report	F-48
Consolidated Balance Sheets as of December 31, 2015 and 2014	F-49
Consolidated Statements of Comprehensive Income for the Years Ended December 31, 2015 and 2014	F-50
Consolidated Statement of Changes in Stockholders Equity for the Years Ended December 31, 2015 and 2014	F-51
Consolidated Statements of Cash Flows for the Years Ended December 31, 2015 and 2014	F-52
Notes to Consolidated Financial Statements	F-54
Supplemental Schedules	F-91

Table of Contents

In the opinion of management all adjustments necessary in order to make the interim financial statements not misleading have been included.

SOLERA NATIONAL BANCORP, INC.

CONSOLIDATED BALANCE SHEETS

(unaudited)

($000s)	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
ASSETS					
Cash and due from banks	$ 1,383	$ 1,097	$ 2,126	$ 719	$ 825
Federal funds sold	2,105	210	185	80	
Interest-bearing deposits with banks	261	1,261	261	261	261
Investment securities, available-for-sale	33,396	35,222	34,645	36,133	36,324
Investment securities, held-to-maturity	4,901	4,900	4,899	4,500	4,500
FHLB and Federal Reserve Bank stocks, at cost	1,073	987	861	879	1,027
Gross loans	116,498	111,990	105,363	105,243	100,336
Net deferred (fees)/expenses	(241)	(246)	(249)	(260)	(270)
Allowance for loan and lease losses	(1,586)	(1,588)	(1,601)	(1,599)	(1,584)
Net loans	114,671	110,156	103,513	103,384	98,482
Premises and equipment, net	1,781	1,783	1,803	1,831	1,861
Accrued interest receivable	855	794	816	798	768
Bank-owned life insurance	4,583	4,554	4,525	4,495	4,464
Other assets	2,625	3,025	3,460	3,011	765
TOTAL ASSETS	$ 167,634	$ 163,989	$ 157,094	$ 156,091	$ 149,277
LIABILITIES AND STOCKHOLDERS EQUITY					
Noninterest-bearing demand deposits	$ 20,538	$ 12,134	$ 8,689	$ 5,941	$ 5,189
Interest-bearing demand deposits	7,684	7,855	8,016	8,374	6,997
Savings and money market deposits	48,938	49,434	43,473	42,569	38,558
Time deposits	57,615	63,031	67,865	69,441	71,382
Total deposits	134,775	132,454	128,043	126,325	122,126
Accrued interest payable	158	151	131	103	144
Short-term FHLB borrowings	964	4,029	1,466	2,415	1,125
Long-term FHLB borrowings	7,400	3,400	3,400	3,400	4,000
Accounts payable and other liabilities	199	178	654	776	390
TOTAL LIABILITIES	143,496	140,212	133,694	133,019	127,785
Common stock	27	27	27	27	27
Additional paid-in capital	27,197	27,190	27,180	27,170	27,160

Accumulated deficit	(2,755)	(3,051)	(3,343)	(3,543)	(5,628)
Accumulated other comprehensive gain (loss)	(175)	(233)	(308)	(426)	89
Treasury stock, at cost	(156)	(156)	(156)	(156)	(156)
TOTAL STOCKHOLDERS EQUITY	24,138	23,777	23,400	23,072	21,492
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 167,634	$ 163,989	$ 157,094	$ 156,091	$ 149,277

I-1

Table of Contents

SOLERA NATIONAL BANCORP, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(unaudited)

	Three Months Ended					Nine Months Ended	
($000s, except per share data)	**9/30/2017**	**6/30/2017**	**3/31/2017**	**12/31/2016**	**9/30/2016**	**9/30/2017**	**9/30/2016**
Interest and dividend income							
Interest and fees on loans	$ 1,331	$ 1,239	$ 1,168	$ 1,175	$ 1,144	$ 3,738	$ 3,209
Investment securities	255	249	256	254	242	760	783
Dividends on bank stocks	14	11	11	12	12	36	33
Other	5	7	3	1	2	15	10
Total interest income	1,605	1,506	1,438	1,442	1,400	4,549	4,035
Interest expense							
Deposits	341	340	322	320	315	1,003	907
FHLB borrowings	28	14	12	15	18	54	58
Total interest expense	369	354	334	335	333	1,057	965
Net interest income	1,236	1,152	1,104	1,107	1,067	3,492	3,070
Provision for loan and lease losses							
Net interest income after provision for loan and lease losses	1,236	1,152	1,104	1,107	1,067	3,492	3,070
Noninterest income							
Customer service and other fees	24	26	23	26	28	73	76
Other income	31	32	32	32	32	95	106
Gain on loans sold							125
Gain on sale of available-for-sale securities					36		157
Total noninterest income	55	58	55	58	96	168	464
Noninterest expense							
Employee compensation and benefits	480	447	486	425	410	1,413	1,192
Occupancy	52	42	49	53	59	143	180
Professional fees	55	26	39	49	129	120	231
Other general and administrative	252	265	267	762	299	784	889
Total noninterest expense	839	780	841	1,289	897	2,460	2,492
Net Income (Loss) Before Taxes	$ 452	$ 430	$ 318	$ (124)	$ 266	$ 1,200	$ 1,042
Income Tax (Expense) Benefit	(156)	(138)	(118)	2,209		(412)	
Net Income	$ 296	$ 292	$ 200	$ 2,085	$ 266	$ 788	$ 1,042
Comprehensive income							
Net change in unrealized gains (losses) on available-for-sale securities	93	119	187	(765)	(123)	399	747
Income tax effect	(35)	(44)	(69)	250		(148)	
Reclassification adjustment for net gains realized in net income					(36)		(157)

Income tax effect							
Total other comprehensive income (loss)	58	75	118	(515)	(159)	251	590
Total comprehensive income	$ 354	$ 367	$ 318	$ 1,570	$ 107	$ 1,039	$ 1,632
Income Per Share	$ 0.11	$ 0.11	$ 0.07	$ 0.77	$ 0.10	$ 0.29	$ 0.38
Tangible Book Value Per Share	$ 8.79	$ 8.66	$ 8.52	$ 8.39	$ 7.80	$ 8.79	$ 7.80
Net Interest Margin	3.11%	3.06%	3.04%	3.04%	2.96%	3.08%	2.98%
Efficiency Ratio	64.99%	64.46%	72.56%	110.64%	79.59%	67.21%	73.79%
Return on Average Assets	0.71%	0.73%	0.51%	5.46%	0.73%	0.64%	0.96%
Return on Average Equity	4.94%	4.95%	3.44%	37.43%	4.96%	4.42%	6.55%
Asset Quality:							
Non-performing loans to gross loans	%	%	%	%	%		
Non-performing assets to total assets	%	%	%	%	%		
Allowance for loan losses to gross loans	1.36%	1.42%	1.52%	1.52%	1.58%		
Criticized loans/assets:							
Special mention	$ 486	$ 1,176	$ 1,210	$ 1,164	$ 1,984		
Substandard: Accruing	3,660	4,128	4,320	4,364	3,935		
Substandard: Nonaccrual							
Doubtful							
Total criticized loans	$ 4,146	$ 5,304	$ 5,530	$ 5,528	$ 5,919		
Other real estate owned							
Investment securities	591	593	594	595	596		
Total criticized assets	$ 4,737	$ 5,897	$ 6,124	$ 6,123	$ 6,515		
Criticized assets to total assets	2.83%	3.60%	3.90%	3.92%	4.36%		
Selected Financial Ratios: (Solera National Bank Only)							
Tier 1 leverage ratio	13.9%	14.2%	13.7%	14.0%	13.2%		
Tier 1 risk-based capital ratio	18.0%	18.5%	18.7%	18.7%	19.1%		
Total risk-based capital ratio	19.3%	19.7%	19.9%	20.0%	20.4%		

Table of Contents

Solera National Bancorp, Inc.

Consolidated Statements of Changes in Stockholders Equity

Nine Months Ended September 30, 2017 and 2016 (unaudited)

	Shares Outstanding	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Loss	Total
	(in thousands, except for shares outstanding)						
Balance at December 31, 2015	2,773,838	$ 27	$ 27,137	$ (6,670)	$ (156)	$ (501)	$ 19,837
Stock-based compensation			23				23
Stock compensation awards/(forfeitures), net	(20,250)						
Net income				1,042			1,042
Other comprehensive loss						590	590
Balance at September 30, 2016	2,753,588	$ 27	$ 27,160	$ (5,628)	$ (156)	$ 89	$ 21,492
Balance at December 31, 2016	2,753,588	$ 27	$ 27,170	$ (3,543)	$ (156)	$ (426)	$ 23,072
Stock-based compensation			27				27
Stock compensation awards/(forfeitures), net	(2,000)						
Net income				788			788
Other comprehensive income						251	251
Balance at September 30, 2017	2,751,588	$ 27	$ 27,197	$ (2,755)	$ (156)	$ (175)	$ 24,138

Table of Contents

Solera National Bancorp, Inc.

Consolidated Statements of Cash Flows (unaudited)

(in thousands)	Nine Months Ended September 30, 2017		Nine Months Ended September 30, 2016	
Cash flows from operating activities				
Net income	$	788	$	1,042
Adjustments to reconcile net income to net cash used by operating activities:				
Depreciation and amortization		187		166
Net amortization of premiums on investment securities		339		475
Recognition of stock-based compensation on stock options/restricted stock awards		27		23
Gain on sale of available-for-sale securities, net				(157)
Loss on disposal of premises and equipment		(1)		
Federal Home Loan Bank stock dividend		(6)		(8)
Increase in bank-owned life insurance cash surrender value		(88)		(95)
Net change in:				
Accrued interest receivable		(57)		(198)
Net deferred income tax assets		386		
Other assets		(266)		(254)
Accrued interest payable		55		56
Accounts payable and other liabilities		(577)		81
Net cash provided by operating activities	$	787	$	1,131
Cash flows from investing activities				
Purchases of investment securities held to maturity		(397)		
Activity in securities available for sale:				
Purchases		(1,492)		(15,631)
Maturities, prepayments, and calls		4,285		4,910
Sales				23,044
Redemption (purchase) of nonmarketable equity securities, net		(188)		(146)
Loan (originations) / principal collections, net		(11,287)		(16,852)
Maturity of interest bearing deposits in banks				489
Purchases of premises and equipment		(18)		(20)
Net cash used by investing activities	$	(9,097)	$	(4,206)
Cash flows from financing activities				
Net change in repurchase agreements and federal funds purchased	$		$	
Net change in deposits		8,450		1,286
Net change in borrowings on FHLB line of credit		(1,451)		1,125
Proceeds from FHLB term advances		4,000		
Repayment of FHLB term advances				(1,000)
Net cash provided by financing activities	$	10,999	$	1,411
Net change in cash and cash equivalents	$	2,689	$	(1,664)
Cash and cash equivalents at beginning of period		799		2,489
Cash and cash equivalents at end of period	$	3,488	$	825
Supplemental Disclosures of Cash Flow Information:				
Cash paid during the period for interest	$	1,009	$	910

Cash paid during the period for income taxes	$	21	$

Table of Contents

INDEPENDENT AUDITOR S REPORT

CONSOLIDATED FINANCIAL STATEMENTS AND

INDEPENDENT AUDITOR S REPORT

SOLERA NATIONAL BANCORP, INC.

AND SUBSIDIARY

December 31, 2016 and 2015

F-1

Table of Contents

Independent Auditor s Report

To the Audit Committee and Board of Directors Solera National Bancorp, Inc. and Subsidiary
Lakewood, Colorado

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of Solera National Bancorp, Inc. and Subsidiary, which comprise the consolidated balance sheets as of December 31, 2016, and the related consolidated statements of comprehensive income, changes in stockholders equity, and cash flows for the year then ended, and the related notes to the consolidated financial statements.

