

HERITAGE COMMERCE CORP  
Form 10-Q  
August 07, 2013

Use these links to rapidly review the document

[TABLE OF CONTENTS](#)

[Table of Contents](#)

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 10-Q**

(MARK ONE)

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

For the quarterly period ended June 30, 2013

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 000-23877

**Heritage Commerce Corp**

(Exact name of Registrant as Specified in its Charter)

**California**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**77-0469558**  
(I.R.S. Employer Identification No.)

**150 Almaden Boulevard, San Jose, California**  
(Address of Principal Executive Offices)

**95113**  
(Zip Code)

**(408) 947-6900**  
(Registrant's Telephone Number, Including Area Code)

**N/A**

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

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

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

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

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

(Do not check if a  
smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

The Registrant had 26,338,521 shares of Common Stock outstanding on July 30, 2013.

---

Table of Contents

**HERITAGE COMMERCE CORP  
QUARTERLY REPORT ON FORM 10-Q  
TABLE OF CONTENTS**

	<b>Page No.</b>
<b><u>Cautionary Note on Forward-Looking Statements</u></b>	<b><u>3</u></b>
<b><u>Part I. FINANCIAL INFORMATION</u></b>	
<b><u>Item 1. Consolidated Financial Statements (unaudited)</u></b>	<b><u>5</u></b>
<u>Consolidated Balance Sheets</u>	<u>5</u>
<u>Consolidated Statements of Income</u>	<u>6</u>
<u>Consolidated Statements of Comprehensive Income (Loss)</u>	<u>7</u>
<u>Consolidated Statement of Changes in Shareholders' Equity</u>	<u>8</u>
<u>Consolidated Statements of Cash Flows</u>	<u>9</u>
<u>Notes to Consolidated Financial Statements</u>	<u>10</u>
<b><u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	<b><u>40</u></b>
<b><u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u></b>	<b><u>75</u></b>
<b><u>Item 4. Controls and Procedures</u></b>	<b><u>75</u></b>
<b><u>PART II. OTHER INFORMATION</u></b>	
<b><u>Item 1. Legal Proceedings</u></b>	<b><u>77</u></b>
<b><u>Item 1A. Risk Factors</u></b>	<b><u>77</u></b>
<b><u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	<b><u>77</u></b>
<b><u>Item 3. Defaults Upon Senior Securities</u></b>	

		<u>77</u>
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>	<u>77</u>
<u>Item 5.</u>	<u>Other Information</u>	<u>77</u>
<u>Item 6.</u>	<u>Exhibits</u>	<u>78</u>
	<b><u>SIGNATURES</u></b>	<u>79</u>
	<b><u>EXHIBIT INDEX</u></b>	<u>80</u>

Table of Contents

**Cautionary Note Regarding Forward-Looking Statements**

This Report on Form 10-Q contains various statements that may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Any statements about our expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and may be forward-looking. These forward-looking statements often can be, but are not always, identified by the use of words such as "assume," "expect," "intend," "plan," "project," "believe," "estimate," "predict," "anticipate," "may," "might," "should," "could," "goal," "potential" and similar expressions. We base these forward-looking statements on our current expectations and projections about future events, our assumptions regarding these events and our knowledge of facts at the time the statements are made. These statements include statements relating to our projected growth, anticipated future financial performance, and management's long-term performance goals, as well as statements relating to the anticipated effects on results of operations and financial condition.

These forward-looking statements are subject to various risks and uncertainties that may be outside our control and our actual results could differ materially from our projected results. In addition, our past results of operations do not necessarily indicate our future results. The forward-looking statements could be affected by many factors, including but not limited to:

Competition for loans and deposits and failure to attract or retain deposits and loans;

Local, regional, and national economic conditions and events and the impact they may have on us and our customers, and our assessment of that impact on our estimates including, the allowance for loan losses;

Risks associated with concentrations in real estate related loans;

Changes in the level of nonperforming assets and charge-offs and other credit quality measures, and their impact on the adequacy of the Company's allowance for loan losses and the Company's provision for loan losses;

The effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Federal Open Market Committee of the Federal Reserve Board;

Stability of funding sources and continued availability of borrowings;

Our ability to raise capital or incur debt on reasonable terms;

Regulatory limits on Heritage Bank of Commerce's ability to pay dividends to the Company;

Continued volatility in credit and equity markets and its effect on the global economy;

The impact of reputational risk on such matters as business generation and retention, funding and liquidity;

Oversupply of inventory and continued deterioration in values of California commercial real estate;

A prolonged slowdown in construction activity;

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities, and executive compensation) which we must comply, including but not limited to, the Dodd-Frank Act of 2010;

The effects of security breaches and computer viruses that may affect our computer systems;

Changes in consumer spending, borrowings and saving habits;

Table of Contents

Changes in the competitive environment among financial or bank holding companies and other financial service providers;

The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters;

The costs and effects of legal and regulatory developments, including resolution of legal proceedings or regulatory or other governmental inquiries, and the results of regulatory examinations or reviews;

The ability to increase market share and control expenses; and

Our success in managing the risks involved in the foregoing items.

We are not able to predict all the factors that may affect future results. You should not place undue reliance on any forward looking statement, which speaks only as of the date of this Report on Form 10-Q. Except as required by applicable laws or regulations, we do not undertake any obligation to update or revise any forward looking statement, whether as a result of new information, future events or otherwise.

Table of Contents**Part I FINANCIAL INFORMATION****ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**HERITAGE COMMERCE CORP**  
**CONSOLIDATED BALANCE SHEETS (Unaudited)**

	June 30, 2013	December 31, 2012
	(Dollars in thousands)	
<b>Assets</b>		
Cash and due from banks	\$ 33,890	\$ 16,520
Interest-bearing deposits in other financial institutions	51,872	357,045
Total cash and cash equivalents	85,762	373,565
Securities available-for-sale, at fair value	293,778	367,912
Securities held-to-maturity, at amortized cost (fair value of \$72,772 at June 30, 2013 and \$50,964 at December 31, 2012)	81,731	51,472
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	6,321	3,409
Loans, net of deferred fees	841,950	812,313
Allowance for loan losses	(19,342)	(19,027)
Loans, net	822,608	793,286
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	10,871	10,728
Company owned life insurance	49,184	48,358
Premises and equipment, net	7,541	7,469
Intangible assets	1,763	2,000
Accrued interest receivable and other assets	39,947	35,113
Total assets	\$ 1,399,506	\$ 1,693,312
<b>Liabilities and Shareholders' Equity</b>		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 407,516	\$ 727,684
Demand, interest-bearing	171,027	155,951
Savings and money market	295,336	272,047
Time deposits under \$100	23,062	25,157
Time deposits \$100 and over	197,718	190,502
Time deposits brokered	76,800	97,807
CDARS money market and time deposits	17,580	10,220
Total deposits	1,189,039	1,479,368
Subordinated debt	9,279	9,279
Accrued interest payable and other liabilities	33,568	34,924
Total liabilities	1,231,886	1,523,571
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at June 30, 2013 and December 31, 2012 (liquidation preference of \$21,004 at June 30, 2013 and December 31, 2012)	19,519	19,519
Common stock, no par value; 60,000,000 shares authorized; 26,338,521 shares issued and outstanding at June 30, 2013 and 26,322,147 shares issued and outstanding at December 31, 2012	132,097	131,820
Retained earnings	20,694	15,721

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Accumulated other comprehensive (loss) income	(4,690)	2,681
Total shareholders' equity	167,620	169,741
Total liabilities and shareholders' equity	\$ 1,399,506	\$ 1,693,312

See notes to consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF INCOME (Unaudited)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
(Dollars in thousands, except per share data)				
<b>Interest income:</b>				
Loans, including fees	\$ 10,051	\$ 10,292	\$ 20,140	\$ 20,608
Securities, taxable	2,399	2,975	4,860	6,072
Securities, non-taxable	358		606	
Interest-bearing deposits in other financial institutions	30	29	99	65
<b>Total interest income</b>	<b>12,838</b>	<b>13,296</b>	<b>25,705</b>	<b>26,745</b>
<b>Interest expense:</b>				
Deposits	595	738	1,220	1,454
Subordinated debt	90	472	178	946
Short-term borrowings		2	1	2
<b>Total interest expense</b>	<b>685</b>	<b>1,212</b>	<b>1,399</b>	<b>2,402</b>
Net interest income before provision for loan losses	12,153	12,084	24,306	24,343
Provision (credit) for loan losses	(270)	815	(270)	915
<b>Net interest income after provision for loan losses</b>	<b>12,423</b>	<b>11,269</b>	<b>24,576</b>	<b>23,428</b>
<b>Noninterest income:</b>				
Service charges and fees on deposit accounts	618	601	1,195	1,191
Increase in cash surrender value of life insurance	410	429	826	858
Servicing income	385	447	750	907
Gain on sales of SBA loans	134	376	270	412
Gain on sales of securities	7	32	38	59
Other	361	205	499	386
<b>Total noninterest income</b>	<b>1,915</b>	<b>2,090</b>	<b>3,578</b>	<b>3,813</b>
<b>Noninterest expense:</b>				
Salaries and employee benefits	5,864	5,377	11,875	11,044
Occupancy and equipment	1,028	967	2,096	1,963
Professional fees	400	470	1,382	1,681
Data processing	327	247	579	492
Low income housing investment losses	300	262	611	531
Software subscriptions	294	313	585	603
Insurance expense	253	224	508	447
FDIC deposit insurance premiums	207	202	466	427
Correspondent bank charges	179	155	343	299
Subordinated debt redemption charges	167		167	
Foreclosed assets, net	(96)	105	(251)	220
Other	1,466	1,132	2,809	2,603
<b>Total noninterest expense</b>	<b>10,389</b>	<b>9,454</b>	<b>21,170</b>	<b>20,310</b>
<b>Income before income taxes</b>	<b>3,949</b>	<b>3,905</b>	<b>6,984</b>	<b>6,931</b>
<b>Income tax expense</b>	<b>1,156</b>	<b>1,226</b>	<b>2,011</b>	<b>2,177</b>

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Net income	2,793	2,679	4,973	4,754
Dividends and discount accretion on preferred stock				(1,206)
Net income available to common shareholders	\$ 2,793	\$ 2,679	\$ 4,973	\$ 3,548
Earnings per common share:				
Basic	\$ 0.09	\$ 0.08	\$ 0.16	\$ 0.11
Diluted	\$ 0.09	\$ 0.08	\$ 0.16	\$ 0.11

See notes to consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (Unaudited)**

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Net income	\$ 2,793	\$ 2,679	\$ 4,973	\$ 4,754
Other comprehensive income (loss):				
Change in net unrealized holding gains (loss) on available-for-sale securities and I/O strips	(10,544)	3,398	(12,708)	3,769
Deferred income taxes	4,428	(1,427)	5,337	(1,583)
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(14)		(28)	
Deferred income taxes	6		12	
Reclassification adjustment for (gains) realized in income	(7)	(32)	(38)	(59)
Deferred income taxes	3	13	16	25
Change in unrealized gains (loss) on securities and I/O strips, net of deferred income taxes	(6,128)	1,952	(7,409)	2,152
Change in net pension and other benefit plan liability adjustment	36	41	65	97
Deferred income taxes	(15)	(17)	(27)	(41)
Change in pension and other benefit plan liability, net of deferred income taxes	21	24	38	56
Other comprehensive income (loss)	(6,107)	1,976	(7,371)	2,208
Total comprehensive income (loss)	\$ (3,314)	\$ 4,655	\$ (2,398)	\$ 6,962