Management s Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor s Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable

assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor s judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity s preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity s internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Solera National Bancorp, Inc. and Subsidiary as of December 31, 2016, and the results of their operations and their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

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Table of Contents

Report on Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary information on pages F-42 through F-46 is presented for the purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Other Matter

The consolidated financial statements of Solera National Bancorp, Inc. and Subsidiary as of December 31, 2015, were audited by other auditors, whose report dated March 11, 2016, expressed an unmodified opinion on those statements.

Denver, Colorado March 22, 2017

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Consolidated Balance Sheets

December 31,

	2016	2015
	(in thousands, except for shares outstanding)	
ASSETS		
Cash and cash equivalents	$ 799	$ 2,489
Interest-bearing deposits with banks	261	750
Investment securities, available-for-sale	36,133	48,374
Investment securities, held-to-maturity	4,500	4,500
Loans held for sale		1,039
Loans, net	103,384	80,590
Nonmarketable equity securities	879	874
Bank-owned life insurance	4,495	4,369
Premises and equipment, net	1,831	1,918
Accrued interest receivable	798	571
Deferred tax asset, net	2,483	
Other assets	528	599
Total Assets	$ 156,091	$ 146,073
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities		
Deposits		
Noninterest-bearing demand	$ 5,941	$ 3,954
Interest-bearing demand	8,374	8,405
Savings and money market	42,569	42,320
Time deposits	69,441	66,160
Total deposits	126,325	120,839
Accrued interest payable	103	88
Accounts payable and other liabilities	776	309
FHLB advances	5,815	5,000
Total liabilities	133,019	126,236
Commitments and contingencies (see Notes H, Q, R)		
Stockholders equity		
Common stock (1)	27	27
Additional paid-in capital	27,170	27,137
Accumulated deficit	(3,543)	(6,670)
Accumulated other comprehensive loss	(426)	(501)
Treasury stock, at cost; 25,776 shares	(156)	(156)
Total stockholders equity	23,072	19,837
Total Liabilities and Stockholders Equity	$ 156,091	$ 146,073

(1) 10,000,000 shares of $0.01 par value authorized; 2,753,588 and 2,773,838 shares outstanding as of December 31, 2016 and 2015, respectively.

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

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income

Years ended December 31,

	2016	2015
	(in thousands)	
Interest income		
Interest and fees on loans	$ 4,384	$ 4,237
Interest on investment securities	1,037	1,044
Dividends on nonmarketable equity securities	45	46
Other interest income	11	15
Total interest income	5,477	5,342
Interest expense		
Deposits	1,227	1,039
FHLB advances	73	96
Total interest expense	1,300	1,135
Net interest income	4,177	4,207
Provision for loan losses		(50)
Net interest income after provision for loan losses	4,177	4,257
Noninterest income		
Service charges and fees	102	110
Other income	138	449
Gain on loans sold	125	
Gain on sale of available-for-sale securities, net	157	186
Total noninterest income	522	745
Noninterest expense		
Employee compensation and benefits	1,617	1,581
Occupancy and equipment	233	203
Professional fees	280	205
Other general and administrative	1,651	1,235
Total noninterest expense	3,781	3,224
Income before income taxes	918	1,778
Income tax benefit	(2,209)	
Net income	$ 3,127	$ 1,778
Comprehensive income		
Net change in unrealized losses on securities	(18)	(213)
Income tax effect	192	
Reclassification adjustment for net gains realized in net income	(157)	(186)
Income tax effect	58	
Total other comprehensive income (loss)	75	(399)
Total comprehensive income	$ 3,202	$ 1,379

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

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Consolidated Statements of Changes in Stockholders Equity

Years ended December 31, 2016 and 2015

	Shares Outstanding	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Loss	Total
	(in thousands, except for shares outstanding)						
Balance at December 31, 2014	2,772,422	$ 27	$ 27,120	$ (8,448)	$ (156)	$ (102)	$ 18,441
Options exercised	1,416		5				5
Stock-based compensation			12				12
Net income				1,778			1,778
Other comprehensive loss						(399)	(399)
Balance at December 31, 2015	2,773,838	$ 27	$ 27,137	$ (6,670)	$ (156)	$ (501)	$ 19,837
Stock-based compensation			27				27
Stock compensation awards/(forfeitures), net	(20,250)		6				6
Net income				3,127			3,127
Other comprehensive income						75	75
Balance at December 31, 2016	2,753,588	$ 27	$ 27,170	$ (3,543)	$ (156)	$ (426)	$ 23,072

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

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Consolidated Statements of Cash Flows

Years ended December 31,	2016	2015
	(in thousands)	
Cash flows from operating activities		
Net income	$ 3,127	$ 1,778
Adjustments to reconcile net income to net cash used by operating activities:		
Depreciation and amortization	224	159
Provision for loan losses		(50)
Net amortization of premiums on investment securities	614	743
Recognition of stock-based compensation on stock options/restricted stock awards	33	12
Gain on sale of available-for-sale securities, net	(157)	(186)
Loss on disposal of premises and equipment	7	34
Deferred income tax benefit	(2,242)	
Federal Home Loan Bank stock dividend	(11)	(15)
Increase in bank-owned life insurance cash surrender value	(126)	(136)
Net change in:		
Accrued interest receivable	(227)	45
Other assets	(42)	270
Accrued interest payable	15	26
Accounts payable and other liabilities	522	(247)
Net cash provided by operating activities	1,737	2,433
Cash flows from investing activities		
Purchases of investment securities held to maturity		(4,500)
Activity in securities available for sale:		
Purchases	(18,080)	(26,234)
Maturities, prepayments, and calls	6,645	6,796
Sales	23,044	23,008
Redemption (purchase) of nonmarketable equity securities, net	5	(79)
Redemption of bank-owned life insurance		229
Loan (originations) / principal collections, net	(21,755)	(2,329)
Proceeds from the sale of OREO		1,392
Purchases of premises and equipment	(22)	(1,402)
Proceeds from the sale of premises and equipment		5
Purchase of interest bearing deposits in banks		(493)
Maturity of interest bearing deposits in banks	490	
Net cash used by investing activities	(9,673)	(3,607)

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

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Consolidated Statements of Cash Flows (Continued)

Years ended December 31,

		2016		2015
		(in thousands)		
Cash flows from financing activities				
Net change in repurchase agreements and federal funds purchased	$	(55)	$	
Net change in deposits		5,486		1,726
Net change in short-term FHLB advances		2,415		
Repayment of long-term FHLB borrowings		(1,600)		(1,500)
Proceeds from stock options exercised				5
Net cash provided by financing activities		6,246		231
Net change in cash and cash equivalents		(1,690)		(943)
Cash and cash equivalents at beginning of year		2,489		3,432
Cash and cash equivalents at end of year	$	799	$	2,489
Supplemental Disclosures of Cash Flow Information:				
Cash paid during the year for interest	$	1,285	$	1,109
Cash paid during the year for income taxes		33		
Supplemental Disclosure of Noncash Activities:				
Loans transferred to held for sale	$		$	1,039

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

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

Solera National Bancorp, Inc. (the Holding Company) is a Delaware corporation that was incorporated to organize and serve as the holding company for Solera National Bank (the Bank), which opened for business in 2007. Solera National Bank is a full-service commercial bank headquartered in Lakewood. The entities collectively are referred to as the Company .

The Company offers a broad range of commercial and consumer banking services to small and medium-sized businesses, licensed professionals and individuals who are particularly responsive to the personalized service that Solera National Bank provides to its customers. The Company believes that local ownership and control allows the Bank to serve customers efficiently and effectively. Solera National Bank competes on the basis of providing a personalized banking experience combined with a broad range of services, customized and tailored to fit the individual needs of its clients. The Company remains focused on executing its strategy of delivering prudent and controlled growth to efficiently leverage the Company s capital while controlling its expense base to achieve sustained profitability.

The Company s ultimate objective is to create shareholder value through its recognition as the premier community bank in Colorado. We are committed to running a lean and efficient organization that can execute on business decisions quickly. Additionally, the Company believes in providing transparent financial reporting to our stakeholders through publication of quarterly earnings releases and annual audited financial statements. The Company s common stock is traded over-the-counter under the ticker symbol SLRK.

Since the Company operates in Colorado, the operating results are significantly influenced by economic conditions in Colorado, particularly the health of the real estate market. Additionally, the Company is subject to competition from other financial institutions and is impacted by fiscal and regulatory policies of the federal government as well as regulatory oversight by the Office of the Comptroller of the Currency, (the OCC) and the Federal Reserve Bank of Kansas City (the FRB).

Basis of Presentation and Consolidation

The accompanying consolidated financial statements include the accounts of Solera National Bancorp, Inc. and its wholly-owned subsidiary, Solera National Bank. All significant intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to the consolidated financial statements and related notes of prior periods to conform to the current presentation. These reclassifications had no impact on stockholders equity or net income for the periods. The accounting and reporting policies of the Company are in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) and prevailing practices within the banking industry.

Use of Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses and the fair value of financial instruments.

In connection with the determination of the allowance for loan losses, management obtains independent appraisals for significant properties and assesses estimated future cash flows from borrowers operations and the liquidation of loan collateral. Management believes that the allowance for loan losses and the valuation of other real estate owned, if any, are adequate. While management uses available information to recognize

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

losses on loans and other real estate owned, changes in economic conditions may necessitate revisions in future years.

Business Segments

The Company uses the management approach for reporting information about segments and has determined that during 2016 and 2015, its business was comprised of one operating segment: community banking.

Presentation of Cash Flows

For the purposes of reporting cash flows, cash and cash equivalents includes cash, balances due from banks and federal funds sold. Generally, federal funds are sold for one day periods. Cash flows from loans, deposits, and securities sold under agreements to repurchase and federal funds purchased are reported net. For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash, balances due from banks and federal funds sold.

The Company may maintain amounts due from banks, which exceed federally insured limits. The Company has not experienced nor does it anticipate any losses in such accounts.

Investment Securities

Securities are classified as held-to-maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Investments to be held for an indefinite amount of time, but not necessarily to maturity, are classified as available-for-sale and reported at fair value using Level 2 inputs. For these securities, the Company obtains fair value measurements from independent pricing services. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels,

trade execution data, market consensus prepayment speeds, credit information and the bonds terms and conditions, among other things. Unrealized gains and losses are reported as a separate component of accumulated other comprehensive income. Premiums or discounts are amortized or accreted into income using the interest method. Realized gains or losses are recorded using the specific identification method.

Investment securities are evaluated for impairment on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation to determine whether a decline in their value below amortized cost is other-than temporary. Securities are evaluated for impairment utilizing criteria such as the magnitude and duration of the decline, current market conditions, payment history, the credit worthiness of the obligor, the intent of the Company to retain the security or whether it is more likely than not that the Company will be required to sell the security before recovery of the value, as well as other qualitative factors. If a decline in value below amortized cost is determined to be other-than-temporary, which does not necessarily indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not favorable, the security is reviewed in more detail in order to determine the portion of the impairment that relates to credit (resulting in a charge to earnings) versus the portion of the impairment that is noncredit related (resulting in a charge to accumulated other comprehensive income). If it is more likely than not that sale of the security will be required prior to recovery of its amortized cost, the entire impairment is recognized in earnings equal to the difference between the amortized cost basis and the fair value. A credit loss is determined by comparing the amortized cost basis to the present value of cash flows expected to be collected, computed using the original yield as the discount rate.