See notes to consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)**

Six Months Ended June 30, 2013 and 2012

	Preferred Stock			Common Stock		Retained Earnings	Accumulated Other Comprehensive Income / (Loss)	Total Shareholders' Equity
	Shares	Amount	Discount	Shares	Amount			
(Dollars in thousands, except share data)								
<b>Balance, January 1, 2012</b>	61,004	\$ 59,365	\$ (833)	26,295,001	\$ 131,172	\$ 7,172	\$ 955	\$ 197,831
Net income						4,754		4,754
Other comprehensive income							2,208	2,208
Repurchase of Series A preferred stock	(40,000)	(40,000)						(40,000)
Series A preferred stock capitalized offering costs		154				(154)		
Issuance (forfeitures) of restricted stock awards, net				(4,000)				
Reversal of restricted stock awards due to forfeitures						39		39
Cash dividends accrued on Series A preferred stock						(373)		(373)
Accretion of discount on Series A preferred stock			833			(833)		
Stock option expense, net of forfeitures and taxes					223			223
Stock options exercised				2,276	9			9
<b>Balance, June 30, 2012</b>	21,004	\$ 19,519	\$	26,293,277	\$ 131,443	\$ 10,566	\$ 3,163	\$ 164,691
<b>Balance, January 1, 2013</b>	21,004	\$ 19,519	\$	26,322,147	\$ 131,820	\$ 15,721	\$ 2,681	\$ 169,741
Net income						4,973		4,973
Other comprehensive loss							(7,371)	(7,371)
Issuance of restricted stock awards				10,000				
Repurchase of warrant					(140)			(140)
Amortization of restricted stock awards, net of forfeitures and taxes					116			116
Stock option expense, net of forfeitures and taxes					275			275
Stock options exercised				6,374	26			26
<b>Balance, June 30, 2013</b>	21,004	\$ 19,519	\$	26,338,521	\$ 132,097	\$ 20,694	\$ (4,690)	\$ 167,620

See notes to consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**

	<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>
	<b>(Dollars in thousands)</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 4,973	\$ 4,754
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	1,384	1,071
Gain on sales of securities available-for-sale	(38)	(59)
Gain on sales of SBA loans	(270)	(412)
Proceeds from sale of SBA loans originated for sale	3,576	5,785
Net change in SBA loans originated for sale	(6,238)	(7,334)
Provision (credit) for loan losses	(270)	915
Increase in cash surrender value of life insurance	(826)	(858)
Depreciation and amortization	356	385
Amortization of intangible assets	237	245
Gains on sale of foreclosed assets, net	(231)	(84)
Stock option expense, net	275	223
Amortization of restricted stock awards, net	116	39
Effect of changes in:		
Accrued interest receivable and other assets	(135)	2,381
Accrued interest payable and other liabilities	668	283
<b>Net cash provided by operating activities</b>	<b>3,577</b>	<b>7,334</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of securities available-for-sale	(8,334)	(49,688)
Purchase of securities held-to-maturity	(34,681)	
Maturities/paydowns/calls of securities available-for-sale	41,588	38,472
Maturities/paydowns/calls of securities held-to-maturity	2,373	
Proceeds from sale of securities available-for-sale	26,944	2,280
Net change in loans	(29,065)	(37,064)
Change in Federal Home Loan Bank and Federal Reserve Bank stock	(143)	(972)
Purchase of premises and equipment	(428)	(145)
Proceeds from sale of foreclosed assets	809	341
Proceeds from sale of other loans transferred to held-for-sale		220
Purchases of company owned life insurance		(250)
<b>Net cash used in investing activities</b>	<b>(937)</b>	<b>(46,806)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net change in deposits	(290,329)	53,325
Repurchase of warrant	(140)	
Repayment of preferred stock		(40,000)
Payment of cash dividends preferred stock		(373)
Exercise of stock options	26	9
<b>Net cash used in provided by financing activities</b>	<b>(290,443)</b>	<b>12,961</b>
Net decrease in cash and cash equivalents	(287,803)	(26,511)
Cash and cash equivalents, beginning of period	373,565	72,872
<b>Cash and cash equivalents, end of period</b>	<b>\$ 85,762</b>	<b>\$ 46,361</b>
<b>Supplemental disclosures of cash flow information:</b>		
Interest paid	\$ 1,442	\$ 2,418
Income taxes paid	2,235	1,230

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Supplemental schedule of non-cash investing activity:

Due to broker for securities purchased	\$	1,538	\$	3,330
Due from broker for securities sold				(378)
Loans transferred to foreclosed assets		33		1,973
Transfer of loans held-for-sale to loan portfolio		20		

See notes to consolidated financial statements

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**1) Basis of Presentation**

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company" or "HCC") and its wholly owned subsidiary, Heritage Bank of Commerce (the "Bank" or "HBC"), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes that were included in the Company's Form 10-K for the year ended December 31, 2012. The Company has also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III, which are Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities. During the third quarter of 2012 the Company dissolved the Heritage Statutory Trust I and the Heritage Capital Trust I.

HBC is a commercial bank serving customers located in Santa Clara, Alameda, and Contra Costa counties of California. No customer accounts for more than 10 percent of revenue for HBC or the Company. Management evaluates the Company's performance as a whole and does not allocate resources based on the performance of different lending or transaction activities. Accordingly, the Company and its subsidiary operate as one business segment.

In management's opinion, all adjustments necessary for a fair presentation of these consolidated financial statements have been included and are of a normal and recurring nature. All intercompany transactions and balances have been eliminated.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ significantly from these estimates.

The results for the three and six months ended June 30, 2013 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2013.

***Reclassifications***

Certain reclassifications of prior year balances have been made to conform to the current year presentation. These reclassifications had no impact on the Company's consolidated financial position, results of operations or net change in cash and cash equivalents.

***Adoption of New Accounting Standards***

In February 2013, the FASB issued an accounting standards update with the primary objective of improving the reporting of reclassifications out of accumulated other comprehensive income ("AOCI"). For significant reclassifications that are required to be presented in their entirety in net income in the same reporting period by U.S. GAAP, the update requires an entity to report the effect of these reclassifications out of AOCI on the respective line items of net income either on the face of the

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****1) Basis of Presentation (Continued)**

statement that reports net income or in the financial statement notes. For AOCI items that are not reclassified to net income in their entirety, presentation in the financial statement notes is required. This update is effective for public companies for fiscal years and interim periods within those years beginning after December 15, 2012, or the first quarter of 2013 for calendar year-end companies, and is required to be applied prospectively. The effect of adopting this standard did not have a material effect on the Company's operating results or financial condition, but the additional disclosures are included in Note 3.

**2) Earnings Per Share**

Basic earnings per common share is computed by dividing net income, less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is convertible into 5,601,000 shares of common stock when transferred in accordance with its terms. The Series C Preferred Stock participate in the earnings of the Company and, therefore, the shares issued on the conversion of the Series C Preferred Stock are considered outstanding under the two-class method of computing basic earnings per common share during periods of earnings. Diluted earnings per share reflect potential dilution from outstanding stock options and common stock warrant, using the treasury stock method. The common stock warrant was antidilutive for the six months ended June 30, 2013 and for the three months and six months ended June 30, 2012. The Company repurchased the warrant for \$140,000 in the second quarter of 2013. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Net income available to common shareholders	\$ 2,793	\$ 2,679	\$ 4,973	\$ 3,548
Less: net income allocated to Series C Preferred Stock	489	470	871	623
Net income allocated to common shareholders	\$ 2,304	\$ 2,209	\$ 4,102	\$ 2,925
Weighted average common shares outstanding for basic earnings per common share	26,336,244	26,290,480	26,332,793	26,289,907
Dilutive effect of stock options outstanding, using the the treasury stock method	35,648	27,011	46,123	28,058
Shares used in computing diluted earnings per common share	26,371,892	26,317,491	26,378,916	26,317,965
Basic earnings per share	\$ 0.09	\$ 0.08	\$ 0.16	\$ 0.11
Diluted earnings per share	\$ 0.09	\$ 0.08	\$ 0.16	\$ 0.11

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

## 3) Accumulated Other Comprehensive Income ("AOCI")

The following table reflects the changes in AOCI by component for the periods indicated:

	For the Three Months Ended June 30, 2013 and 2012				Total(1)
	Unrealized Gains (Losses) on Available- for-Sale Securities and I/O Strips(1)	Unamortized Unrealized Gain on Available- for-Sale Securities Reclassified to Held-to- Maturity(1)	Defined Benefit Pension Plan Items(1)		
	(Dollars in thousands)				
Beginning balance April 1, 2013, net of taxes	\$ 6,614	\$ 489	\$ (5,686)	\$ 1,417	
Other comprehensive (loss) before reclassification, net of taxes	(6,116)		(23)	(6,139)	
Amounts reclassified from other comprehensive income (loss), net of taxes	(4)	(8)	44	32	
Net current period other comprehensive income (loss), net of taxes	(6,120)	(8)	21	(6,107)	
Ending balance June 30, 2013, net of taxes	\$ 494	\$ 481	\$ (5,665)	\$ (4,690)	
Beginning balance April 1, 2012, net of taxes	\$ 6,410	\$	\$ (5,223)	\$ 1,187	
Other comprehensive income (loss) before reclassification, net of taxes	1,971		(17)	1,954	
Amounts reclassified from other comprehensive income (loss), net of taxes	(19)		41	22	
Net current period other comprehensive income, net of taxes	1,952		24	1,976	
Ending balance June 30, 2012, net of taxes	\$ 8,362	\$	\$ (5,199)	\$ 3,163	

(1) Amounts in parenthesis indicate debits.

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

## 3) Accumulated Other Comprehensive Income ("AOCI") (Continued)

	For the Six Months Ended June 30, 2013 and 2012			
	Unrealized Gains (Losses) on Available- for-Sale Securities and I/O Strips(1)	Unamortized Unrealized Gain on Available- for-Sale Securities Reclassified to Held-to- Maturity(1)	Defined Benefit Pension Plan Items(1)	Total(1)
	(Dollars in thousands)			
Beginning balance January 1, 2013, net of taxes	\$ 7,887	\$ 497	\$ (5,703)	\$ 2,681
Other comprehensive (loss) before reclassification, net of taxes	(7,371)		(47)	(7,418)
Amounts reclassified from other comprehensive income (loss), net of taxes	(22)	(16)	85	47
Net current period other comprehensive income (loss), net of taxes	(7,393)	(16)	38	(7,371)
Ending balance June 30, 2013, net of taxes	\$ 494	\$ 481	\$ (5,665)	\$ (4,690)
Beginning balance January 1, 2012, net of taxes	\$ 6,210	\$	\$ (5,255)	\$ 955
Other comprehensive income (loss) before reclassification, net of taxes	2,186		(25)	2,161
Amounts reclassified from other comprehensive income (loss), net of taxes	(34)		81	47
Net current period other comprehensive income, net of taxes	2,152		56	2,208
Ending balance June 30, 2012, net of taxes	\$ 8,362	\$	\$ (5,199)	\$ 3,163

(1) Amounts in parenthesis indicate debits.

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

## 3) Accumulated Other Comprehensive Income ("AOCI") (Continued)

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Three Months Ended June 30, 2013      2012 (Dollars in thousands)		Affected Line Item Where Net Income is Presented
	2013	2012	
Unrealized gains on available-for-sale securities and I/O strips	\$ 7 (3)	\$ 32 (13)	Realized gains on sale of securities Income tax expense
	4	19	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	14 (6)		Interest income on taxable securities Income tax expense
	8		Net of tax
Amortization of defined benefit pension plan items(2)			
Prior service cost		(7)	
Actuarial losses	(75)	(63)	
	(75)	(70)	Income before income tax
	31	29	Income tax expense
	(44)	(41)	Net of tax
Total reclassification for the period	\$ (32)	\$ (22)	

(1) Amounts in parenthesis indicate debits.

(2) This AOCI component is included in the computation of net periodic benefit cost (see Note 7 Benefit Plans).

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

## 3) Accumulated Other Comprehensive Income ("AOCI") (Continued)

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Six Months Ended June 30,		Affected Line Item Where Net Income is Presented
	2013	2012	
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	\$ 38	\$ 59	Realized gains on sale of securities
	(16)	(25)	Income tax expense
	22	34	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	28		Interest income on taxable securities
	(12)		Income tax expense
	16		Net of tax
Amortization of defined benefit pension plan items(2)			
Prior service cost		(14)	
Actuarial losses	(146)	(126)	
	(146)	(140)	Income before income tax
	61	59	Income tax expense
	(85)	(81)	Net of tax
Total reclassification for the period	\$ (47)	\$ (47)	

(1) Amounts in parenthesis indicate debits.

(2) This AOCI component is included in the computation of net periodic benefit cost (see Note 7 Benefit Plans).

[Table of Contents](#)**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****4) Securities**

The amortized cost and estimated fair value of securities at June 30, 2013 and December 31, 2012 were as follows:

<b>June 30, 2013</b>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
<b>(Dollars in thousands)</b>				
<b>Securities available-for-sale:</b>				
Agency mortgage-backed securities	\$ 224,760	\$ 3,085	\$ (2,448)	\$ 225,397
Corporate bonds	49,089	418	(1,861)	47,646
Trust preferred securities	20,809	114	(188)	20,735
<b>Total</b>	<b>\$ 294,658</b>	<b>\$ 3,617</b>	<b>\$ (4,497)</b>	<b>\$ 293,778</b>

<b>Securities held-to-maturity:</b>				
Agency mortgage-backed securities	\$ 14,211	\$	\$ (438)	\$ 13,773
Municipals tax exempt	67,520		(8,521)	58,999
<b>Total</b>	<b>\$ 81,731</b>	<b>\$</b>	<b>\$ (8,959)</b>	<b>\$ 72,772</b>

<b>December 31, 2012</b>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
<b>(Dollars in thousands)</b>				
<b>Securities available-for-sale:</b>				
Agency mortgage-backed securities	\$ 281,598	\$ 9,668	\$ (22)	\$ 291,244
Corporate bonds	53,739	1,849		55,588
Trust preferred securities	20,769	375	(64)	21,080
<b>Total</b>	<b>\$ 356,106</b>	<b>\$ 11,892</b>	<b>\$ (86)</b>	<b>\$ 367,912</b>

<b>Securities held-to-maturity:</b>				
Agency mortgage-backed securities	\$ 16,659	\$ 2	\$ (177)	\$ 16,484
Municipals tax exempt	34,813	80	(413)	34,480
<b>Total</b>	<b>\$ 51,472</b>	<b>\$ 82</b>	<b>\$ (590)</b>	<b>\$ 50,964</b>

There were no holdings of securities of any one issuer, other than the U.S. Government and its sponsored entities, in an amount greater than 10% of shareholders' equity. At June 30, 2013, the Company held 353 securities (160 available-for-sale and 193 held-to-maturity), of which 235 had fair values below amortized cost. No securities had been carried with an unrealized loss for over 12 months. Unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The Company does not consider these securities to be other-than-temporarily impaired at June 30, 2013.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

At December 31, 2012, the Company held 269 securities (168 available-for-sale and 101 held-to-maturity), of which 70 had fair values below amortized cost. No securities had been carried with

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****4) Securities (Continued)**

an unrealized loss for over 12 months. The Company does not consider these securities to be other-than-temporarily impaired at December 31, 2012.

The proceeds from sales of securities and the resulting gains and losses are listed below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Proceeds	\$ 23,414	\$ 375	\$ 26,944	\$ 2,280
Gross gains	279	32	310	59
Gross losses	(272)		(272)	

The amortized cost and estimated fair values of securities as of June 30, 2013, by contractual maturity, are shown below. The expected maturities will differ from contractual maturities if borrowers have the right to call or pre-pay obligations with or without call or pre-payment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after one through five years	\$ 2,032	\$ 2,115
Due after five through ten years	47,057	45,531
Due after ten years	20,809	20,735
Agency mortgage-backed securities	224,760	225,397
Total	\$ 294,658	\$ 293,778

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after five through ten years	\$ 1,093	\$ 1,011
Due after ten years	66,427	57,988
Agency mortgage-backed securities	14,211	13,773
Total	\$ 81,731	\$ 72,772

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****5) Loans**

Loans were as follows:

	<b>June 30, 2013</b>	<b>December 31, 2012</b>
	<b>(Dollars in thousands)</b>	
<b>Loans held-for-investment:</b>		
Commercial	\$ 383,068	\$ 375,469
<b>Real estate:</b>		
Commercial and residential	370,620	354,934
Land and construction	26,705	22,352
Home equity	48,667	43,865
Consumer	13,097	15,714
Loans	842,157	812,334
Deferred loan origination fees, net	(207)	(21)
Loans, net of deferred fees	841,950	812,313
Allowance for loan losses	(19,342)	(19,027)
Loans, net	\$ 822,608	\$ 793,286

Changes in the allowance for loan losses were as follows for the periods indicated:

	<b>Three Months Ended June 30, 2013</b>			
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
Balance, beginning of period	\$ 12,455	\$ 6,770	\$ 117	\$ 19,342
Charge-offs	(119)	(56)		(175)
Recoveries	188	257		445
Net recoveries	69	201		270
Provision (credit) for loan losses	287	(583)	26	(270)
Balance, end of period	\$ 12,811	\$ 6,388	\$ 143	\$ 19,342

	<b>Three Months Ended June 30, 2012</b>			
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
Balance, beginning of period	\$ 13,734	\$ 6,409	\$ 163	\$ 20,306
Charge-offs	(1,280)	(101)		(1,381)
Recoveries	60	223		283

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Net (charge-offs)/recoveries	(1,220)	122	(1,098)	
Provision (credit) for loan losses	864	8	(57)	815
Balance, end of period	\$ 13,378	\$ 6,539	\$ 106	\$ 20,023

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****5) Loans (Continued)****Six Months Ended June 30, 2013**

	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
Balance, beginning of period	\$ 12,866	\$ 6,034	\$ 127	\$ 19,027
Charge-offs	(959)	(56)		(1,015)
Recoveries	1,338	262		1,600
Net recoveries	379	206		585
Provision (credit) for loan losses	(434)	148	16	(270)
Balance, end of period	\$ 12,811	\$ 6,388	\$ 143	\$ 19,342

**Six Months Ended June 30, 2012**

	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
Balance, beginning of period	\$ 13,215	\$ 7,338	\$ 147	\$ 20,700
Charge-offs	(2,190)	(146)		(2,336)
Recoveries	521	223		744
Net (charge-offs)/recoveries	(1,669)	77		(1,592)
Provision (credit) for loan losses	1,832	(876)	(41)	915
Balance, end of period	\$ 13,378	\$ 6,539	\$ 106	\$ 20,023

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment, based on the impairment method at the following period-ends:

	<b>June 30, 2013</b>			
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
<b>Allowance for loan losses:</b>				
<b>Ending allowance balance attributable to loans:</b>				
Individually evaluated for impairment	\$ 2,588	\$ 786	\$ 28	\$ 3,402
Collectively evaluated for impairment	10,223	5,602	115	15,940
<b>Total allowance balance</b>	<b>\$ 12,811</b>	<b>\$ 6,388</b>	<b>\$ 143</b>	<b>\$ 19,342</b>
<b>Loans:</b>				
Individually evaluated for impairment	\$ 5,342	\$ 9,569	\$ 135	\$ 15,046

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Collectively evaluated for impairment	377,726	436,423	12,962	827,111
Total loan balance	\$ 383,068	\$ 445,992	\$ 13,097	\$ 842,157

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****5) Loans (Continued)**

	<b>December 31, 2012</b>			
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
<b>Allowance for loan losses:</b>				
<b>Ending allowance balance attributable to loans:</b>				
Individually evaluated for impairment	\$ 1,963	\$ 760	\$ 17	\$ 2,740
Collectively evaluated for impairment	10,903	5,274	110	16,287
<b>Total allowance balance</b>	<b>\$ 12,866</b>	<b>\$ 6,034</b>	<b>\$ 127</b>	<b>\$ 19,027</b>
<b>Loans:</b>				
Individually evaluated for impairment	\$ 10,161	\$ 9,336	\$ 147	\$ 19,644
Collectively evaluated for impairment	365,308	411,815	15,567	792,690
<b>Total loan balance</b>	<b>\$ 375,469</b>	<b>\$ 421,151</b>	<b>\$ 15,714</b>	<b>\$ 812,334</b>

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of June 30, 2013 and December 31, 2012. The recorded investment included in the following table represents loan principal net of any partial charge-offs recognized on the loans. The unpaid principal balance represents the recorded balance prior to any partial charge-offs.

	<b>June 30, 2013</b>			<b>December 31, 2012</b>		
	<b>Unpaid Principal Balance</b>	<b>Recorded Investment</b>	<b>Allowance for Loan Losses Allocated</b>	<b>Unpaid Principal Balance</b>	<b>Recorded Investment</b>	<b>Allowance for Loan Losses Allocated</b>
	<b>(Dollars in thousands)</b>					
<b>With no related allowance recorded:</b>						
Commercial	\$ 1,031	\$ 948	\$	\$ 7,829	\$ 6,978	\$
<b>Real estate:</b>						
Commercial and residential	3,509	3,509		2,755	2,741	
Land and construction	2,070	2,070		2,310	2,223	
Home Equity	2,077	2,077		2,141	2,141	
<b>Total with no related allowance recorded</b>	<b>8,687</b>	<b>8,604</b>	<b></b>	<b>15,035</b>	<b>14,083</b>	<b></b>
<b>With an allowance recorded:</b>						
Commercial	4,487	4,394	2,588	3,678	3,182	1,963
<b>Real estate:</b>						
Commercial and residential	1,560	1,560	480	3,183	1,937	465
Land and construction	59	59	12			
Home Equity	294	294	294	295	295	295
Consumer	135	135	28	147	147	17

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total with an allowance recorded	6,535	6,442	3,402	7,303	5,561	2,740
Total	\$ 15,222	\$ 15,046	\$ 3,402	\$ 22,338	\$ 19,644	\$ 2,740



Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

## 5) Loans (Continued)

Six Months Ended June 30, 2012

	Real Estate						
	Commercial and Residential		Land and Construction	Home Equity	Consumer		Total
	Commercial						
	(Dollars in thousands)						
Average of impaired loans during the period	\$ 11,341	\$ 2,214	\$ 2,733	\$ 143	\$ 61		\$ 16,492
Interest income during impairment	\$	\$ 1	\$ 14	\$	\$		\$ 15
Cash-basis interest earned	\$	\$ 1	\$ 14	\$	\$		\$ 15

Nonperforming loans include both smaller dollar balance homogenous loans that are collectively evaluated for impairment and individually classified loans. Nonperforming loans were as follows at period-end:

	June 30, 2013	June 30, 2012	December 31, 2012
	(Dollars in thousands)		
Nonaccrual loans held-for-sale	\$	\$ 177	\$
Nonaccrual loans held-for-investment	13,868	12,890	17,335
Restructured and loans over 90 days past due and still accruing	510	1,665	859
Total nonperforming loans	\$ 14,378	\$ 14,732	\$ 18,194
Other restructured loans	\$ 668	\$ 416	\$ 1,450
Impaired loans, excluding loans held-for-sale	\$ 15,046	\$ 14,971	\$ 19,644

The following table presents the nonperforming loans by class as of June 30, 2013 and December 31, 2012:

	June 30, 2013 Restructured and Loans Over 90 Days Past Due and Still Accruing			December 31, 2012 Restructured and Loans Over 90 Days Past Due and Still Accruing		
	Nonaccrual	Accruing	Total	Nonaccrual	Accruing	Total
	(Dollars in thousands)					
Commercial	\$ 4,164	\$ 510	\$ 4,674	\$ 7,852	\$ 859	\$ 8,711
Real estate:						
Commercial and residential	5,069		5,069	4,676		4,676
Land and construction	2,129		2,129	2,223		2,223
Home equity	2,371		2,371	2,437		2,437
Consumer	135		135	147		147

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total	\$	13,868	\$	510	\$	14,378	\$	17,335	\$	859	\$	18,194
-------	----	--------	----	-----	----	--------	----	--------	----	-----	----	--------

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****5) Loans (Continued)**

The following table presents the aging of past due loans as of June 30, 2013 by class of loans:

	<b>June 30, 2013</b>					
	<b>30 - 59 Days Past Due</b>	<b>60 - 89 Days Past Due</b>	<b>90 Days or Greater Past Due</b>	<b>Total Past Due</b>	<b>Loans Not Past Due</b>	<b>Total</b>
	(Dollars in thousands)					
Commercial	\$ 2,540	\$ 567	\$ 1,871	\$ 4,978	\$ 378,090	\$ 383,068
Real estate:						
Commercial and residential	139		1,639	1,778	368,842	370,620
Land and construction			59	59	26,646	26,705
Home equity			294	294	48,373	48,667
Consumer		99		99	12,998	13,097
<b>Total</b>	<b>\$ 2,679</b>	<b>\$ 666</b>	<b>\$ 3,863</b>	<b>\$ 7,208</b>	<b>\$ 834,949</b>	<b>\$ 842,157</b>