Loans Held for Sale

Particular loans may be considered held for sale as of the Company s balance sheet date. From time to time, the Company sells SBA guaranteed loans and may designate select classified or nonaccrual loans as held for sale as part of the Company s strategy to dispose of non-earning assets. Once the decision to sell a loan has been made, the loan is designated held for sale and is carried at the lower of cost or fair value, with any required write-down being charged to earnings at the time of the reclassification.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Loan Commitments and Related Financial Instruments

In the ordinary course of business, the Company has entered into off-balance-sheet financial instruments consisting of commitments to extend credit, commercial letters of credit, and standby letters of credit as described in Note Q. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

Loans Held for Investment

Loans receivable that the Company has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding unpaid principal balances net of any deferred fees or costs, and reduced by any charge-offs and the allowance for loan losses.

Credit and loan decisions are made by management and the Board of Directors Credit Committee in conformity with established loan policies. The Company s practice is to charge-off any loan or portion of a loan when the loan is determined to be uncollectible due to the borrower s failure to meet repayment terms, the borrower s deteriorated financial condition, the depreciation of the underlying collateral, the loan s classification as a loss, or for other reasons.

The Company considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. Measurement of impairment is based on the expected future cash flows of an impaired loan, which are to be discounted at the loan s effective interest rate, or measured by reference to an observable market value, if one exists, or the fair value of the collateral for a collateral-dependent loan. The Company selects the measurement method on a loan-by-loan basis except that collateral-dependent loans for which foreclosure is probable are measured at the fair value of the collateral. The Company recognizes interest income on impaired loans based on its existing methods of recognizing interest income on nonaccrual loans (see Interest and Fees on Loans, below).

Troubled debt restructurings are loans for which concessions in terms have been made as a result of the borrower experiencing financial difficulty. Generally, concessions granted to customers include

lower interest rates and modification of the payment stream to lower or defer payments. Interest on troubled debt restructurings is accrued under the new terms if the loans are performing and full collection of principal and interest is expected. However, interest accruals are discontinued on troubled debt restructurings that meet the Company s nonaccrual criteria.

Generally, loans are charged off in whole or in part on a loan-by-loan basis after they become significantly past due and based upon management s review of the collectability of all or a portion of the loan unless the loan is in the process of restructuring. Charge off amounts are determined based upon the carrying amount of loans and the amount estimated to be collectible as determined by analyses of expected future cash flows and the liquidation of loan collateral.

Interest and Fees on Loans

Interest income is recognized daily in accordance with the terms of each note based on the outstanding principal balance. Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. Generally, the accrual of interest on loans is discontinued when principal or interest is 90 days past due based on the contractual terms of the loan or when, in the opinion of management, there is reasonable doubt as to collectability. When loans are placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period interest income. Income on nonaccrual loans is subsequently recognized only to the extent that cash is received and the Company s recorded investment in the loan (the customer s balance less any partial charge-offs) is deemed collectible. Interest accruals are resumed on such loans only when they are brought current and when, in the judgment of management, the loans are estimated to be fully collectible as to all interest and the Company s recorded investment.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Generally, for all classes of loans, loans are considered past due when contractual payments are delinquent by 30 days or more. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan using the effective interest method and without anticipating prepayments.

Provision and Allowance for Loan Losses

Implicit in the Company s lending activities is the fact that loan losses will be experienced and that the risk of loss will vary with the type of loans being made and the creditworthiness of the borrowers over the terms of the loans. The allowance for loan losses represents the Company s recognition of the risks of extending credit and its evaluation of the loan portfolio. The evaluation of the allowance is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. The allowance for loan losses is maintained at a level considered adequate to provide for probable loan losses based on management s assessment of various factors affecting the loan portfolio, including a review of problem loans, business conditions, historical loss experience, evaluation of the quality of the underlying collateral, and holding and disposal costs. The allowance for loan losses is increased by provisions charged to expense and reduced by loans charged-off, net of recoveries. Loan losses are charged against the allowance for loan losses when management believes the balance is uncollectible.

The Company has established a formal process for determining an adequate allowance for loan losses. The allowance for loan losses calculation has two components. The first component represents the allowance for loan losses for impaired loans; that is, loans where the Company believes collection of the contractual principal and interest payments is not probable. To determine this component of the calculation, impaired loans and leases are individually evaluated by either discounting the expected future cash flows or determining the fair value of the collateral, if repayment is expected solely from collateral. The fair value of the collateral is determined using internal analyses as well as third-party information, such as appraisals. That value, less estimated costs to sell, is compared to the recorded investment in the loan and any shortfall is charged-off. Unsecured loans and loans that are not collateral-dependent are evaluated by calculating the discounted cash flow of the payments expected over the life of the loan using the loan s effective interest rate and giving consideration to currently existing factors that would impact the amount or timing of the cash flows. The shortfall between the recorded investment in the loan and the discounted cash flows, or the fair value of the collateral less estimated costs to sell, represents the first component of the allowance for loan losses.

The second component of the allowance for loan losses represents contingent losses the estimated probable losses inherent within the portfolio due to uncertainties. To determine this component, management calculates an historical loss rate based on the Bank s actual loss rate over its history. Management then adjusts the loss rate for environmental factors which include, but are not limited to, 1) historical and current trends in downgraded loans; 2) the level of the allowance in relation to total loans; 3) the levels and trends in non-performing and past due loans; and 4) management s assessment of economic conditions and certain qualitative factors as defined by bank regulatory guidance, including but not limited to, changes in the size, composition and concentrations of the loan portfolio, changes in the legal and regulatory environment, and changes in lending management. The qualitative factors also consider the risk elements within each segment of the loan portfolio.

The risk of loss on any particular loan is primarily influenced by the difference between the expected and actual cash flows of the borrower and the type of collateral securing the loan. For real estate secured loans, conditions in the real estate markets as well as the general economy influence real estate values and may impact the Company s ability to recover its investment due to declines in the fair value of the underlying collateral. The risks in non-real estate secured loans include general economic conditions as well as interest rate changes.

Additionally, classified and criticized loans, which are closely monitored by management, are taken out of their original category for calculating their contingent loss rate and are assigned an appropriate loss rate. The aggregate of the above described segments represents the contingent losses in the loan portfolio.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

The recorded allowance for loan losses is the aggregate of the impaired loan component and the contingent loss component. The Company aggregates loans into five portfolio segments: Commercial Real Estate; Residential Real Estate; Commercial and Industrial; Construction and Land Development; and Consumer. These segments are based upon the loan s categorization in the Consolidated Report of Condition and Income, as set forth by banking regulators, (the Call Report). The methodology for estimating the allowance has not changed materially during the current or prior reporting period and is consistent across all portfolio segments and classes of loans.

At December 31, 2016, the Company had an allowance for loan losses of approximately $1.6 million. The Company believes that this is adequate to cover probable losses based on currently available information. Future additions to the allowance for loan losses may be required based on management s continuing evaluation of the inherent risks in the portfolio. Additional provisions for loan losses may be needed if the economy declines, asset quality deteriorates, or the loss experience changes.

Nonmarketable Equity Securities

The Bank is a member of the Federal Home Loan Bank of Topeka (FHLB) and the Federal Reserve Bank of Kansas City (FRB). In both banks, members are required to own a certain amount of stock. As such, the Bank owns stock in both the FHLB and FRB. Bank stocks are carried at cost, classified as restricted securities and periodically reviewed for impairment. Both cash and stock dividends are reported as income in the period declared.

Other Real Estate Owned

Other real estate owned represents real estate acquired through foreclosure or deed in lieu of foreclosure and is carried at its fair value less estimated costs to sell. Prior to foreclosure, the value of the underlying loan is written down to the fair market value of the real estate to be acquired by a charge to the allowance for loan losses, if necessary. Any subsequent write-downs are taken as a valuation allowance and charged to earnings as an operating expense. Operating income of such properties, net of related expenses, are included in other noninterest income. There was no other real estate owned as of December 31, 2016 or 2015.

Premises and Equipment

Land is carried at cost. Buildings, equipment and software are carried at cost less accumulated depreciation and amortization computed on the straight-line method over the estimated useful life of the asset. Building and leasehold improvements carry an estimated useful life of 39 years and equipment and software carry estimated useful lives ranging from one to seven years. Expenditures for leasehold improvements or major repairs are capitalized and those for ordinary repairs and maintenance are charged to noninterest expense when incurred.

Core Deposit Intangible

The Company s core deposit intangible includes the deposit premium paid and other transaction costs incurred in conjunction with the acquisition of customer deposits. Intangible assets are amortized over their estimated useful lives, using the straight-line method. Intangible assets are assessed for impairment at least quarterly, or when events or circumstances indicate a possible inability to realize the carrying amount. The core deposit intangible is included in Other Assets on the Company s Consolidated Balance Sheets and the amortization of the core deposit intangible is included in Other General and Administrative expenses on the Company s Consolidated Statements of Comprehensive Income.

Share-Based Compensation

The Company can grant stock options as incentive compensation to employees and directors. The cost of employee/director services received in exchange for an award of equity instruments is based on the grant-date fair value of the award, which is determined using a Black-Scholes-Merton model. This cost, net of estimated

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

forfeitures, is expensed to employee compensation and benefits over the period in which the recipient is required to provide services in exchange for the award, generally the vesting period.

Additionally, the Company can grant restricted stock awards. These stock awards may vest based on a performance or service condition. For awards that vest based on a service condition, the compensation expense is recognized over the service period based on the grant-date fair value of the award (as determined by the quoted market price on the date of grant). For awards that vest based on a performance condition, the expense is recognized based on the number of awards that are expected to vest based on then-current projections. Should these expectations change in future periods, additional expense could be recorded or expense previously recorded could be reversed. Prior to the vesting of stock awards, each restricted stock grantee shall have the rights of a stockholder with respect to voting and dividend rights of the granted stock.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Fair Value Measurement

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1 Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2 Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 Significant unobservable inputs that reflect a company s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Applicable Accounting Standards Updates

In January 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-01, *Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. Under the new standard, certain equity investments are required to be carried at fair value, with changes in fair value recognized in net income. This applies to equity investments with readily determinable fair values that are not consolidated or carried on the equity method. Debt securities classified as available-for-sale will continue to be carried at fair value with changes in fair value recorded through other comprehensive income. The standard also reduces or eliminates several financial reporting disclosure requirements.

The standard is effective for the Company beginning January 1, 2018. The provisions of the standard are not expected to have a significant impact to the consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)* (ASU 2016-02). ASU 2016-02 is intended to increase transparency and comparability among organizations by recognizing lease assets and liabilities on the balance sheet and disclosing key information about lease arrangements. For the Company, ASU 2016-02 is effective for the Company beginning January 1, 2019. The Company is still evaluating the effects of ASU 2016-02 on its financial statements, but given the Company s currently insignificant amount of operating leases, the provisions of ASU 2016-02 are not expected to have a significant impact on the Company s consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* (ASU 2016-13). The objective of ASU 2016-13 is to provide financial statement users with decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit. ASU 2016-13 includes provisions that require financial assets measured at amortized cost (such as loans and held to maturity (HTM) debt securities) to be presented at the net amount expected to be collected. This will be accomplished through recognition of an estimate of all current expected credit losses. The estimate will include forecasted information for the timeframe that an entity is able to develop reasonable and supportable forecasts. This is a change from the current practice of recognizing incurred losses based on the probable initial recognition threshold under current GAAP. In addition, credit losses on available for sale (AFS) debt securities will be recorded through an allowance for credit losses rather than as a write-down. Under ASU 2016-13, an entity will be able to record reversals of credit losses in current period income when the estimate of credit losses declines, whereas current GAAP prohibits reflecting those improvements in current period earnings.