The following table presents the aging of past due loans as of December 31, 2012 by class of loans:

	<b>December 31, 2012</b>					
	<b>30 - 59 Days Past Due</b>	<b>60 - 89 Days Past Due</b>	<b>90 Days or Greater Past Due</b>	<b>Total Past Due</b>	<b>Loans Not Past Due</b>	<b>Total</b>
	(Dollars in thousands)					
Commercial	\$ 1,699	\$ 355	\$ 5,120	\$ 7,174	\$ 368,295	\$ 375,469
Real estate:						
Commercial and residential	1,603		3,290	4,893	350,041	354,934
Land and construction			78	78	22,274	22,352
Home equity	742		2,045	2,787	41,078	43,865
Consumer					15,714	15,714
<b>Total</b>	<b>\$ 4,044</b>	<b>\$ 355</b>	<b>\$ 10,533</b>	<b>\$ 14,932</b>	<b>\$ 797,402</b>	<b>\$ 812,334</b>

Past due loans 30 days or greater totaled \$7,208,000 and \$14,932,000 at June 30, 2013 and December 31, 2012, respectively, of which \$4,446,000 and \$12,020,000 were on nonaccrual. At June 30, 2013, there were also \$9,422,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2012, there were also \$5,315,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**June 30, 2013**

**(Unaudited)**

**5) Loans (Continued)**

*Credit Quality Indicators*

Concentrations of credit risk arise when a number of customers are engaged in similar business activities, or activities in the same geographic region, or have similar features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions. The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and service) and real estate lending, with the balance in consumer loans. While no specific industry concentration is considered significant, the Company's lending operations are located in the Company's market areas that are dependent on the technology and real estate industries and their supporting companies. Thus, the Company's borrowers could be adversely impacted by a continued downturn in these sectors of the economy which could reduce the demand for loans and adversely impact the borrowers' ability to repay their loans.

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis. Nonclassified loans generally include those loans that are expected to be repaid in accordance with contractual loans terms. Classified loans are those loans that are assigned a substandard, substandard-nonaccrual, or doubtful risk rating using the following definitions:

*Substandard.* Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

*Substandard-Nonaccrual.* Loans classified as substandard-nonaccrual are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. In addition, the Company no longer accrues interest on the loan because of the underlying weaknesses.

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

*Loss.* Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for loan losses. Therefore, there is no balance to report at June 30, 2013 or December 31, 2012.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****5) Loans (Continued)**

The following table provides a summary of the loan portfolio by loan type and credit quality classification at June 30, 2013 and December 31, 2012:

	June 30, 2013			December 31, 2012		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)					
Commercial	\$ 372,077	\$ 10,991	\$ 383,068	\$ 355,440	\$ 20,029	\$ 375,469
Real estate:						
Commercial and residential	363,222	7,398	370,620	345,045	9,889	354,934
Land and construction	24,576	2,129	26,705	18,858	3,494	22,352
Home equity	45,974	2,693	48,667	41,187	2,678	43,865
Consumer	12,729	368	13,097	15,321	393	15,714
<b>Total</b>	<b>\$ 818,578</b>	<b>\$ 23,579</b>	<b>\$ 842,157</b>	<b>\$ 775,851</b>	<b>\$ 36,483</b>	<b>\$ 812,334</b>

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company's underwriting policy.

The recorded investment of troubled debt restructurings at June 30, 2013 was \$2,759,000, which included \$1,581,000 of nonaccrual loans and \$1,178,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2012 was \$4,107,000, which included \$1,798,000 of nonaccrual loans and \$2,309,000 of accruing loans. Approximately \$804,000 and \$1,152,000 in specific reserves were established with respect to these loans as of June 30, 2013 and December 31, 2012, respectively. As of June 30, 2013 and December 31, 2012, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

There were no new loans modified as troubled debt restructurings during the three month period ended June 30, 2013. The following table presents loans by class modified as troubled debt restructurings during the three month period ended June 30, 2012:

	During the Three Months Ended June 30, 2012		
	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
	(Dollars in thousands)		
Consumer	1	\$ 117	\$ 117
<b>Total</b>	<b>1</b>	<b>\$ 117</b>	<b>\$ 117</b>

The troubled debt restructurings described above increased the allowance for loan losses by \$13,000 through the allocation of specific reserves, and resulted in no net charge-offs during the three month period ended June 30, 2012.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****5) Loans (Continued)**

There were no new loans modified as troubled debt restructurings during the six month period ended June 30, 2013. The following table presents loans by class modified as troubled debt restructurings during the six month period ended June 30, 2012:

	Number of Contracts	During the Six Months Ended June 30, 2012	
		Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
(Dollars in thousands)			
Commercial	1	\$ 112	\$ 112
Consumer	1	117	117
<b>Total</b>	<b>2</b>	<b>\$ 229</b>	<b>\$ 229</b>

The troubled debt restructurings described above increased the allowance for loan losses by \$44,000 through the allocation of specific reserves, and resulted in no net charge-offs during the six month period ended June 30, 2012.

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the three month period ended June 30, 2013 and 2012.

A loan that is a troubled debt restructuring on nonaccrual status may return to accruing status after a period of at least six months of consecutive payments in accordance with the modified terms.

**6) Income Taxes**

Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles, leading to timing differences between the Company's actual tax liability and the amount accrued for this liability based on book income. These temporary differences comprise the "deferred" portion of the Company's tax expense or benefit, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as they reverse.

Realization of the Company's deferred tax assets is primarily dependent upon the Company generating sufficient taxable income to obtain benefit from the reversal of net deductible temporary differences and utilization of tax credit carryforwards and the net operating loss carryforwards for Federal and California state income tax purposes. The amount of deferred tax assets considered realizable is subject to adjustment in future periods based on estimates of future taxable income. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****6) Income Taxes (Continued)**

The Company had net deferred tax assets of \$24,600,000, and \$19,264,000, at June 30, 2013, and December 31, 2012, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at June 30, 2013 and December 31, 2012 will be fully realized in future years.

**7) Benefit Plans*****Supplemental Retirement Plan***

The Company has a supplemental retirement plan (the "Plan") covering current and former key executives and directors. The Plan is a nonqualified defined benefit plan. Benefits are unsecured as there are no Plan assets. The following table presents the amount of periodic cost recognized for the periods indicated:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
	<b>(Dollars in thousands)</b>			
<b>Components of net periodic benefit cost:</b>				
Service cost	\$ 302	\$ 294	\$ 606	\$ 588
Interest cost	196	193	392	386
Amortization of prior service cost		7		14
Amortization of net actuarial loss	75	63	146	126
Net periodic benefit cost	\$ 573	\$ 557	\$ 1,144	\$ 1,114

***Split-Dollar Life Insurance Benefit Plan***

The Company maintains life insurance policies for current and former directors and officers that are subject to split-dollar life insurance agreements. The following table sets forth the funded status of the split-dollar life insurance benefits for the periods indicated:

	<b>June 30, 2013</b>	<b>December 31, 2012</b>
	<b>(Dollars in thousands)</b>	
<b>Change in projected benefit obligation</b>		
Projected benefit obligation at beginning of year	\$ 4,717	\$ 4,525
Interest cost	89	185
Actuarial gain	2	7
Projected benefit obligation at end of period	\$ 4,808	\$ 4,717

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**June 30, 2013**

**(Unaudited)**

**8) Preferred Stock**

*Series A Preferred Stock*

On November 21, 2008, the Company issued 40,000 shares of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") to the U.S. Treasury under the terms of the U.S. Treasury Capital Purchase Program for \$40,000,000 with a liquidation preference of \$1,000 per share. On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve Board, the Company repurchased all of the Series A Preferred Stock and paid all of the related accrued and unpaid dividends. HCC used available cash and proceeds from a \$30,000,000 distribution approved by the California Department of Financial Institutions from HBC to HCC. The repurchase of the Series A Preferred Stock accelerated the accretion of the remaining issuance discount on the Series A Preferred Stock. Total dividends and discount accretion on Preferred Stock, including accelerated accretion of approximately \$765,000, reduced net income available to common shareholders by \$1,206,000 in the first quarter of 2012. On June 12, 2013, the Company completed the repurchase of the common stock warrant issued to the U.S. Department of the Treasury on November 21, 2008, which was exercisable into 462,963 shares of common stock at an exercise price of \$12.96. The Company repurchased the warrant for \$140,000.

*Series C Preferred Stock*

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

**9) Fair Value**

Accounting guidance establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (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 in active markets; quoted prices for identical assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data (for example, interest rates and yield curves observable at commonly quoted intervals, prepayment speeds, credit risks, and default rates).

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****9) Fair Value (Continued)**

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

***Financial Assets and Liabilities Measured on a Recurring Basis***

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

The fair value of interest-only ("I/O") strip receivable assets is based on a valuation model used by a third party. The Company is able to compare the valuation model inputs and results to widely available published industry data for reasonableness (Level 2 inputs).

	Balance	Fair Value Measurements Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
(Dollars in thousands)			
Assets at June 30, 2013:			
Available-for-sale securities:			
Agency mortgage-backed securities	\$ 225,397		\$ 225,397
Corporate bonds	47,646		47,646
Trust preferred securities	20,735		20,735
I/O strip receivables	1,726		1,726
Assets at December 31, 2012:			
Available-for-sale securities:			
Agency mortgage-backed securities	\$ 291,244		\$ 291,244
Corporate bonds	55,588		55,588
Trust preferred securities	21,080		21,080
I/O strip receivables	1,786		1,786

There were no transfers between Level 1 and Level 2 during the period for assets measured at fair value on a recurring basis.

***Assets and Liabilities Measured on a Non-Recurring Basis***

The fair value of loans held-for-sale is generally based on obtaining bids and broker indications on the estimated value of these loans held-for-sale, resulting in a Level 2 classification.

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. The appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**June 30, 2013**

**(Unaudited)**

**9) Fair Value (Continued)**

routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Foreclosed assets are valued at the time the loan is foreclosed upon and the asset is transferred to foreclosed assets. The fair value is based primarily on third party appraisals, less costs to sell. The appraisals may utilize a single valuation approach or a combination of approaches including the comparable sales and income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****9) Fair Value (Continued)**

adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

	Balance	Fair Value Measurements Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
(Dollars in thousands)			
<b>Assets at June 30, 2013:</b>			
Impaired loans held-for-investment:			
Commercial	\$ 2,109		\$ 2,109
Real estate:			
Commercial and residential	3,041		3,041
Land and construction	1,632		1,632
Consumer	108		108
	\$ 6,890		\$ 6,890
<b>Foreclosed assets:</b>			
Commercial	\$ 29		\$ 29
Land and construction	630		630
	\$ 659		\$ 659
<b>Assets at December 31, 2012:</b>			
Impaired loans held-for-investment:			
Commercial	\$ 3,645		\$ 3,645
Real estate:			
Commercial and residential	3,674		3,674
Land and construction	1,723		1,723
Consumer	130		130
	\$ 9,172		\$ 9,172
<b>Foreclosed assets:</b>			
Commercial	\$ 83		\$ 83
Land and construction	1,187		1,187
	\$ 1,270		\$ 1,270

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****9) Fair Value (Continued)**

The following table shows the detail of the impaired loans held-for-investment and the impaired loans held-for-investment carried at fair value for the periods indicated:

	<b>June 30, 2013</b>	<b>December 31, 2012</b>
	<b>(Dollars in thousands)</b>	
<b>Impaired loans held-for-investment:</b>		
Book value of impaired loans held-for-investment carried at fair value	\$ 10,292	\$ 11,912
Book value of impaired loans held-for-investment carried at cost	4,754	7,732
<b>Total impaired loans held-for-investment</b>	<b>\$ 15,046</b>	<b>\$ 19,644</b>
<b>Impaired loans held-for-investment carried at fair value:</b>		
Book value of impaired loans held-for-investment carried at fair value	\$ 10,292	\$ 11,912
Specific valuation allowance	(3,402)	(2,740)
<b>Impaired loans held-for-investment carried at fair value, net</b>	<b>\$ 6,890</b>	<b>\$ 9,172</b>

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were \$15,046,000 at June 30, 2013, after partial charge-offs of \$176,000 in the first six months of 2013. In addition, these loans had a specific valuation allowance of \$3,402,000 at June 30, 2013. Impaired loans held-for-investment totaling \$10,292,000 at June 30, 2013 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining \$4,754,000 of impaired loans were carried at cost at June 30, 2013, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during the first six months of 2013 on impaired loans held-for-investment carried at fair value at June 30, 2013 resulted in an additional provision for loan losses of \$1,440,000.