ASU 2016-13 is effective for the Company beginning January 1, 2021, and early adoption is permitted for fiscal years, including interim periods, beginning January 1, 2019. ASU 2016-13 will be applied through a cumulative effect adjustment to retained earnings (modified-retrospective approach), except for debt securities for which an other-than-temporary impairment had been recognized before the effective date. A

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

prospective transition approach is required for these debt securities. The Company is currently evaluating the effects of ASU 2016-13 on its financial statements and disclosures, and expects ASU 2016-13 to add complexity and costs to its current credit loss evaluation process.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* (ASU 2016-15), regarding how certain cash receipts and cash payments are presented and classified in the statements of cash flows. ASU 2016-15 addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. The amendments of ASU 2016-15 are effective for the Company beginning January 1, 2018. Amendments in this ASU should be applied using a retrospective transition method to each period presented. The Company is evaluating the effects ASU 2016-15 will have on its financial statements and disclosures, and does not expect these effects to be material.

During 2016, and thus far in 2017, the FASB issued other ASU s which may impact banks or other entities but do not, or are not expected to, have a material impact on our financial position, results of operations or cash flows.

Income per Common Share

Basic earnings per common share (EPS) is based on the weighted-average number of common shares outstanding during the period. Diluted earnings per share is similar to basic EPS except that the weighted-average number of common shares outstanding is increased by the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued at the beginning of the period. When the Company s net operating results are a loss, all dilutive potential common shares are anti-dilutive so there is no difference between basic EPS and diluted EPS.

Income Taxes

Income taxes expense (benefit) is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred taxes relate primarily to differences between

the timing of recognizing tax expense for items such as start-up costs, the allowance for loan losses, unrealized gains or losses on securities available for sale and accumulated depreciation. The deferred tax assets and liabilities represent the future tax return consequences of those differences, which will be either taxable or deductible when the assets and liabilities are recovered or settled. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The Company recognizes interest and penalties, if any, in Other General and Administrative expense. There were no material interest or penalties recorded or accrued at December 31, 2016 or 2015. Similarly, as of December 31, 2016 and 2015, the Company has no uncertain income tax positions as defined in Accounting Standards Codification (ASC) 740, *Income Taxes*.

Comprehensive Income

For the years ended December 31, 2016 and 2015, the Company s comprehensive income included net income from operations and unrealized losses on investment securities, net of applicable taxes.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Dividend Restriction

Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Bank to the Holding Company or by the Holding Company to stockholders. With certain exceptions, the Company may not pay a dividend to its stockholders unless its retained earnings equal at least the amount of the proposed dividend.

Reclassifications

Certain reclassifications have been made to 2015 amounts to conform to the current year s presentation.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

NOTE B - SECURITIES

The Company owns bonds in corporations, state and local municipalities, residential agency mortgage-backed securities (MBS), residential agency collateralized mortgage obligations (CMOs) and bonds issued directly by the United States Government (U.S. Agency). The amortized cost and fair values of securities, with gross unrealized gains and losses, follows:

	December 31, 2016 (in thousands)			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities Available-for-Sale:				
Corporate	$ 10,220	$ 8	$ (279)	$ 9,949
State and municipal	9,679	11	(216)	9,474
Residential agency MBS and CMOs	15,911	36	(220)	15,727
U.S. agency	999		(16)	983
Total securities available-for-sale	$ 36,809	$ 55	$ (731)	$ 36,133
Securities Held-to-Maturity:				
Corporate	$ 4,500	$	$ (269)	$ 4,231
Total securities held-to-maturity	$ 4,500	$	$ (269)	$ 4,231

	December 31, 2015 (in thousands)			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities Available-for-Sale:				
Corporate	$ 6,683	$ 26	$ (185)	$ 6,524
State and municipal	13,710	31	(200)	13,541
Residential Agency MBS and CMOs	26,466	41	(215)	26,292
U.S. agency	2,016	1		2,017
Total securities available-for-sale	$ 48,875	$ 99	$ (600)	$ 48,374
Securities Held-to-Maturity:				
Corporate	$ 4,500	$ 8	$ (110)	$ 4,398
Total securities held-to-maturity	$ 4,500	$ 8	$ (110)	$ 4,398

The amortized cost and estimated fair value of investment securities by contractual maturity at December 31, 2016 are shown below.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
	(in thousands)			
Due in one year or less	$ 999	$ 1,002	$	$
Due after one year through five years	5,012	4,950		
Due after five years through ten years	11,893	11,620	2,750	2,585
Due after ten years	2,994	2,834	1,750	1,646
	20,898	20,406	4,500	4,231
Residential agency MBS and CMOs	15,911	15,727		
	$ 36,809	$ 36,133	$ 4,500	$ 4,231

The following tables show the estimated fair value and gross unrealized losses, aggregated by investment category and length of time the individual securities have been in a continuous loss position as of December 31, 2016 and 2015.

	December 31, 2016					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
	(in thousands)					
Securities Available-for-Sale						
Corporate	$ 7,040	$ (237)	$ 1,466	$ (42)	$ 8,506	$ (279)
State and municipal	6,937	(172)	551	(44)	7,488	(216)
Residential agency MBS and CMOs	8,274	(151)	4,601	(69)	12,875	(220)
U.S. Agency	983	(16)			983	(16)
Total temporarily-impaired	$ 23,234	$ (576)	$ 6,618	$ (155)	$ 29,852	$ (731)

	December 31, 2015					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
	(in thousands)					

Securities Available-for-Sale												
Corporate	$	2,932	$	(100)	$	2,778	$	(86)	$	5,710	$	(186)
State and municipal		7,428		(155)		2,015		(45)		9,443		(200)
Residential agency MBS and CMOs		14,478		(153)		4,948		(61)		19,426		(214)
U.S. Agency		1,014								1,014		
Total temporarily-impaired	$	25,852	$	(408)	$	9,741	$	(192)	$	35,593	$	(600)

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. At December 31, 2016, no declines were deemed to be other than temporary.

For the years ended December 31, 2016 and 2015, the Company received $23.0 million in proceeds from the sale of investment securities with gross realized gains of $159,000 and $199,000, respectively. Gross realized losses amounted to $2,000 and $13,000, respectively.

Securities with carrying values of $17.8 million and $21.0 million at December 31, 2016 and 2015, respectively, were pledged as collateral to secure public deposits, borrowings from the FHLB, repurchase agreements and for other purposes as required or permitted by law.

NOTE C LOANS HELD FOR SALE

There were no loans held for sale as of December 31, 2016. As of December 31, 2015, the Company had approximately $1.0 million in loans held for sale related to a single borrower whose commercial loans had been identified for sale to a third party and were carried at the lower of cost or fair value.

NOTE D LOANS AND ALLOWANCE FOR LOAN LOSSES

The following table sets forth the composition of the loan portfolio, excluding loans held for sale:

	December 31,	
	2016	2015
	(in thousands)	
Commercial real estate (CRE)	$ 49,806	$ 42,395
Residential real estate	28,767	26,080

Commercial and industrial		9,065		10,046
Construction and land development		3,110		3,571
Consumer and other		14,495		31
Subtotal		105,243		82,123
Less: Allowance for loan losses		(1,599)		(1,518)
Net deferred loan fees		(260)		(15)
Loans, net	$	103,384	$	80,590

The Company s loan portfolio generally consists of loans to borrowers within Colorado. Although the Company seeks to avoid concentrations of loans to a single industry or based upon a single class of collateral, the Company s loan portfolio consists primarily of loans secured by real estate located in Colorado, making the value of the portfolio more susceptible to declines in real estate values and other changes in economic conditions in Colorado. No single borrower can be approved for a loan over the Company s current legal lending limit of approximately $3.2 million. This regulatory requirement helps to ensure the Company s exposure to one individual customer is limited.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Activity in the allowance for loan and lease losses for the years ended December 31, 2016 and 2015 is summarized as follows:

Rollforward of Allowance for Loan and Lease Losses by Portfolio Segment
Twelve Months Ended December 31, 2016

(in thousands)	Commercial Real Estate	Residential Real Estate	Commercial and Industrial	Construction and Land Development	Consumer	Total
Balance at December 31, 2015	$ 866	$ 322	$ 206	$ 123	$ 1	$ 1,518
Provision for loan losses	84	(41)	7	(95)	45	
Charge-offs					(1)	(1)
Recoveries		35	3	44		82
Net (charge-offs) recoveries		35	3	44	(1)	81
Balance at December 31, 2016	$ 950	$ 316	$ 216	$ 72	$ 45	$ 1,599

Rollforward of Allowance for Loan and Lease Losses by Portfolio Segment
Twelve Months Ended December 31, 2015

(in thousands)	Commercial Real Estate	Residential Real Estate	Commercial and Industrial	Construction and Land Development	Consumer	Total
Balance at December 31, 2014	$ 926	$ 391	$ 187	$ 95	$ 1	$ 1,600
Provision for loan losses	(60)	(117)	136	(8)	(1)	(50)
Charge-offs			(117)			(117)
Recoveries		48		36	1	85
Net (charge-offs) recoveries		48	(117)	36	1	(32)
Balance at December 31, 2015	$ 866	$ 322	$ 206	$ 123	$ 1	$ 1,518

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Components of the allowance for loan and lease losses, and the related carrying amount of loans for which the allowance is determined, are as follows:

Loan and Allowance for Loan and Lease Losses by Portfolio Segment
December 31, 2016

(in thousands)	Commercial Real Estate	Residential Real Estate	Commercial and Industrial	Construction and Land Development	Consumer	Total
Loan Balance based on Evaluation of Impairment Method:						
Individually	$	$	$	$	$	$
Collectively	49,806	28,767	9,065	3,110	14,495	105,243
Total	$ 49,806	$ 28,767	$ 9,065	$ 3,110	$ 14,495	$ 105,243
Allowance for Loan Losses based on Evaluation of Impairment Method:						
Individually	$	$	$	$	$	$
Collectively	950	316	216	72	45	1,599
Total	$ 950	$ 316	$ 216	$ 72	$ 45	$ 1,599

Loan and Allowance for Loan and Lease Losses by Portfolio Segment
December 31, 2015

(in thousands)	Commercial Real Estate	Residential Real Estate	Commercial and Industrial	Construction and Land Development	Consumer	Total
Loan Balance based on Evaluation of Impairment Method:						
Individually	$	$	$	$	$	$
Collectively	42,395	26,080	10,046	3,571	31	82,123
Total	$ 42,395	$ 26,080	$ 10,046	$ 3,571	$ 31	$ 82,123
Allowance for Loan Losses based on Evaluation of Impairment Method:						
Individually	$	$	$	$	$	$

Collectively		866		322		206		123		1		1,518
Total	$	866	$	322	$	206	$	123	$	1	$	1,518

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Impaired Loans and Troubled Debt Restructurings

There were no impaired loans or troubled debt restructurings (TDRs) as of December 31, 2016. There was one impaired loan and no TDRs as of December 31, 2015. The impaired loan was a commercial and industrial loan with a recorded investment(1) of $131,000, and an unpaid principal balance of $147,000 as of December 31, 2015. The impaired loan had no valuation allowance at December 31, 2015, as the loan was held for sale at par value. No interest income was recognized during 2015 on this impaired loan.

No previously restructured loans subsequently defaulted and were charged-off during 2016 or 2015.