Foreclosed assets measured at fair value less costs to sell, had a carrying amount of \$659,000, with no valuation allowance at June 30, 2013.

Impaired loans held-for-investment of \$19,644,000 at December 31, 2012, after partial charge-offs of \$2,694,000 in 2012, were analyzed for additional impairment primarily using the fair value of collateral. In addition, these loans had a specific valuation allowance of \$2,740,000 at December 31, 2012. Impaired loans held-for-investment totaling \$11,912,000 at December 31, 2012 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining \$7,732,000 of impaired loans were carried at cost at December 31, 2012, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during 2012 on impaired loans held-for-investment carried at fair value at December 31, 2012 resulted in an additional provision for loan losses of \$3,856,000.

At December 31, 2012, foreclosed assets had a carrying amount of \$1,270,000, with no valuation allowance at December 31, 2012.

[Table of Contents](#)**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****9) Fair Value (Continued)**

The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at the periods indicated:

	June 30, 2013			Range (Weighted Average)
	Fair Value	Valuation Techniques	Unobservable Inputs	
(Dollars in thousands)				
Impaired loans held-for-investment:				
Commercial	\$ 2,109	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (2%)
Real estate:				
Commercial and residential	3,041	Market Approach	Discount adjustment for differences between comparable sales	1% to 15% (1%)
Land and construction	1,632	Market Approach	Discount adjustment for differences between comparable sales	1% to 4% (2%)
Foreclosed assets:				
Land and construction	630	Market Approach	Discount adjustment for differences between comparable sales	1% to 16% (7%)

	December 31, 2012			Range (Weighted Average)
	Fair Value	Valuation Techniques	Unobservable Inputs	
(Dollars in thousands)				
Impaired loans held-for-investment:				
Commercial	\$ 3,645	Market Approach	Discount adjustment for differences between comparable sales	0% to 4% (1%)
Real estate:				

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Commercial and residential	3,674	Market Approach	Discount adjustment for differences between comparable sales	0% to 13% (1%)
Land and construction	1,723	Market Approach	Discount adjustment for differences between comparable sales	1% to 4% (2%)
Foreclosed assets:				
Land and construction	1,187	Market Approach	Discount adjustment for differences between comparable sales	0% to 23% (6%)

The Company obtains third party appraisals on its impaired loans held-for-investment and foreclosed assets to determine fair value. Generally, the third party appraisals apply the "market

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****9) Fair Value (Continued)**

approach," which is a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business. Adjustments are then made based on the type of property, age of appraisal, current status of property and other related factors to estimate the current value of collateral.

The carrying amounts and estimated fair values of financial instruments at June 30, 2013 are as follows:

	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Estimated Fair Value Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
(Dollars in thousands)					
<b>Assets:</b>					
Cash and cash equivalents	\$ 85,762	\$ 85,762	\$	\$	\$ 85,762
Securities available-for-sale	293,778		293,778		293,778
Securities held-to-maturity	81,731		72,772		72,772
Loans (including loans held-for-sale), net	828,929		6,321	821,053	827,374
FHLB and FRB stock	10,871				N/A
Accrued interest receivable	4,138		1,552	2,586	4,138
Loan servicing rights and I/O strips receivables	2,357		4,474		4,474
<b>Liabilities:</b>					
Time deposits	\$ 306,214	\$	\$ 306,834	\$	\$ 306,834
Other deposits	882,825		882,825		882,825
Subordinated debt	9,279			5,670	5,670
Accrued interest payable	234		234		234

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****9) Fair Value (Continued)**

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2012:

	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Estimated Fair Value		Total
			Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
(Dollars in thousands)					
<b>Assets:</b>					
Cash and cash equivalents	\$ 373,565	\$ 373,565	\$	\$	\$ 373,565
Securities available-for-sale	367,912		367,912		367,912
Securities held-to-maturity	51,472		50,964		50,964
Loans (including loans held-for-sale), net	796,695		3,409	793,911	797,320
FHLB and FRB stock	10,728				N/A
Accrued interest receivable	3,773		1,514	2,259	3,773
Loan servicing rights and I/O strips receivables	2,495		4,715		4,715
<b>Liabilities:</b>					
Time deposits	\$ 318,664	\$	\$ 319,476	\$	\$ 319,476
Other deposits	1,160,704		1,160,704		1,160,704
Subordinated debt	9,279			5,400	5,400
Accrued interest payable	277		277		277

The methods and assumptions, not previously discussed, used to estimate the fair value are described as follows:

***Cash and Cash Equivalents***

The carrying amounts of cash on hand, noninterest and interest bearing due from bank accounts, and Fed funds sold approximate fair values and are classified as Level 1.

***Loans***

The carrying amounts of loans held-for-sale approximate fair value resulting in a Level 2 classification.

Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**June 30, 2013**

**(Unaudited)**

**9) Fair Value (Continued)**

cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

***FHLB and FRB Stock***

It was not practical to determine the fair value of FHLB and FRB stock due to restrictions placed on their transferability.

***Accrued Interest Receivable/Payable***

The carrying amounts of accrued interest approximate fair value resulting in a Level 2 or Level 3 classification.

***Deposits***

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 2 classification. The carrying amounts of variable rate, fixed-term money market accounts approximate their fair values at the reporting date resulting in a Level 2 classification. The carrying amounts of variable rate, certificates of deposit approximate their fair values at the reporting date resulting in a Level 2 classification. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

***Subordinated Debt***

The fair values of the subordinated debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 3 classification.

***Off-balance Sheet Instruments***

Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material.

***Limitations***

Fair value estimates are made at a specific point in time, based on relevant market information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering for sale at one time the entire holdings of a particular financial instrument. 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 and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****10) Equity Plan**

The Company has maintained an Amended and Restated 2004 Equity Plan (the "2004 Plan") for directors, officers, and key employees. The Equity Plan provides for the grant of incentive and non-qualified stock options and restricted stock. The Equity Plan provides that the option price for both incentive and non-qualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally, options vest over four years. All options expire no later than ten years from the date of grant. The 2004 Plan was terminated on May 23, 2013. On May 23, 2013, the Company's shareholders approved the 2013 Equity Incentive Plan (the "2013 Plan") for equity awards including stock options and restricted stock for directors, officers, and key employees. As of June 30, 2013, there were no equity awards issued and 1,750,000 shares available for issuance under the 2013 Plan.

Stock option activity under the 2004 Plan is as follows:

<b>Total Stock Options</b>	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life (Years)</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at January 1, 2013	1,314,347	\$ 12.90		
Granted	272,050	\$ 6.57		
Exercised	(6,374)	\$ 4.09		
Forfeited or expired	(29,885)	\$ 11.49		
Outstanding at June 30, 2013	1,550,138	\$ 11.85	6.1	\$ 1,030,000
Vested or expected to vest	1,472,631		6.1	\$ 978,000
Exercisable at June 30, 2013	1,033,651		4.6	\$ 592,000

As of June 30, 2013, there was \$1,914,000 of total unrecognized compensation cost related to nonvested stock options granted under the 2004 Plan. That cost is expected to be recognized over a weighted-average period of approximately 3.22 years.

Restricted stock activity under the 2004 Plan is as follows:

<b>Total Restricted Stock Award</b>	<b>Number of Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Nonvested shares at January 1, 2013	88,000	\$ 5.74
Granted	10,000	\$ 6.51
Vested	(40,000)	\$ 5.16
Forfeited		\$
Nonvested shares at June 30, 2013	58,000	\$ 6.28

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****10) Equity Plan (Continued)**

As of June 30, 2013, there was \$198,000 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the 2004 Plan. The cost is expected to be recognized over a weighted-average period of approximately 1.1 years.

**11) Subordinated Debt**

The Company has supported its growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt issued to the trusts is senior to the outstanding shares of common stock and Series C Preferred Stock. As a result, payments must be made on the subordinated debt before any dividends can be paid on the common stock and Series C Preferred Stock. Under the terms of the subordinated debt, the Company may defer interest payments for up to five years. Interest payments on the subordinated notes payable to the Company's subsidiary grantor Trusts are deductible for tax purposes. The subordinated debt is not registered with the Securities and Exchange Commission. For regulatory reporting purposes, the subordinated debt qualified for Tier 1 capital treatment at June 30, 2013, June 30, 2012, and December 31, 2012.

During the third quarter of 2012, the Company redeemed its 10.875% fixed-rate subordinated debentures in the amount of \$7,000,000 issued to Heritage Capital Trust I (and the related premium cost of \$304,500) and the Company's 10.600% fixed-rate subordinated debentures in the amount of \$7,000,000 issued to Heritage Statutory Trust I (and the related premium cost of \$296,800). The related trust securities issued by Capital Trust I and Statutory Trust I were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved. A \$15,000,000 distribution from the Bank to the HCC provided the cash for the redemption. The Company incurred a charge of \$601,300 in 2012 for the early payoff premium on the redemption of the subordinated debt.

The table below summarizes the Company's subordinated debt as of the periods indicated:

	<b>June 30, 2013</b>	<b>December 31, 2012</b>
	<b>(Dollars in thousands)</b>	
Subordinated debentures due to Heritage Statutory Trust II with interest payable quarterly based on 3-month Libor plus 3.58% (3.85% at June 30, 2013), redeemable with a premium beginning July 31, 2006 and with no premium beginning July 31, 2011, due July 31, 2031	\$ 5,155	\$ 5,155
Subordinated debentures due to Heritage Statutory Trust III with interest payable quarterly based on 3-month Libor plus 3.40% (3.67% at June 30, 2013), redeemable with a premium beginning September 26, 2007 and due September 26, 2032	4,124	4,124
<b>Total</b>	<b>\$ 9,279</b>	<b>\$ 9,279</b>

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**June 30, 2013**

**(Unaudited)**

**12) Loss Contingencies**

The Company's policy is to accrue for legal costs associated with both asserted and unasserted claims when it is probable that such costs will be incurred and such costs can be reasonably estimated. The Company had previously accrued for such costs associated with an unasserted claim arising from an apparent transfer of funds for personal use by an authorized signatory of a customer. The litigation is in the very early stages and the Company intends to vigorously defend the litigation. At this time it is not possible to determine the amount of the loss, if any, arising from the claim in excess of the legal expenses expected to be incurred in defense of the litigation.

**13) Subsequent Event**

On June 5, 2013, the Company provided notice to the trustee that it intends to redeem the Company's Floating Rate Junior Subordinated Debentures due July 31, 2031 in the amount of \$5,000,000 issued to Heritage Statutory Trust II and the Company's Floating Rate Junior Subordinated Debentures due September 26, 2032, in the amount of \$4,000,000 issued to Heritage Statutory Trust III (collectively referred to as the "Floating-Rate Sub Debt"). The \$5,000,000 Floating-Rate Sub Debt was redeemed on July 31, 2013. The \$4,000,000 Floating-Rate Sub Debt will be redeemed on September 26, 2013. Additionally, the Company will pay its regularly scheduled interest payments on the Floating-Rate Sub Debt totaling approximately \$90,000 on the respective redemption dates. The Company used available cash and proceeds from a \$9,000,000 distribution from the Bank for the redemption. The Company incurred a total charge of \$167,000 in the second quarter of 2013, representing the agency origination fees associated with the Floating-Rate Sub Debt. On an annual basis, the redemption of the Floating-Rate Sub Debt will eliminate approximately \$360,000 in interest expense.

Table of Contents

**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources of Heritage Commerce Corp (the "Company" or "HCC") and its wholly owned subsidiary, Heritage Bank of Commerce (sometimes referred to as the "Bank" or "HBC"). This information is intended to facilitate the understanding and assessment of significant changes and trends related to our financial condition and the results of operations. This discussion and analysis should be read in conjunction with our consolidated financial statements and the accompanying notes presented elsewhere in this report. Unless we state otherwise or the context indicates otherwise, references to the "Company," "Heritage," "we," "us," and "our," in this Report on Form 10-Q refer to Heritage Commerce Corp and Heritage Bank of Commerce.

**CRITICAL ACCOUNTING POLICIES**

Critical accounting policies are discussed in our Form 10-K for the year ended December 31, 2012. There are no changes to these policies as of June 30, 2013.

**EXECUTIVE SUMMARY**

This summary is intended to identify the most important matters on which management focuses when it evaluates the financial condition and performance of the Company. When evaluating financial condition and performance, management looks at certain key metrics and measures. The Company's evaluation includes comparisons with peer group financial institutions and its own performance objectives established in the internal planning process.

The primary activity of the Company is commercial banking. The Company's operations are located entirely in the southern and eastern regions of the general San Francisco Bay Area of California in the counties of Santa Clara, Alameda and Contra Costa. The largest city in this area is San Jose and the Company's market includes the headquarters of a number of technology based companies in the region known commonly as Silicon Valley. The Company's customers are primarily closely held businesses and professionals.

***Performance Overview***

For the three months ended June 30, 2013, net income was \$2.8 million, or \$0.09 per average diluted common share, compared to \$2.7 million, or \$0.08 per average diluted common share, for the three months ended June 30, 2012. There were no dividends or discount accretion on preferred stock in the second quarter of 2013 and 2012. The Company's annualized return on average assets was 0.82% and annualized return on average equity was 6.53% for the second quarter of 2013, compared to 0.81% and 6.61%, respectively, a year ago.

For the six months ended June 30, 2013, net income available to common shareholders was \$5.0 million, or \$0.16 per average diluted common share, an increase from \$3.6 million, or \$0.11 per average diluted common share, for the six months ended June 30, 2012. In the first quarter of 2012, the Company redeemed its \$40 million of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") issued to the U.S. Treasury Department under the TARP Capital Purchase Program, and recorded the final payment for dividends and discount accretion on its Series A Preferred Stock, which totaled \$1.2 million. The Company's annualized return on average assets was 0.71% and annualized return on average equity was 5.88% for the first six months of 2013, compared to 0.72% and 5.44%, respectively, a year ago.

Late in the fourth quarter of 2012, the Company received short-term demand deposits in the amount of \$467.5 million from one customer for specific transactions. Of this amount, \$195.6 million

Table of Contents

was subsequently withdrawn, for a net outstanding balance of \$271.9 million at December 31, 2012. The outstanding balance of the short-term demand deposits was \$17.0 million at June 30, 2013. Because of the short-term nature of these funds, the excess liquidity was placed in low-interest earning deposits at the Federal Reserve Bank.

The following are major factors that impacted the Company's results of operations:

The net interest margin decreased six basis points to 3.89% in the second quarter of 2013, compared to 3.95% for the second quarter of 2012, primarily due to lower yields on loans and securities, partially offset by a lower cost of funds. The net interest margin decreased 21 basis points to 3.80% for the six months ended June 30, 2013, compared to 4.01% for the six months ended June 30, 2012, primarily as a result of a lower yield on loans and securities, and a higher average balance of excess deposits at the Federal Reserve, partially offset by a lower cost of funds.

Net interest income increased slightly to \$12.2 million for the second quarter of 2013, compared to \$12.1 million for the second quarter of 2012, primarily due to a higher average volume of loans and securities. Net interest income remained flat at \$24.3 million for the six months ended June 30, 2013, compared to the six months ended June 30, 2012.

A credit to the provision for loan losses of \$270,000 for the second quarter of 2013 was the result of improving overall asset quality and net recoveries of \$270,000. This compares to a provision for loan losses of \$815,000 for the second quarter of 2012. A credit to the provision for loan losses for the six months ended June 30, 2013 was \$270,000, compared to a provision for loan losses \$915,000 for the first six months of 2012.

Noninterest income was \$1.9 million for the second quarter of 2013, compared to \$2.1 million for the second quarter of 2012. Noninterest income was \$3.6 million for the first six months of 2013, compared to \$3.8 million for the first six months of 2012. Noninterest income was lower in the second quarter and first six months of 2013, compared to the same periods in 2012, primarily due to a lower gain on sales of SBA loans and servicing income.

Noninterest expense was \$10.4 million for the second quarter of 2013, compared to \$9.5 million for the second quarter of 2012. For the six months ended June 30, 2013, noninterest expense was \$21.2 million, compared to \$20.3 million for the six months ended June 30, 2012. The increase in noninterest expense from the same periods a year ago was primarily due to increased salaries and employee benefits expense due to annual salary increases and the hiring of additional lending relationship officers, and a \$167,000 charge in the second quarter of 2013 related to the redemption of the floating-rate subordinated debt, partially offset by gains on the sale of foreclosed assets.

The efficiency ratio was 73.85% for the second quarter of 2013, compared to 66.70% for the second quarter of 2012. The efficiency ratio for the six months ended June 30, 2013 was 75.92%, compared to 72.13% for the six months ended June 30, 2012. The increase in the efficiency ratio compared to the same periods in 2012, was primarily due to higher salary and benefits expense, lower gains on sales of SBA loans and servicing income.

Income tax expense for the quarter ended June 30, 2013 was \$1.2 million, the same as the second quarter of 2012. The effective tax rate for the second quarter of 2013 was 29%, compared to 31% for the second quarter a year ago. For the first six months of 2013, income tax expense was \$2.0 million, compared to \$2.2 million for the first six months a year ago. The effective tax rate for the six months ended June 30, 2013 was 29%, compared to 31% for the six months ended June 30, 2012. The decrease in the effective tax rate for the second quarter and first six months of 2013, compared to the same periods in 2012, was primarily the result of tax-exempt interest income earned on municipal bonds.

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

### Table of Contents

The following are important factors in understanding our current financial condition and liquidity position:

Cash, Federal funds sold, interest-bearing deposits in other financial institutions and securities available-for-sale decreased 13% to \$379.5 million at June 30, 2013, from \$436.2 million at June 30, 2012, and decreased 49% from \$741.5 million at December 31, 2012. Excluding the short-term deposits at the Federal Reserve Bank offsetting the short-term demand deposits from one customer of \$17.0 million at June 30, 2013 and \$271.9 million at December 31, 2012, total cash, Federal funds sold, interest-bearing deposits in other financial institutions and securities available-for-sale decreased 17% to \$362.5 million at June 30, 2013, from \$436.2 million at June 30, 2012, and decreased 23% from \$469.6 million at December 31, 2012.

Securities held-to-maturity, at amortized cost, were \$81.7 million at June 30, 2013, compared to no securities held-to-maturity at June 30, 2012. Securities held-to-maturity, at amortized cost, were \$51.5 million at December 31, 2012.

Total loans, excluding loans held-for-sale, increased \$43.8 million, or 5%, to \$842.0 million at June 30, 2013, compared to \$798.1 million at June 30, 2012, and increased \$29.6 million, or 4%, from \$812.3 million at December 31, 2012.

Nonperforming assets were \$15.0 million, or 1.07% of total assets at June 30, 2013, compared to \$17.8 million or 1.35% of total assets at June 30, 2012, and \$19.5 million, or 1.15% of total assets at December 31, 2012. Nonperforming assets were 1.09% of total assets at June 30, 2013, compared to 1.37% of total assets at December 31, 2012, excluding the short-term deposits of \$17.0 million and \$271.9 million, respectively, at the Federal Reserve Bank offsetting the short-term demand deposits from one customer.

Classified assets, net of Small Business Administration ("SBA") guarantees, decreased 57% to \$23.8 million at June 30, 2013 from \$54.9 million at June 30, 2012, and decreased 35% from \$36.8 million at December 31, 2012.

Net recoveries totaled \$270,000 for the second quarter of 2013, compared to net charge-offs of \$1.1 million for the second quarter of 2012, and net charge-offs of \$766,000 for the fourth quarter of 2012.

The allowance for loan losses at June 30, 2013 was \$19.3 million, or 2.30% of total loans, representing 134.52% of nonperforming loans (there were no nonaccrual loans in loans held-for-sale at June 30, 2013). The allowance for loan losses at June 30, 2012 was \$20.0 million, or 2.51% of total loans, representing 137.57% of nonperforming loans, excluding the \$177,000 nonaccrual loans in loans held-for-sale. The allowance for loan losses at December 31, 2012 was \$19.0 million, or 2.34% of total loans, representing 104.58% of nonperforming loans (there were no nonaccrual loans in loans held-for-sale at December 31, 2012).

Total deposits, excluding brokered deposits and short-term demand deposits from one customer of \$17.0 million at June 30, 2013 and \$271.9 million at December 31, 2012, were \$1.10 billion at June 30, 2013, compared to \$1.01 billion at June 30, 2012, and \$1.11 billion at December 31, 2012.

The ratio of noncore funding (which consists of time deposits \$100,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase and short-term borrowings) to total assets was 20.87% at June 30, 2013, compared to 20.17% at June 30, 2012, and 17.63% at December 31, 2012. The ratio of noncore funding to total assets was 21.13% at June 30, 2013 and 21.00% at December 31, 2012, excluding the short-term deposits of \$17.0 million and \$271.9 million, respectively, at the Federal Reserve Bank offsetting the short-term demand deposits from one customer.

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

### Table of Contents

The loan to deposit ratio was 70.81% at June 30, 2013, compared to 72.37% at June 30, 2012, and 54.91% at December 31, 2012. The loan to deposit ratio was 71.84% at June 30, 2013 and 67.27% at December 31, 2012, excluding the \$17.0 million and \$271.9 million, respectively, of short-term demand deposits from one customer.

Accumulated other comprehensive loss was (\$4.7) million at June 30, 2013, compared to accumulated other comprehensive income of \$3.2 million at June 30, 2012, and accumulated other comprehensive income of \$2.7 million at December 31, 2012. The decrease was primarily due to an increase in interest rates which resulted in an unrealized loss on securities available-for-sale of (\$507,000), net of taxes, at June 30, 2013, compared to an unrealized gain on securities available-for-sale of \$7.1 million, net of taxes, at June 30, 2012, and an unrealized gain on securities available-for-sale of \$6.9 million, net of taxes, at December 31, 2012.

Capital ratios exceed regulatory requirements for a well-capitalized financial institution, both on a consolidated basis and at the bank level at June 30, 2013:

Capital Ratios	Heritage Commerce Corp	Heritage Bank of Commerce	Well-Capitalized Financial Institution Regulatory Guidelines
Total Risk-Based	16.4%	15.6%	10.0%
Tier 1 Risk-Based	15.1%	14.3%	6.0%
Leverage	12.4%	11.7%	5.0%

### ***Recent Events***

On June 5, 2013, the Company provided notice to the trustee that it intends to redeem the Company's Floating Rate Junior Subordinated Debentures due July 31, 2031 in the amount of \$5 million issued to Heritage Statutory Trust II and the Company's Floating Rate Junior Subordinated Debentures due September 26, 2032, in the amount of \$4 million issued to Heritage Statutory Trust III (collectively referred to as the "Floating-Rate Sub Debt"). The \$5 million Floating-Rate Sub Debt was redeemed on July 31, 2013. The \$4 million Floating-Rate Sub Debt will be redeemed on September 26, 2013. Additionally, the Company will pay its regularly scheduled interest payments on the Floating-Rate Sub Debt totaling approximately \$90,000 on the respective redemption dates. The Company used available cash and proceeds from a \$9 million distribution from the Bank for the redemption. The Company incurred a total charge of \$167,000 in the second quarter of 2013, representing the agency origination fees associated with the Floating-Rate Sub Debt. On an annual basis, the redemption of the Floating-Rate Sub Debt will eliminate approximately \$360,000 in interest expense.

On June 12, 2013, the Company completed the repurchase of the common stock warrant issued to the U.S. Department of the Treasury on November 21, 2008, which was exercisable into 462,963 shares of common stock at an exercise price of \$12.96. The Company repurchased the warrant for \$140,000.