Past Due and Nonaccrual Loans

The following tables show past due loans, by class, as of December 31, 2016 and 2015:

Age Analysis of Loans by Class
Year Ended December 31, 2016

(in thousands)	30-59 Days Past Due	60-89 Days Past Due	Past Due 90 Days or More and Still Accruing	Nonaccrual	Total Past Due and Nonaccrual
CRE - owner occupied	$	$	$	$	$
CRE - non-owner occupied					
Commercial and industrial					
Residential real estate	74				74
Construction and land development					
Government guaranteed	1,220	727	3,595		5,542
Consumer					

Total	$	1,294	$	727	$	3,595	$		$	5,616

The increase in past due loans relates to the Company s purchase, in 2016, in a pool of government guaranteed rehabilitated student loans. Approximately 97.5% of the principal and interest is guaranteed by the full faith and credit of the United States Treasury under the Higher Education Act of 1965.

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(1) The recorded investment represents the customer balance less partial charge-offs, if any, and excluding any accrued interest receivable since most impaired loans are on nonaccrual status.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Age Analysis of Loans by Class
Year Ended December 31, 2015

(in thousands)	30-59 Days Past Due	60-89 Days Past Due	Past Due 90 Days or More and Still Accruing	Nonaccrual	Total Past Due and Nonaccrual
CRE - owner occupied	$	$	$	$	$
CRE - non-owner occupied					
Commercial and industrial		20			20
Residential real estate	112				112
Construction and land development					
Government guaranteed					
Consumer	1				1
Total	$ 113	$ 20	$	$	$ 133

The Company uses the following definitions for risk ratings, which are consistent with the definitions used in supervisory guidance and are the same for all classes of loans:

Special Mention: Loans in this category have potential weaknesses that deserve management s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment at some future date.

Substandard: Loans in this category are inadequately protected by the current sound worth and paying capacity of the borrower or of the collateral pledged, if any. These loans have well-defined weaknesses that jeopardize the liquidation of the debt and have the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful: Loans in this category have all the weaknesses inherent in those classified as substandard, above, with the added characteristic that the weaknesses make the collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

Loss: Loans in this category are deemed not collectible and are charged-off.

Loans not meeting any of the definitions above are considered to be pass rated loans.

As of December 31, 2016, and based on the most recent analysis performed during the month of December 2016, the recorded investment in each risk category of loans by class of loan is as follows:

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Credit Quality of Loans by Class
Year Ended December 31, 2016

(in thousands)	Pass	Special Mention	Substandard	Doubtful	Total
CRE - owner occupied	$ 15,674	$ 754	$ 3,048	$	$ 19,476
CRE - non-owner occupied	29,851		479		30,330
Commercial and industrial	6,527	410	628		7,565
Residential real estate	28,558		209		28,767
Construction and land development	3,110				3,110
Government guaranteed	15,968				15,968
Consumer	27				27
Total	$ 99,715	$ 1,164	$ 4,364	$	$ 105,243

As of December 31, 2015, and based on the analysis performed during the month of December 2015, the recorded investment in each risk category of loans by class of loan is as follows:

Credit Quality of Loans by Class
Year Ended December 31, 2015

(in thousands)	Pass	Special Mention	Substandard	Doubtful	Total
CRE - owner occupied	$ 20,391	$ 740	$ 2,093	$	$ 23,224
CRE - non-owner occupied	18,669	502			19,171
Commercial and industrial	7,978		307		8,285
Residential real estate	26,080				26,080
Construction and land development	3,571				3,571
Government guaranteed	1,761				1,761
Consumer	31				31
Total	$ 78,481	$ 1,242	$ 2,400	$	$ 82,123

NOTE E   NONMARKETABLE EQUITY SECURITIES

The Company, through its subsidiary bank, is a member of both the Federal Reserve Bank of Kansas City and the Federal Home Loan Bank of Topeka. Membership in these banks requires the Company to maintain an investment in the capital stock of each. These investments are restricted in that they can only be redeemed by the issuer at par value. The Company s investments at December 31, were as follows:

(in thousands)	**2016**	**2015**
Federal Reserve Bank of Kansas City	$ 599	$ 545
Federal Home Loan Bank of Topeka	280	329
	$ 879	$ 874

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

NOTE F BANK-OWNED LIFE INSURANCE

Bank-owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value. Increases in the cash surrender value are recognized as other noninterest income. In 2015, the Company received a one-time bank-owned life insurance benefit of $293,000.

NOTE G OTHER REAL ESTATE OWNED

The balance of other real estate owned as of December 31, 2016 and 2015 was $0. The Company did not record any operating income or expense for its OREO property in 2015, which was sold for $657,000 in early 2015.

NOTE H PREMISES AND EQUIPMENT

At December 31, premises and equipment, less accumulated depreciation consisted of the following:

(in thousands)	**2016**	**2015**
Land	$ 269	$ 269
Leasehold improvements	1,476	1,476
Furniture, fixtures and equipment	948	946
	2,693	2,691
Accumulated depreciation	(862)	(773)
Total premises and equipment	$ 1,831	$ 1,918

Depreciation expense on premises and equipment was $102,000 and $115,000 for the years ended December 31, 2016 and 2015, respectively, and is included in occupancy expense in the accompanying consolidated statements of comprehensive income. Rent expense on premises was approximately $12,000 for the year ended December 31, 2016. The Company reversed $11,000 of expense for the year ended December 31, 2015 due to adjustments in the abandoned lease calculation as subleases were secured for office space previously occupied by the Company s mortgage division.

The Company has noncancelable operating leases for one former mortgage production office that expires in February 2017 and a copier/printer/scanner that expires in 2020. The following table shows future minimum noncancelable operating lease payments as of December 31, 2016:

Year ending December 31,	**(in thousands)**	
2017	$	8
2018		3
2019		3
2020		2
2021		
Thereafter		
Total	$	16

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

NOTE I DEPOSITS

The aggregate amount of time deposits in denominations of $250,000 or more at December 31, 2016 and 2015 was $13.8 million and $12.5 million, respectively.

At December 31, 2016, the scheduled maturities of interest-bearing time deposits are as follows:

		2016 **(in thousands)**
2017		27,085
2018		15,258
2019		7,163
2020		12,491
2021		6,930
Thereafter		514
Total	$	69,441

Time deposits at December 31, 2016 included approximately $5.0 million in brokered deposits. The majority of this balance consisted of time deposits opened during 2016 that mature during 2017. There was $1.0 million in reciprocal time deposits included in brokered deposits at December 31, 2016. Time deposits at December 31, 2015 included approximately $5.5 million in brokered deposits. The majority of this balance consisted of time deposits opened during 2015 that matured during 2016. There were no reciprocal time deposits included in brokered deposits at December 31, 2015.

In 2013, the Company completed its acquisition of customer deposits, excluding certificates of deposit, and a nominal amount of overdraft lines of credit balances, totaling approximately $6.0 million, associated with deposit accounts from the Lakewood branch of Liberty Savings Bank, FSB. The Company paid a deposit premium of $468,000 based upon the average daily total deposits during the 30 calendar days immediately preceding the closing of the transaction. The deposit premium, as well as other transaction costs incurred, were capitalized as a core deposit intangible and are being amortized on a straight-line basis over a period of seven years. In 2016 and 2015, the Company recorded $67,000 in amortization expense. As of December 31, 2016 and 2015, the core deposit intangible is $228,000 and $295,000 and is included in Other Assets on the Company s Consolidated Balance Sheets. Quarterly, the Company evaluates the core deposit intangible for

impairment. As of December 31, 2016, no impairment has been noted.

NOTE J   FHLB ADVANCES

The Company is a member of the Federal Home Loan Bank of Topeka (FHLB) and, as a regular part of its business, obtains advances from this FHLB. Overnight advances bear interest at a variable rate while all other advances bear interest at a fixed rate. All advances are collateralized by certain securities pledged by the Company and some of the Company s qualifying loans. The Company s authorized borrowing line with the FHLB is capped at 40% of total assets, subject to the availability of sufficient collateral to pledge against such borrowings. As of December 31, 2016, the Company had $1.4 million in fixed-rate borrowings and $2.0 million in variable-rate, callable borrowings from the FHLB with varying maturity dates between November 2017 and October 2018 and a weighted-average effective interest rate of 1.05%. As of December 31, 2016, the contractual interest rates ranged from 0.70% to 1.81%. Additionally, the Company had $2.4 million in variable-rate, overnight borrowings at 0.72% as of December 31, 2016.

As of December 31, 2015, the Company had $3.0 million in fixed-rate borrowings and $2.0 million in variable-rate, callable borrowings from the FHLB with varying maturity dates between June 2016 and October 2018 and a weighted-average effective interest rate of 1.54%. The Company had no overnight borrowings from the FHLB as of December 31, 2015.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

In addition to FHLB borrowings, the Company may borrow overnight funds on an unsecured basis from its correspondent banks. As of December 31, 2016 and 2015, the Company had approved borrowing lines up to $13.1 million, from correspondent banks. As of both December 31, 2016 and 2015, there were no outstanding borrowings under these arrangements. The Company also has the ability to borrow at the Federal Reserve Bank Discount Window on a secured basis.

At December 31, 2016, the scheduled maturities and weighted-average effective interest rate of FHLB borrowings are as follows:

(in thousands)		Amount Maturing	Weighted-Average Interest Rate
Overnight	$	2,415	0.72%
2017		2,400	1.09%
2018		1,000	1.76%
Total	$	5,815	1.05%

NOTE K INCOME TAXES

A deferred tax asset or liability is recognized for the tax consequences of temporary differences in the recognition of revenue and expense for financial reporting and tax purposes. Listed below are the components of the net deferred tax asset at December 31:

		2016		2015
		(in thousands)		
Deferred tax assets:				
Start-up and organizational expenses	$	456	$	535
Net operating loss carryforward		1,054		1,325
Net unrealized loss on available-for-sale securities		250		186
Allowance for loan losses		399		411
Non-qualified stock options		14		80
Other		316		115
Total deferred tax assets		2,489		2,652

Deferred tax liabilities:				
Federal Home Loan Bank dividends		(6)		(21)
Other				(99)
Total deferred tax liabilities		(6)		(120)
Valuation reserve				(2,532)
Net deferred tax asset (liability)	$	2,483	$	

During the twelve months ended December 31, 2016, the Company reversed the valuation allowance on its deferred tax asset. Realization of deferred tax assets is dependent upon the generation of sufficient future taxable income during the period that deductible temporary differences and carryforwards are expected to be available to reduce taxable income. After nine consecutive quarters of earnings, the Company believes it is more likely than not that the Company will generate sufficient taxable income to utilize the $2.5 million net deferred tax asset.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

During the period ended December 31, 2015, the Company had a full valuation allowance reducing its $2.5 million net deferred tax asset to $0. The valuation allowance was established because the Company had not reported earnings sufficient enough to support the recognition of the deferred tax assets.

The Company has net operating loss carryforwards of approximately $2.8 million for federal income tax purposes. Federal and state net operating loss carryforwards, to the extent not used, will expire starting in 2027. The Company is no longer subject to examination by Federal and State taxing authorities for years before 2013.