### ***Deposits***

The composition and cost of the Company's deposit base are important in analyzing the Company's net interest margin and balance sheet liquidity characteristics. Except for brokered and State of California time deposits, the Company's depositors are generally located in its primary market area. Depending on loan demand and other funding requirements, the Company also obtains deposits from wholesale sources including deposit brokers. The Company had \$76.8 million in brokered deposits at June 30, 2013, compared to \$97.7 million at June 30, 2012, and \$97.8 million at December 31, 2012. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators decreased to \$18.2 million at June 30, 2013, compared to \$35.7 million at June 30, 2012, and \$21.4 million at December 31, 2012. Certificates of deposit from the State of California totaled \$98.0 million at June 30, 2013, compared to \$50.0 million at June 30, 2012, and \$85.0 million at

Table of Contents

December 31, 2012. Total deposits at June 30, 2013 were \$1.19 billion, compared to \$1.10 billion at June 30, 2012 and \$1.48 billion at December 31, 2012. Core deposits (excluding all time deposits, CDARS deposits, and the short-term demand deposits from one customer of \$17.0 million at June 30, 2013 and \$271.9 million at December 31, 2012) increased to \$856.9 million at June 30, 2013, an increase of \$49.3 million, or 6% from \$807.6 million at June 30, 2012, and decreased \$26.9 million, or 3%, from \$883.8 million at December 31, 2012. The Company has a policy to monitor all deposits that may be sensitive to interest rate changes to help assure that liquidity risk does not become excessive due to concentrations.

HBC is a member of the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program allows customers with deposits in excess of FDIC insured limits to obtain coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through this program are considered brokered deposits under regulatory guidelines. Deposits in the CDARS program totaled \$17.6 million at June 30, 2013, compared to \$5.4 million at June 30, 2012, and \$10.2 million at December 31, 2012.

***Liquidity***

Our liquidity position refers to our ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely fashion. At June 30, 2013, we had \$85.8 million in cash and cash equivalents and approximately \$330.1 million in available borrowing capacity from various sources including the Federal Home Loan Bank ("FHLB"), the Federal Reserve Bank of San Francisco ("FRB"), and Federal funds facilities with several financial institutions. The Company also had \$247.2 million in unpledged securities available at June 30, 2013. Our loan to deposit ratio decreased to 70.81% at June 30, 2013, compared to 72.37% at June 30, 2012, and increased from 54.91% at December 31, 2012. The loan to deposit ratio was 71.84% at June 30, 2013 and 67.27% at December 31, 2012, excluding the \$17.0 million and \$271.9 million, respectively, of short-term demand deposits from one customer.

***Lending***

Our lending business originates principally through our branch offices located in our primary markets. The Company also has an additional SBA loan production office in Santa Rosa, California. Total loans, excluding loans held-for-sale, increased 5% to \$842.0 million at June 30, 2013, from \$798.1 million at June 30, 2012, and increased 4% from \$812.3 million at December 31, 2012. The loan portfolio remains well diversified with commercial and industrial ("C&I") loans accounting for 46% of the total loan portfolio at June 30, 2013. Commercial and residential real estate loans accounted for 44% of the total loan portfolio at June 30, 2013, of which 50% were owner-occupied by businesses. Consumer and home equity loans accounted for 7% of the total loan portfolio, and land and construction loans accounted for the remaining 3% of the total loan portfolio at June 30, 2013. The yield on the loan portfolio was 4.93% for the second quarter of 2013, compared to 5.23% for the second quarter of 2012, and 5.13% for the first quarter of 2013. The yield on the loan portfolio was 5.03% for the six months ended June 30, 2013, compared to 5.32% for six months ended June 30, 2012.

***Net Interest Income***

The management of interest income and expense is fundamental to the performance of the Company. Net interest income, the difference between interest income and interest expense, is the largest component of the Company's total revenue. Management closely monitors both total net interest income and the net interest margin (net interest income divided by average earning assets).

The Company through its asset and liability policies and practices seeks to maximize net interest income without exposing the Company to an excessive level of interest rate risk. Interest rate risk is

Table of Contents

managed by monitoring the pricing, maturity and repricing options of all classes of interest bearing assets and liabilities. This is discussed in more detail under "*Liquidity and Asset/Liability Management*." In addition, we believe there are measures and initiatives we can take to improve the net interest margin, including increasing loan rates, adding floors on floating rate loans, reducing nonperforming assets, managing deposit interest rates, and reducing higher cost deposits.

The net interest margin is also adversely impacted by the reversal of interest on nonaccrual loans and the reinvestment of loan payoffs into lower yielding investment securities and other short-term investments.

***Management of Credit Risk***

We continue to proactively identify, quantify, and manage our problem loans. Early identification of problem loans and potential future losses helps enable us to resolve credit issues with potentially less risk and ultimate losses. We maintain an allowance for loan losses in an amount that we believe is adequate to absorb probable incurred losses in the portfolio. While we strive to carefully manage and monitor credit quality and to identify loans that may be deteriorating, circumstances can change at any time for loans included in the portfolio that may result in future losses, that as of the date of the financial statements have not yet been identified as potential problem loans. Through established credit practices, we adjust the allowance for loan losses accordingly. However, because future events are uncertain, there may be loans that deteriorate some of which could occur in an accelerated time frame. As a result, future additions to the allowance for loan losses may be necessary. Because the loan portfolio contains a number of commercial loans, commercial real estate, construction and land development loans with relatively large balances, deterioration in the credit quality of one or more of these loans may require a significant increase to the allowance for loan losses. Future additions to the allowance may also be required based on changes in the financial condition of borrowers. Additionally, Federal and state banking regulators, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to recognize further loan loss provisions or charge-offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses would have an adverse effect, which may be material, on our financial condition and results of operation.

Further discussion of the management of credit risk appears under "*Provision for Loan Losses*" and "*Allowance for Loan Losses*."

***Noninterest Income***

While net interest income remains the largest single component of total revenues, noninterest income is an important component. A portion of the Company's noninterest income is associated with its SBA lending activity, consisting of gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing retained. Other sources of noninterest income include loan servicing fees, service charges and fees, cash surrender value from company owned life insurance policies, and gains on the sale of securities.

***Noninterest Expense***

Management considers the control of operating expenses to be a critical element of the Company's performance. Noninterest expense for the second quarter of 2013 increased to \$10.4 million, compared to \$9.5 million for the same period in 2012. Noninterest expense for the first six months of 2013 increased to \$21.2 million, compared to \$20.3 million for the six months of 2012. The increase in noninterest expense from the same periods a year ago was primarily due to increased salaries and employee benefits expense due to annual salary increases and the hiring of additional lending relationship officers, and a \$167,000 charge in the second quarter of 2013 related to the redemption of the floating-rate subordinated debt.

Table of Contents

**Capital Management**

As part of its asset and liability management process, the Company continually assesses its capital position to take into consideration growth, expected earnings, risk profile and potential corporate activities that it may choose to pursue.

On November 21, 2008, the Company issued to the U.S. Treasury under its Capital Purchase Program 40,000 shares of Series A Preferred Stock for \$40.0 million and issued a warrant to purchase 462,963 shares of common stock at an exercise price of \$12.96.

On June 21, 2010, the Company issued Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") to a limited number of institutional investors. The Series C Preferred Stock remains outstanding until its conversion to common stock upon the transfer of the Series C Preferred Stock in accordance with its terms. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock.

On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve, the Company repurchased all shares of the Series A Preferred Stock and paid the related accrued and unpaid dividends. The repurchase of the Series A Preferred Stock will save \$2.0 million in annual dividends. On June 12, 2013, the Company completed the repurchase of the common stock warrant for \$140,000.

We have supported our growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt that we issued to the trusts is senior to our shares of common stock and Series C Preferred Stock. As a result, we must make payments on the subordinated debt before any dividends can be paid on our common stock and Series C Preferred Stock. Under the terms of the subordinated debt, we may defer interest payments for up to five years. During the third quarter of 2012, the Company completed the redemption of \$14 million fixed-rate subordinated debt, and had \$9.3 million of floating-rate subordinated debt outstanding at June 30, 2013. In June 2013, the Company announced that it will redeem the remaining \$9.3 million of floating-rate subordinated debt during the third quarter of 2013. The \$5 million Floating-Rate Sub Debt was redeemed on July 31, 2013. The \$4 million Floating-Rate Sub Debt will be redeemed on September 26, 2013. The Company is current with respect to interest accrued on trust preferred subordinated debt securities as of June 30, 2013 and was current as of December 31, 2012.

**RESULTS OF OPERATIONS**

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on interest-bearing liabilities. The second is noninterest income, which primarily consists of gains on the sale of loans, loan servicing fees, customer service charges and fees, the increase in cash surrender value of life insurance, and gains on the sale of securities. The majority of the Company's noninterest expenses are operating costs that relate to providing a full range of banking services to our customers.

***Net Interest Income and Net Interest Margin***

The level of net interest income depends on several factors in combination, including yields on earning assets, the cost of interest-bearing liabilities, the relative volumes of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. To maintain its net interest margin the Company must manage the relationship between interest earned and paid.

The following Distribution, Rate and Yield table presents the average amounts outstanding for the major categories of the Company's balance sheet, the average interest rates earned or paid thereon,

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

and the resulting net interest margin on average interest earning assets for the periods indicated. Average balances are based on daily averages.

**Distribution, Rate and Yield**

NET INTEREST INCOME AND NET INTEREST MARGIN	For the Three Months Ended June 30, 2013			For the Three Months Ended June 30, 2012		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
(Dollars in thousands)						
<b>Assets:</b>						
Loans, gross(1)	\$ 817,565	\$ 10,051	4.93%	\$ 791,660	\$ 10,292	5.23%
Securities taxable	358,532	2,399	2.68%	398,143	2,975	3.01%
Securities tax exempt(2)	58,474	550	3.77%			
Federal funds sold and interest-bearing deposits in other financial institutions	39,198	30	0.31%	41,508	29	0.28%
Total interest earning assets(2)	1,273,769	13,030	4.10%	1,231,311	13,296	4.34%
Cash and due from banks	22,658			21,191		
Premises and equipment, net	7,611			7,841		
Intangible assets	1,830			2,316		
Other assets	67,334			69,115		
Total assets	\$ 1,373,202			\$ 1,331,774		
<b>Liabilities and shareholders' equity:</b>						
<b>Deposits:</b>						
Demand, noninterest-bearing	\$ 392,122			\$ 370,086		
Demand, interest-bearing	167,726	57	0.14%	147,767	56	0.15%
Savings and money market	281,565	124	0.18%	298,544	179	0.24%
Time deposits under \$100	23,292	21	0.36%	28,011	35	0.50%
Time deposits \$100 and over	194,738	194	0.40%	166,486	246	0.59%
Time deposits brokered	81,118	197	0.97%	93,259	219	0.94%
CDARS money market and time deposits	17,918	2	0.04%	5,900	3	0.20%
Total interest-bearing deposits	766,357	595	0.31%	739,967	738	0.40%
Total deposits	1,158,479	595	0.21%	1,110,053	738	0.27%
Subordinated debt	9,279	90	3.89%	23,702	472	8.01%
Short-term borrowings	288		0.00%	3,196	2	0.25%
Total interest-bearing liabilities	775,924	685	0.35%	766,865	1,212	0.64%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,168,046	685	0.24%	1,136,951	1,212	0.43%
Other liabilities	33,681			31,905		
Total liabilities	1,201,727			1,168,856		
Shareholders' equity	171,475			162,918		
Total liabilities and shareholders' equity	\$ 1,373,202			\$ 1,331,774		
<b>Net interest income and margin</b>						
Net interest income(2) / margin		12,345	3.89%		12,084	3.95%
Less tax equivalent adjustment(2)		(192)				
Net interest income	\$ 12,153			\$ 12,084		

- (1) Includes loans held-for-sale. Yield amounts earned on loans include loan fees and costs. Nonaccrual loans are included in average balance.
- (2) Reflects tax equivalent adjustment for tax exempt income based on a 35% tax rate.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