The income tax provision differs from the amount of income tax determined by applying the U.S. federal income tax rate of 34% to pretax income from continuing operations for the years ended December 31, 2016 and 2015, due to the following:

	Year ended December 31,			
	2016		2015	
	(in thousands)			
Computed expected tax expense	$	312	$	605
Change in income taxes resulting from:				
Change in valuation allowance		(2,596)		(702)
Other		75		97
Income tax provision (benefit)	$	(2,209)	$	

NOTE L - EMPLOYEE BENEFIT PLANS

The Company sponsors a Qualified Automatic Contribution Arrangement (QACA) 401(k) Plan whereby the Company contributes three percent of an employee s compensation to the Plan. Employer contributions cliff-vest after two years of service. Employees may also make volunteer contributions to the Plan, subject to certain limits based on federal tax laws. The employee s contributions vest immediately. For the years ended December 31, 2016 and 2015, expense attributable to the Plan amounted to $4,000 and $25,000, respectively. The decrease in expense in 2016 is attributed to the utilization of Plan forfeitures to offset the Company s current year contributions.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

NOTE M STOCK-BASED COMPENSATION

In 2012, the Board of Directors adopted the Company s 2012 Long-Term Incentive Plan, (the 2012 Plan). Under the terms of the 2012 Plan, the Company may grant incentive stock options, nonqualified stock options, restricted stock awards, and/or stock appreciation rights to eligible persons, including officers and directors of the Company. The 2012 Plan does not terminate or amend the Company s 2007 Stock Incentive Plan (the 2007 Plan). The 2012 Plan reserves 250,000 shares of common stock of the Company for issuance. At December 31, 2016 and 2015, approximately 242,000 and 246,000 shares, respectively, were available for future grants. Stock options expire no later than 10 years from the date of the grant and generally vest over 4 years. The 2012 Plan provides for accelerated vesting if there is a change of control, as defined in the 2012 Plan.

Under the terms of the Company s 2007 Plan, employees may be granted both nonqualified and incentive stock options and directors and other consultants, who are not also officers or employees, may only be granted nonqualified stock options. The Board reserved 510,734 shares of common stock for issuance under the 2007 Plan. At December 31, 2016, approximately 99,000 shares were available for future grants. The 2007 Plan provides for options to purchase shares of common stock at a price not less than 100% of the fair market value of the stock on the date of grant. Stock options expire no later than 10 years from the date of the grant and generally vest over 5 years. The 2007 Plan provides for accelerated vesting if there is a change of control, as defined in the 2007 Plan.

The Company recognized stock-based compensation costs of approximately $33,000 during 2016, compared to $12,000 during 2015.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes-Merton option pricing model. As of December 31, 2016, there was approximately $98,000 of unrecognized compensation costs related to outstanding stock options that will be recognized over a weighted-average period of 2.4 years.

There were no options granted during 2016. The fair value of the 2015 stock option grants was estimated on the date of grant using the Black-Scholes-Merton option pricing model with the assumptions presented in the following table:

	2015 Nonqualified Grants
Number of Options Granted	250,000
Expected Volatility	22.7%
Expected Term	4.2 - 6.0 years
Expected Dividend	0%
Risk-Free Rate	1.42% - 1.80%
Grant-Date Fair Value	$0.71 - $1.01

The expected volatility is based on the volatility of the Company s stock using historical activity. The expected term represents the estimated average period of time that the options will remain outstanding. The expected dividend is set to zero since the Company does not expect to pay dividends in the foreseeable future. The risk-free rate of return reflects the grant-date interest rate offered for zero coupon U.S. Treasury bonds with the same expected term as the options. The Company s estimated forfeiture rate is 36% for executive officers and 41% for employees. The different ranges result from certain groups of individuals exhibiting different behavior. The estimated forfeiture rate is reviewed at each reporting date to confirm that it is the best estimate to support the then-current trends within the Company. Options forfeited impact the amount of compensation expense recognized. Share-based compensation expense is based on awards that are ultimately

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

expected to vest; accordingly, share-based compensation expense may be impacted if actual forfeitures differ from estimated forfeitures.

As of December 31, 2016 and 2015, the aggregate intrinsic value of in-the-money outstanding stock options was approximately $18,000 and $11,000, respectively. As of December 31, 2016, there were approximately 62,000 fully-vested and exercisable stock options outstanding with a weighted-average exercise price of $6.93 per share, a weighted-average remaining contractual term of 3.5 years. As of December 31, 2016, there were 42,000 options expected to vest over the next 12 months.

The following is a summary of the Company s outstanding stock options and related activity for the year ended December 31, 2016:

	Options	Weighted-Average Grant Date Fair Value	Weighted-Average Exercise Price
Outstanding at January 1, 2016	270,750	$ 0.83	$ 6.98
Granted			
Exercised			
Expired	(562)	1.86	7.15
Forfeited	(188)	1.86	7.15
Outstanding at December 31, 2016	270,000	$ 0.83	$ 6.98

The following is a summary of the Company s outstanding stock options and related activity for the year ended December 31, 2015:

	Options	Weighted-Average Grant Date Fair Value	Weighted-Average Exercise Price
Outstanding at January 1, 2015	90,362	$ 2.18	$ 8.29

Granted	250,000		0.76		7.00
Exercised	(1,416)		0.63		3.24
Expired	(67,014)		2.37		8.90
Forfeited	(1,182)		1.43		5.88
Outstanding at December 31, 2015	270,750	$	0.83	$	6.98

Restricted Stock

During 2015, the Company granted 4,750 performance-based restricted shares to its outside Directors. The fair value of these grants equaled the value of the Company s stock on the date of grant which ranged between $6.00 and $6.20 per share. As of December 31, 2016, 2,750 shares are expected to meet the performance criteria and vest in June 2017.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

The Company recognized approximately $6,000 and $0 of stock-based compensation expense associated with stock awards for the year ended December 31, 2016 and December 31, 2015, respectively. As of December 31, 2016, there was approximately $7,000 of unrecorded compensation expense associated with restricted stock grants to be recognized in 2017. The entire 4,750 restricted stock awards are considered issued and outstanding as they have voting and dividend rights; however, since none of those shares are vested they are excluded from the computation of earnings per share.

A summary of the status of unearned stock awards and the change during the period is presented in the table below:

	Shares	Weighted-Average Fair Value on Award Date
Unearned at January 1, 2016		$
Awarded	4,750	6.03
Forfeited		
Vested		
Unearned at December 31, 2016	4,750	$ 6.03

NOTE N   WARRANTS

In recognition of the substantial financial risks undertaken by the members of the organizing group, the Company granted an aggregate of 317,335 warrants to its organizers and one non-organizer director. These warrants are exercisable at a price of $10.00 per share, subject to an effective registration statement, and may be exercised any time prior to September 10, 2017.

	Warrants Outstanding and Exercisable			
Type	**Exercise Price**	**Number**	**Weighted Average Remaining Contractual Life**	**Weighted Average Exercise Price**

Organizer warrants	$	10.00	317,335	0.75	$	10.00

Organizer warrants to purchase fractional shares were not issued. Instead, rounding down to the next whole number was used in calculating the number of warrants issued to any stockholder. Holders of warrants will be able to profit from any rise in the market price of the Company s common stock over the exercise price of the warrants because they will be able to purchase shares of the Company s common stock at a price that is less than the then-current market value. If the Bank s capital falls below the minimum level required by the OCC, management may be directed to require the holders to exercise or forfeit their warrants.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

NOTE O EARNINGS PER SHARE

The following table presents the net earnings and weighted average common shares outstanding used to calculate earnings per share for the years ended December 31, 2016 and 2015:

		2016		2015
Basic earnings per share computation				
Net earnings to common stockholders	$	3,126,582	$	1,778,199
Weighted average shares outstanding - basic		2,723,062		2,722,473
Basic earnings per share	$	1.15	$	0.65
Diluted earnings share computation				
Net earnings to common stockholders	$	3,126,582	$	1,778,199
Weighted average shares outstanding - basic		2,723,062		2,722,473
Shares assumed issued:				
Stock options		2,985		2,019
Unvested restricted stock				
Organizer stock warrants				
Weighted average shares outstanding - diluted		2,726,047		2,724,492
Diluted earnings per share	$	1.15	$	0.65

For the years ended December 31, 2016 and 2015, respectively, approximately 77,000 and 107,000 anti-dilutive options were not included in the calculation of diluted EPS. Additionally, approximately 217,000 and 281,000, organizer warrants were not included in the calculation of diluted EPS for the years ended December 31, 2016 and 2015, respectively, as their exercise prices were above the market price of the stock making them anti-dilutive.

As of December 31, 2016 and 2015, respectively, 4,750 and 25,000 unvested restricted stock awards were not included in the weighted average shares outstanding for the computation of basic earnings per share as they are only considered issued and outstanding due to their voting and dividend rights.

F-33

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

NOTE P RELATED PARTY TRANSACTIONS

In the ordinary course of business, the Company may grant loans to or hold deposits of principal officers, directors and/or their affiliates. The following details the related party loan and deposit balances as of December 31:

	2016	2015
	(in thousands)	
Loans to principal officers, directors and/or their affiliates	$	$ 37
Deposits from related parties	854	252

NOTE Q COMMITMENTS AND CONTINGENCIES

The Company is a party to credit related financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The Company s exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance-sheet instruments.

At December 31, 2016 and 2015, the Company had $15.1 million and $16.2 million, respectively, in unfunded commitments outstanding whose contract amounts represent credit risk.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the commitments do not necessarily represent future cash requirements. The Company evaluates each customer s creditworthiness on a case-by-case

basis. The amount of collateral obtained is based on management s credit evaluation. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment and income producing commercial properties.

NOTE R LEGAL CONTINGENCIES

In the ordinary course of the business, the Company may be party to various legal actions, which it believes are incidental to the operation of the business and will not have a material impact on the financial condition, cash flow, or results of operations of the Company.

During 2016, the Company was involved in a legal proceeding. On August 20, 2015, the Company s former Chief Executive Officer, Mr. John Carmichael, filed a lawsuit against the Company in the District Court of Jefferson County, Colorado seeking approximately $430,000 in salary compensation, 10,000 shares of common stock and stock options relating to 30,000 shares of common stock. The case went to trial in September 2016. The jury awarded Mr. Carmichael approximately $515,000 as salary and interest due by the Company for breach of contract. This cost, as well as the $138,000 in legal fees incurred were recorded to expense in 2016.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

NOTE S NONINTEREST EXPENSE

The following table details the items comprising other general and administrative expenses:

(in thousands)	Year Ended December 31, 2016	2015	Increase/ (Decrease)
Other general and administrative expenses:			
Data processing	$ 515	$ 524	$ (9)
Other loan expenses	57	86	(29)
Marketing and promotions	13	17	(4)
Regulatory and reporting fees	127	115	12
FDIC assessment	133	159	(26)
Telephone/communication	21	26	(5)
Travel and entertainment	9	8	1
Printing, stationary and supplies	23	28	(5)
Training, education and conferences	16	11	5
Insurance	68	70	(2)
Dues and memberships	10	9	1
Core deposit intangible amortization	67	67	
Postage and shipping	8	10	(2)
ATM and debit card fees	18	20	(2)
Franchise taxes	29	24	5
Operating losses / legal settlements	531	52	479
Miscellaneous other	6	9	(3)
Total	$ 1,651	$ 1,235	$ 416

The increase in operating losses/legal settlements primarily relates to the loss contingency recorded in 2016. See Note R for more details.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

NOTE T FAIR VALUE MEASUREMENTS

The Company carries its available-for-sale securities, at fair value measured on a recurring basis. Fair value measurements are determined based on the assumptions the market participants would use in pricing the asset. See additional discussion regarding fair value measurement in Note A under the discussion of significant accounting policies.

For available-for-sale securities, fair value measurement is obtained from independent pricing services which utilize observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bonds terms and conditions, among other things. As of December 31, 2016 and 2015, all of the Company s available-for-sale securities were valued using Level 2 inputs.

Impaired loans, if any, are evaluated and valued at the time the loan is identified as impaired, at the lower of cost or fair value. Fair value is measured based on the value of the collateral securing these loans or the present value of expected cash flows and is classified as Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable and is determined based on appraisals performed by qualified licensed appraisers hired by the Company. Appraised and reported values may be adjusted based on management s historical knowledge, changes in market conditions from the time of valuation, and/or management s expertise and knowledge of the client and client s business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. Impaired loans, if any, are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly.

Other real estate owned, if any, is valued at the time the loan is foreclosed upon and the asset is transferred to other real estate owned. The value is based primarily on third party appraisals, less costs to sell. The appraisals may be adjusted based on management s historical knowledge, changes in market conditions from the time of valuation, and/or management s expertise and knowledge of the client and client s business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. Other real estate owned, if any, is reviewed and evaluated on at least an annual basis for additional impairment and adjusted accordingly.

There were no changes to management s valuation methodology during 2016 or 2015.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Assets and Liabilities Measured on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis are summarized below:

(in thousands)	Level 1	Level 2	Level 3	Total
Assets at December 31, 2016				
Securities available for sale				
Corporate	$	$ 9,949	$	$ 9,949
State and municipal		9,474		9,474
Residential agency MBS/CMOs		15,727		15,727
U.S. Agency		983		983
Assets at December 31, 2015				
Securities available for sale				
Corporate	$	$ 6,524	$	$ 6,524
State and municipal		13,541		13,541
Residential agency MBS/CMOs		26,293		26,293
U.S. Agency		2,016		2,016

Assets and Liabilities Measured on a Nonrecurring Basis

The Company had no assets and liabilities that were measured at fair value on a nonrecurring basis as of December 31, 2016 and 2015. Specifically, the Company had no impaired loans or other real estate owned as of December 31, 2016 and 2015.

Fair Value of Financial Instruments

Disclosure of fair value information about financial instruments, whether or not recognized in the consolidated balance sheets, for which it is practicable to estimate such value is required by U.S. GAAP. Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. Because no market value exists for a significant portion of the financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature, involve uncertainties and matters of judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value information is not required to be disclosed for certain financial instruments and all nonfinancial instruments. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the financial instruments held by the Company. Fair value estimates are based on financial instruments both on and off the balance sheet without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Additionally, tax consequences related to the realization of the unrealized gains and losses can have a potential effect on fair value estimates and have not been considered in many of the estimates.

The following methods and assumptions were used to estimate the fair value of significant financial instruments:

Cash and cash equivalents: The carrying amounts of cash, due from banks and federal funds sold approximate their fair values.

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Interest-bearing deposits with banks: The carrying amount of interest-bearing deposits with banks is estimated using a discounted cash flow calculation that applies interest rates currently being offered for deposits of similar remaining maturities.

Investment securities: Fair value measurement is obtained from independent pricing services which utilize observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bonds terms and conditions, among other things.

Loans held for sale: Loans held for sale are carried at the lower of cost or fair value. As of December 31, 2015, the value of loans held for sale approximated their fair value.

Loans, net: The fair value of fixed rate loans is estimated by discounting the future cash flows using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are estimated to be equivalent to carrying values. Variable rate loans that are currently priced at their contractual floor or ceiling, and thus similar to fixed rate loans, are reviewed to determine the interest rate that would be currently offered on similar credits. If the current floor/ceiling rate is equivalent to current market rates, fair value is estimated to be equivalent to carrying value. If the current market rates differ from the loan s current rate, the contractual cash flows are discounted using the current market rate to derive the loan s estimated fair value. Both the estimated fair value and the carrying value have been reduced by specific and general reserves for loan losses.

Nonmarketable equity securities: It is not practical to determine the fair value of bank stocks due to the restrictions placed on the transferability of FHLB stock and

Federal Reserve Bank stock.

Bank-owned life insurance: The carrying amount of bank-owned life insurance is based on the cash surrender value of the policies which is a reasonable estimate of fair value.

Accrued interest receivable: The carrying value of interest receivable approximates fair value due to the short period of time between accrual and receipt of payment.

Deposits: The fair value of noninterest-bearing demand deposits, interest-bearing demand deposits and savings and money market accounts is determined to be the amount payable on demand at the reporting date. The fair value of fixed rate time deposits is estimated using a discounted cash flow calculation that applies interest rates currently being offered for deposits of similar remaining maturities. Carrying value is assumed to approximate fair value for all variable rate time deposits.

Securities sold under agreements to repurchase: The carrying amount of securities sold under agreements to repurchase approximates fair value due to the short-term nature of these agreements, which generally mature within one to four days from the transaction date. Securities sold under agreement to repurchase are included in accounts payable and other liabilities on the Company s Consolidated Balance Sheets.

Federal Home Loan Bank advances: Fair value of fixed rate FHLB advances are estimated using a discounted cash flow model based on current market rates for similar types of borrowing arrangements including similar remaining maturities. The fair value of variable rate FHLB advances is assumed to approximate the carrying value.

Accrued interest payable: The carrying value of interest payable approximates fair value due to the short period of time between accrual and payment.

Loan commitments and letters of credit: The fair values of commitments are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. The difference between the carrying value of commitments to

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

fund loans or standby letters of credit and their fair values are not significant and, therefore, are not included in the following table.

The carrying amounts and estimated fair values of financial instruments are summarized as follows:

	2016		2015	
(in thousands)	**Carrying Value**	**Fair Value**	**Carrying Value**	**Fair Value**
Financial Assets:				
Cash and cash equivalents	$ 799	$ 799	$ 2,489	$ 2,489
Interest-bearing deposits with banks	261	273	750	765
Investment securities, available for sale	36,133	36,133	48,374	48,374
Investment securities, held to maturity	4,500	4,231	4,500	4,398
Loans held for sale			1,039	1,039
Loans, net	103,384	106,673	80,590	83,094
Nonmarketable equity securities	879	879	874	874
Bank-owned life insurance	4,495	4,495	4,369	4,369
Accrued interest receivable	798	798	571	571
Financial Liabilities:				
Deposits - demand, savings, and money market	$ 56,884	$ 56,884	$ 54,679	$ 54,679
Time deposits	69,441	70,062	66,160	66,383
Securities sold under agreements to repurchase			55	55
FHLB advances	5,815	5,808	5,000	4,987
Accrued interest payable	103	103	88	88

NOTE U REGULATORY MATTERS

Banks and bank holding companies are subject to various regulatory capital requirements administered by state and federal banking agencies. Capital adequacy guidelines, and additionally

for banks prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting and other factors.

The Basel III Capital Rules became effective for the Bank on January 1, 2015 subject to a phase-in for certain provisions. Quantitative measures established by the Basel III Capital Rules to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the table below) of common equity tier 1 capital, tier 1 capital and total capital (as defined in the regulations) to risk-weighted assets (as defined), and of tier 1 capital to quarterly average assets (as defined).

At December 31, 2016, the Bank s regulatory capital is comprised of the following: 1) Common equity tier 1 capital consisting of common stock and related paid-in-capital, and retained earnings; 2) Additional tier 1 capital there are no components of tier 1 capital beyond common equity tier 1 capital; 3) Tier 2 capital consisting of a permissible portion of the allowance for loan losses; and 4) total capital the aggregate of all tier 1 and tier 2 capital. In connection with the adoption of the Basel III Capital Rules, the Bank elected to opt-out of the requirement to include most components of accumulated other comprehensive income in common equity tier 1 capital. At December 31, 2015, the Bank s regulatory capital is comprised of the same components as at December 31, 2016, except that the regulations in effect at that time did not distinguish between common equity tier 1 and additional tier 1 capital.

When fully phased in on January 1, 2019, the Basel III capital rules will require the Bank to maintain a minimum ratio of common equity tier 1 capital to risk-weighted assets of at least 4.5%, plus a 2.5% capital

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

conservation buffer (which is added to the 4.5% common equity tier 1 capital ratio as the buffer is phased in, effectively resulting in a minimum ratio of common equity tier 1 capital to risk-weighted assets of 7% upon full phase in). The Bank will also be required to maintain a tier 1 capital to risk-weighted assets ratio of 8.0% (10.5% including the capital conservation buffer), and a tier 1 capital to quarterly average assets ratio of 4.0%.

The aforementioned capital conservation buffer phases in at 0.625% annually over a four year period beginning January 1, 2016, and is designed to absorb losses during periods of economic stress. Banking institutions with capital ratios above the base minimums but below the effective minimums (which include the buffer) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

The following tables present actual and required capital ratios as of December 31, 2016 and 2015 for the Bank under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of December 31, 2016 based on the phase-in provisions of the Basel III Capital Rules and the minimum required capital levels as of January 1, 2019 when the Basel III Capital Rules have been fully phased-in, and include the capital conservation buffer. Capital levels required to be considered well capitalized are based on prompt corrective action regulations, as amended to reflect changes under the Basel III Capital Rules.

	December 31, 2016			
	Risk-based			Leverage
	Tier 1	Common Equity Tier 1	Total capital	Tier 1
	(in thousands)			
Actual regulatory capital	$ 20,968	$ 20,968	$ 22,372	$ 20,968
Well-capitalized requirement	8,951	7,273	11,189	7,805
Excess regulatory capital	$ 12,017	$ 13,695	$ 11,183	$ 13,163
Capital ratios	18.7%	18.7%	20.0%	14.0%
Well-capitalized requirement	8.0%	6.5%	10.0%	5.0%
Minimum required for capital adequacy, purposes - Basel III phased-in schedule	7.3%	5.7%	9.3%	4.0%
Minimum required for capital adequacy, purposes - Basel III fully	8.5%	7.0%	10.5%	4.0%

phased-in

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

	December 31, 2015			
	Risk-based			Leverage
	Tier 1	Common Equity Tier 1	Total capital	Tier 1
	(in thousands)			
Actual regulatory capital	$ 18,557	$ 18,557	$ 19,797	$ 18,557
Well-capitalized requirement	5,937	6,431	9,894	7,033
Excess regulatory capital	$ 12,620	$ 12,620	$ 9,903	$ 11,524
Capital ratios	18.8%	18.8%	20.0%	13.2%
Well-capitalized requirement	8.0%	6.5%	10.0%	5.0%
Minimum required for capital adequacy, purposes - Basel III phased-in schedule	6.6%	5.1%	8.6%	4.0%
Minimum required for capital adequacy, purposes - Basel III fully phased-in	8.5%	7.0%	10.5%	4.0%

Capital adequacy ratios are not presented on a consolidated basis, as they are only applicable for bank holding companies with consolidated assets of $500 million or more, or for those bank holding companies that are engaged in significant nonbanking activities.

The Bank is restricted as to the amount of dividends which can be paid. Dividends declared by national banks that exceed net income (as defined by OCC regulations) for the current year plus retained net income for the preceding two years must be approved by the OCC. Also, the Bank may not pay dividends until it has received a prior written determination of no supervisory objection from the Assistant Deputy Comptroller of the Western District of the OCC.

With certain exceptions, the Company may not pay a dividend to its stockholders unless its retained earnings equal at least the amount of the proposed dividend.

NOTE V   SUBSEQUENT EVENTS

Management evaluates events occurring subsequent to the balance sheet date, through the date the financial statements are eligible to be issued, to determine whether the events require recognition or disclosure in the financial statements. If a subsequent event evidences conditions existing at the balance sheet date, the effects are recognized in the financial statements (recognized subsequent event). If a subsequent event evidences conditions arising after the balance sheet date, the effects are not recognized in the financial statements but rather disclosed in the notes to the financial statements (non-recognized subsequent events). The effects of subsequent events are only recognized if material, or disclosed if the financial statements would otherwise be misleading.

With respect to the December 31, 2016 financial statements, management has considered subsequent events through March 22, 2017 and determined there are no recognized subsequent events.

Table of Contents

Supplemental Consolidating Schedules

December 31, 2016 and 2015

SOLERA NATIONAL BANCORP, INC.

AND SUBSIDIARY

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Consolidating Balance Sheet

December 31, 2016

(in thousands)	Solera National Bank	Solera National Bancorp, Inc.	Consolidating Entries	Consolidated
ASSETS				
Cash and cash equivalents	$ 799	$ 1,532	$ (1,532)	$ 799
Interest-bearing deposits with banks	261			261
Investment securities, available-for-sale	36,133			36,133
Investment securities, held-to-maturity	4,500			4,500
Loans held for sale				
Loans, net	103,384			103,384
Nonmarketable equity securities	879			879
Investment in subsidiary		21,357	(21,357)	
Bank-owned life insurance	4,495			4,495
Premises and equipment, net	1,831			1,831
Accrued interest receivable	798			798
Deferred tax asset, net	2,008	475		2,483
Other assets	540	(12)		528
Total Assets	155,628	23,352	(22,889)	156,091
LIABILITIES AND STOCKHOLDERS EQUITY				
Liabilities				
Deposits				
Noninterest-bearing demand	5,941			5,941
Interest-bearing demand	8,374			8,374
Savings and money market	44,101		(1,532)	42,569
Time deposits	69,441			69,441
Total deposits	127,857		(1,532)	126,325
Accrued interest payable	103			103
Accrued payable and other liabilities	496	280		776
FHLB advances	5,815			5,815
Total liabilities	134,271	280	(1,532)	133,019
Stockholders equity				
Common stock	10,500	27	(10,500)	27
Additional paid-in capital	11,594	27,170	(11,594)	27,170
Accumulated deficit	(311)	(3,543)	311	(3,543)
Accumulated other comprehensive loss	(426)	(426)	426	(426)
		(156)		(156)

Treasury stock, at cost, 25,776 shares							
Total stockholders equity		21,357		23,072		(21,357)	23,072
Total Liabilities & Stockholders Equity	$	155,628	$	23,352	$	(22,889) $	156,091

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Consolidating Statement of Income

Year Ended December 31, 2016

(in thousands)	Solera National Bank	Solera National Bancorp, Inc.	Consolidating Entries	Consolidated
Interest income				
Interest and fees on loans	$ 4,384	$	$	$ 4,384
Interest on loans held for sale				
Interest on investment securities	1,037			1,037
Dividends on FHLB and FRB stocks	45			45
Other interest income	11	2	(2)	11
Total interest income	5,477	2	(2)	5,477
Interest expense				
Deposits	1,229		(2)	1,227
FHLB advances	73			73
Total interest expense	1,302		(2)	1,300
Net interest income before provision	4,175	2		4,177
Provision for loan losses				
Net interest income	4,175	2		4,177
Noninterest income				
Service charges and fees	102			102
Other income	138			138
Equity in undistributed earnings of subsidiary		3,081	(3,081)	
Gain on loans sold	125			125
Gain on sale of available-for-sale securities, net	157			157
Total noninterest income	522	3,081	(3,081)	522
Noninterest expense				
Employee compensation and benefits	1,611	6		1,617
Occupancy and equipment	233			233
Professional fees	147	133		280
Other general and administrative	1,359	292		1,651
Total noninterest expense	3,350	431		3,781
Income before income taxes	1,347	2,652	(3,081)	918
Income tax benefit	(1,734)	(475)		(2,209)
Net income	$ 3,081	$ 3,127	$ (3,081)	$ 3,127

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Consolidating Balance Sheet

December 31, 2015

(in thousands)	Solera National Bank	Solera National Bancorp, Inc.	Consolidating Entries	Consolidated
ASSETS				
Cash and cash equivalents	$ 2,489	$ 1,689	$ (1,689)	$ 2,489
Interest-bearing deposits with banks	750			750
Investment securities, available-for-sale	48,374			48,374
Investment securities, held-to-maturity	4,500			4,500
Loans held for sale	1,039			1,039
Loans, net	80,590			80,590
Nonmarketable equity securities	874			874
Investment in subsidiary		18,174	(18,174)	
Bank-owned life insurance	4,369			4,369
Premises and equipment, net	1,918			1,918
Accrued interest receivable	571			571
Deferred tax asset, net				
Other assets	620	(21)		599
Total Assets	146,094	19,842	(19,863)	146,073
LIABILITIES AND STOCKHOLDERS EQUITY				
Liabilities				
Deposits				
Noninterest-bearing demand	3,954			3,954
Interest-bearing demand	8,405			8,405
Savings and money market	44,009		(1,689)	42,320
Time deposits	66,160			66,160
Total deposits	122,528		(1,689)	120,839
Accrued interest payable	88			88
Accrued payable and other liabilities	304	5		309
FHLB advances	5,000			5,000
Total liabilities	127,920	5	(1,689)	126,236
Stockholders equity				
Common stock	10,500	27	(10,500)	27
Additional paid-in capital	11,566	27,137	(11,566)	27,137
Accumulated deficit	(3,391)	(6,670)	3,391	(6,670)
Accumulated other comprehensive loss	(501)	(501)	501	(501)
		(156)		(156)

Treasury stock, at cost, 14,208 shares							
Total stockholders equity		18,174		19,837		(18,174)	19,837
Total Liabilities & Stockholders Equity	$	146,094	$	19,842	$	(19,863) $	146,073

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Consolidating Statement of Income

Year Ended December 31, 2015

(in thousands)	Solera National Bank	Solera National Bancorp, Inc.	Consolidating Entries	Consolidated
Interest income				
Interest and fees on loans	$ 4,237	$	$	$ 4,237
Interest on loans held for sale				
Interest on investment securities	1,044			1,044
Dividends on FHLB and FRB stocks	46			46
Other interest income	15	2	(2)	15
Total interest income	5,342	2	(2)	5,342
Interest expense				
Deposits	1,041		(2)	1,039
FHLB advances	96			96
Total interest expense	1,137		(2)	1,135
Net interest income before provision	4,205	2		4,207
Provision for loan losses	(50)			(50)
Net interest income	4,255	2		4,257
Noninterest income				
Service charges and fees	110			110
Other income	449			449
Equity in undistributed earnings of subsidiary		1,873	(1,873)	
Gain on loans sold				
Gain on sale of available-for-sale securities, net	186			186
Total noninterest income	745	1,873	(1,873)	745
Noninterest expense				
Employee compensation and benefits	1,581			1,581
Occupancy and equipment	203			203
Professional fees	139	66		205
Other general and administrative	1,204	31		1,235
Total noninterest expense	3,127	97		3,224
Income before income taxes	1,873	1,778	(1,873)	1,778
Income tax expense (benefit)				
Net income	$ 1,873	$ 1,778	$ (1,873)	$ 1,778

Table of Contents

CONSOLIDATED FINANCIAL STATEMENTS AND

INDEPENDENT AUDITORS REPORT

SOLERA NATIONAL BANCORP, INC.

AND SUBSIDIARY

December 31, 2015 and 2014

Table of Contents

FORTNER, BAYENS, LEVKULICH & GARISON, P.C.

INDEPENDENT AUDITORS REPORT

Board of Directors

Solera National Bancorp, Inc.

Lakewood, Colorado

We have audited the accompanying consolidated financial statements of Solera National Bancorp, Inc. and Subsidiary, which are comprised of the balance sheets as of December 31, 2015 and 2014, the related consolidated statements of comprehensive income, stockholders equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management s Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor s judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity s preparation and fair

presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity s internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Solera National Bancorp, Inc. and Subsidiary as of December 31, 2015 and 2014, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ Fortner, Bayens, Levkulich & Garrison, P.C.

Denver, Colorado

March 11, 2016

1580 Lincoln Street • Suite 700 • Denver, CO 80203

303/296-6033 • FAX 303/296-8553

Certified Public Accountants • A Professional Corporation

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Consolidated Balance Sheets

December 31,

	2015	2014
	(in thousands)	
ASSETS		
Cash and cash equivalents	$ 2,489	$ 3,432
Interest-bearing deposits with banks	750	257
Investment securities, available-for-sale	48,374	52,900
Investment securities, held-to-maturity	4,500	
Loans held for sale	1,039	
Loans held for investment, net	80,591	79,288
Nonmarketable equity securities	874	780
Bank-owned life insurance	4,369	4,462
Other real estate owned		657
Premises and equipment, net	1,918	646
Accrued interest receivable	570	616
Other assets	599	1,634
	$ 146,073	$ 144,672
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities		
Deposits		
Noninterest-bearing demand	$ 3,954	$ 5,853
Interest-bearing demand	8,405	7,866
Savings and money market	42,320	48,007
Time deposits	66,160	57,387
Total deposits	120,839	119,113
Accrued interest payable	88	62
Accrued payable and other liabilities	309	556
FHLB advances	5,000	6,500
Total liabilities	126,236	126,231
Commitments and contingencies (see Notes H, Q, R)		
Stockholders equity		
Common stock - 10,000,000 shares of $0.01 par value authorized; 2,773,838 and 2,772,422 shares outstanding as of December 31, 2015 and 2014, respectively	27	27
Additional paid-in capital	27,137	27,120
Accumulated deficit	(6,670)	(8,448)
Accumulated other comprehensive loss	(501)	(102)
Treasury stock, at cost; 25,776 shares	(156)	(156)

Total stockholders equity		19,837		18,441
	$	146,073	$	144,672

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income

December 31,

	2015	2014
	(in thousands)	
Interest income		
Interest and fees on loans	$ 4,237	$ 4,338
Interest on loans held for sale		201
Interest on investment securities	1,044	1,445
Dividends on nonmarketable equity securities	46	54
Other interest income	15	11
Total interest income	5,342	6,049
Interest expense		
Deposits	1,039	1,065
FHLB advances	96	144
Total interest expense	1,135	1,209
Net interest income	4,207	4,840
Provision (credit) for loan losses	(50)	426
Net interest income after provision for loan losses	4,257	4,414
Noninterest income		
Service charges and fees	110	115
Other income	449	146
Gain on loans sold		2,877
Gain on sale of available-for-sale securities, net	186	254
Total noninterest income	745	3,392
Noninterest expense		
Employee compensation and benefits	1,581	4,280
Occupancy and equipment	203	949
Professional fees	205	784
Other general and administrative	1,235	2,226
Total noninterest expense	3,224	8,239
Income (loss) before income taxes	1,778	(433)
Income tax expense (benefit)		
Net income (loss)	$ 1,778	$ (433)
Other comprehensive income, net of tax		
Net change in unrealized (losses) gains on securities	(213)	1,644
Reclassification adjustment for net gains realized in net loss	(186)	(254)
Total other comprehensive (loss) income	(399)	1,390
Total comprehensive income	$ 1,379	$ 957

Table of Contents

Solera National Bancorp, Inc. and Subsidiary

Consolidated Statement of Changes in Stockholders Equity

Years ended December 31, 2015 and 2014

	Shares Outstanding	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
			(in thousands)				
Balance at December 31, 2013	2,654,890	$ 26	$ 26,558	$ (8,015)	$ (102)	$ (1,492)	$ 16,975
Options exercised	127,532	1	473				474
Stock compensation awards (forfeitures), net	(10,000)						
Stock-based compensation			89				89
Purchase of treasury stock (11,568 shares)					(54)		(54)
Net loss				(433)			(433)
Other comprehensive income						1,390	1,390
Balance at December 31, 2014	2,772,422	$ 27	$				