NET INTEREST INCOME AND NET INTEREST MARGIN	For the Six Months Ended June 30, 2013			For the Six Months Ended June 30, 2012		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
(Dollars in thousands)						
<b>Assets:</b>						
Loans, gross(1)	\$ 807,901	\$ 20,140	5.03%	\$ 778,640	\$ 20,608	5.32%
Securities taxable	372,044	4,860	2.63%	394,031	6,072	3.10%
Securities tax exempt(2)	49,563	932	3.79%			
Federal funds sold and interest-bearing deposits in other financial institutions	77,858	99	0.26%	48,750	65	0.27%
Total interest earning assets(2)	1,307,366	26,031	4.02%	1,221,421	26,745	4.40%
Cash and due from banks	23,104			21,089		
Premises and equipment, net	7,566			7,909		
Intangible assets	1,892			2,378		
Other assets	67,944			69,082		
Total assets	\$ 1,407,872			\$ 1,321,879		
<b>Liabilities and shareholders' equity:</b>						
<b>Deposits:</b>						
Demand, noninterest-bearing	\$ 426,424			\$ 358,689		
Demand, interest-bearing	166,073	116	0.14%	145,208	109	0.15%
Savings and money market	282,392	244	0.17%	293,374	345	0.24%
Time deposits under \$100	23,940	43	0.36%	28,117	73	0.52%
Time deposits \$100 and over	192,518	398	0.42%	168,090	501	0.60%
Time deposits brokered	86,561	416	0.97%	88,992	420	0.95%
CDARS money market and time deposits	14,714	3	0.04%	6,083	6	0.20%
Total interest-bearing deposits	766,198	1,220	0.32%	729,864	1,454	0.40%
Total deposits	1,192,622	1,220	0.21%	1,088,553	1,454	0.27%
Subordinated debt	9,279	178	3.87%	23,702	946	8.03%
Short-term borrowings	207	1	0.97%	1,618	2	0.25%
Total interest-bearing liabilities	775,684	1,399	0.36%	755,184	2,402	0.64%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,202,108	1,399	0.23%	1,113,873	2,402	0.43%
Other liabilities	35,080			32,287		
Total liabilities	1,237,188			1,146,160		
Shareholders' equity	170,684			175,719		
Total liabilities and shareholders' equity	\$ 1,407,872			\$ 1,321,879		
Net interest income(2) / margin		24,632	3.80%		24,343	4.01%
Less tax equivalent adjustment(2)		(326)				
Net interest income		\$ 24,306			\$ 24,343	

(1)

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Includes loans held-for-sale. Yield amounts earned on loans include loan fees and costs. Nonaccrual loans are included in average balance.

(2)

Reflects tax equivalent adjustment for tax exempt income based on a 35% tax rate.

Table of Contents**Volume and Rate Variances**

The Volume and Rate Variances table below sets forth the dollar difference in interest earned and paid for each major category of interest-earning assets and interest-bearing liabilities for the noted periods, and the amount of such change attributable to changes in average balances (volume) or changes in average interest rates. Volume variances are equal to the increase or decrease in the average balance times the prior period rate, and rate variances are equal to the increase or decrease in the average rate times the prior period average balance. Variances attributable to both rate and volume changes are equal to the change in rate times the change in average balance and are included below in the average volume column.

	<b>Three Months Ended June 30, 2013 vs. 2012 Increase (Decrease) Due to Change In:</b>		
	<b>Average Volume</b>	<b>Average Rate</b>	<b>Net Change</b>
<b>(Dollars in thousands)</b>			
<b>Income from interest earning assets:</b>			
Loans, gross	\$ 321	\$ (562)	\$ (241)
Securities taxable	(261)	(315)	(576)
Securities tax exempt	550		550
Federal funds sold and interest-bearing deposits in other financial institutions	(2)	3	1
<b>Total interest income from interest earnings assets</b>	<b>608</b>	<b>(874)</b>	<b>(266)</b>
<b>Expense on interest-bearing liabilities:</b>			
Demand, interest-bearing	5	(4)	1
Savings and money market	(10)	(45)	(55)
Time deposits under \$100	(4)	(10)	(14)
Time deposits \$100 and over	28	(80)	(52)
Time deposits brokered	(29)	7	(22)
CDARS money market and time deposits	1	(2)	(1)
Subordinated debt	(140)	(242)	(382)
Short-term borrowings		(2)	(2)
<b>Total interest expense on interest-bearing liabilities</b>	<b>(149)</b>	<b>(378)</b>	<b>(527)</b>
<b>Net interest income</b>	<b>\$ 757</b>	<b>\$ (496)</b>	<b>\$ 261</b>

Table of Contents

	Six Months Ended June 30, 2013 vs. 2012 Increase (Decrease) Due to Change In:		
	Average Volume	Average Rate	Net Change
(Dollars in thousands)			
<b>Income from interest earning assets:</b>			
Loans, gross	\$ 718	\$ (1,186)	\$ (468)
Securities taxable	(279)	(933)	(1,212)
Securities tax exempt	932		932
Federal funds sold and interest-bearing deposits in other financial institutions	36	(2)	34
<b>Total interest income from interest earnings assets</b>	<b>1,407</b>	<b>(2,121)</b>	<b>(714)</b>
<b>Expense on interest-bearing liabilities:</b>			
Demand, interest-bearing	15	(8)	7
Savings and money market	(3)	(98)	(101)
Time deposits under \$100	(7)	(23)	(30)
Time deposits \$100 and over	48	(151)	(103)
Time deposits brokered	(12)	8	(4)
CDARS money market and time deposits	2	(5)	(3)
Subordinated debt	(277)	(491)	(768)
Short-term borrowings	(7)	6	(1)
<b>Total interest expense on interest-bearing liabilities</b>	<b>(241)</b>	<b>(762)</b>	<b>(1,003)</b>
<b>Net interest income</b>	<b>\$ 1,648</b>	<b>\$ (1,359)</b>	<b>\$ 289</b>

The Company's net interest margin, expressed as a percentage of average earning assets was 3.89% for the second quarter of 2013, compared to 3.95% for the second quarter a year ago, as a decrease in average yields on loans and investment securities was primarily offset by a lower cost of funds in the second quarter of 2013. For the first six months of 2013, the net interest margin decreased to 3.80%, compared to 4.01% for the first six months of 2012. The decrease in net interest margin was primarily as a result of lower yields on loans and securities, and an average balance of excess deposits at the Federal Reserve, partially offset by a lower cost of funds.

Net interest income increased slightly to \$12.2 million for the second quarter of 2013, compared to \$12.1 million for the second quarter of 2012, primarily due to a higher average volume of loans and securities. Net interest income remained flat at \$24.3 million for the six months ended June 30, 2013, compared to the six months ended June 30, 2012.

A substantial portion of the Company's earning assets are variable-rate loans that re-price when the Company's prime lending rate is changed, compared to a large base of core deposits that are generally slower to re-price. This causes the Company's balance sheet to be asset-sensitive, which means that all else being equal, the Company's net interest margin will be lower during periods when short-term interest rates are falling and higher when rates are rising.

***Provision for Loan Losses***

Credit risk is inherent in the business of making loans. The Company establishes an allowance for loan losses through charges to earnings, which are presented in the statements of income as the provision for loan losses. Specifically identifiable and quantifiable known losses are promptly charged off against the allowance. The provision for loan losses is determined by conducting a quarterly evaluation of the adequacy of the Company's allowance for loan losses and charging the shortfall, if

Table of Contents

any, to the current quarter's expense. This has the effect of creating variability in the amount and frequency of charges to the Company's earnings. The provision for loan losses and level of allowance for each period are dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of the quality of the loan portfolio, the valuation of problem loans and the general economic conditions in the Company's market area.

A credit to the provision for loan losses of \$270,000 for the second quarter of 2013 was the result of improving overall asset quality and net recoveries of \$270,000. This compares to a provision for loan losses of \$815,000 for the second quarter of 2012. A credit to the provision for loan losses for the six months ended June 30, 2013 was \$270,000, compared to a provision for loan losses \$915,000 for the first six months of 2012.

The allowance for loan losses totaled \$19.3 million, or 2.30% of total loans at June 30, 2013, compared to \$20.0 million, or 2.51% of total loans at June 30, 2012, and \$19.0 million, or 2.34% of total loans at December 31, 2012. The decrease in the allowance for loan losses at June 30, 2013, compared to June 30, 2012, was primarily due to improved risk grading and credit metrics on non-impaired real estate loans, as well as a decline in historical charge-off levels. Net recoveries totaled \$270,000 for the second quarter of 2013, compared to net charge-offs of \$1.1 million for the second quarter of 2012, and net charge-offs of \$766,000 for the fourth quarter of 2012. Provisions for loan losses are charged to operations to bring the allowance for loan losses to a level deemed appropriate by the Company based on the factors discussed under "Allowance for Loan Losses".

**Noninterest Income**

The following table sets forth the various components of the Company's noninterest income for the periods indicated:

	For the Three Months Ended June 30,		Increase (decrease) 2013 versus 2012	
	2013	2012	Amount	Percent
(Dollars in thousands)				
Service charges and fees on deposit accounts	\$ 618	\$ 601	\$ 17	3%
Increase in cash surrender value of life insurance	410	429	(19)	-4%
Servicing income	385	447	(62)	-14%
Gain on sales of SBA loans	134	376	(242)	-64%
Gain on sales of securities	7	32	(25)	-78%
Other	361	205	156	76%
<b>Total noninterest income</b>	<b>\$ 1,915</b>	<b>\$ 2,090</b>	<b>\$ (175)</b>	<b>-8%</b>

	For the Six Months Ended June 30,		Increase (decrease) 2013 versus 2012	
	2013	2012	Amount	Percent
(Dollars in thousands)				
Service charges and fees on deposit accounts	\$ 1,195	\$ 1,191	\$ 4	0%
Increase in cash surrender value of life insurance	826	858	(32)	-4%
Servicing income	750	907	(157)	-17%
Gain on sales of SBA loans	270	412	(142)	-34%
Gain on sales of securities	38	59	(21)	-36%
Other	499	386	113	29%
<b>Total noninterest income</b>	<b>\$ 3,578</b>	<b>\$ 3,813</b>	<b>\$ (235)</b>	<b>-6%</b>

Table of Contents

The decrease in noninterest income in the second quarter and first six months of 2013, compared to the same periods in 2012 was primarily attributable to a lower gain on sales of SBA loans.

Historically, a significant percentage of the Company's noninterest income has been associated with its SBA lending activity, as gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. For the three months ended June 30, 2013, SBA loan sales resulted in a \$134,000 gain, compared to a \$376,000 gain on sale of SBA loans for the three months ended June 30, 2012. For the six months ended June 30, 2013, SBA loan sales resulted in a \$270,000 gain, compared to a \$412,000 gain on sale of SBA loans for the six months ended June 30, 2012. The gain on sales of SBA loans were lower in the second quarter and first six months of 2013, compared to the same periods in 2012, primarily due to a lower balance of SBA loans sold. The servicing assets that result from the sales of SBA loans with servicing retained are amortized over the expected term of the loans using a method approximating the interest method. Servicing income generally declines as the respective loans are repaid.

**Noninterest Expense**

The following table sets forth the various components of the Company's noninterest expense for the periods indicated:

	For the Three Months Ended June 30,		Increase (decrease) 2013 versus 2012	
	2013	2012	Amount	Percent
(Dollars in thousands)				
Salaries and employee benefits	\$ 5,864	\$ 5,377	\$ 487	9%
Occupancy and equipment	1,028	967	61	6%
Professional fees	400	470	(70)	-15%
Data processing	327	247	80	32%
Low income housing investment losses	300	262	38	15%
Software subscriptions	294	313	(19)	-6%
Insurance expense	253	224	29	13%
FDIC deposit insurance premiums	207	202	5	2%
Correspondent bank charges	179	155	24	15%
Subordinated debt redemption charges	167		167	N/A
Foreclosed assets, net	(96)	105	(201)	-191%
Other	1,466	1,132	334	30%
<b>Total noninterest expense</b>	<b>\$ 10,389</b>	<b>\$ 9,454</b>	<b>\$ 935</b>	<b>10%</b>

Table of Contents

	For the Six Months Ended June 30,		Increase (decrease) 2013 versus 2012	
	2013	2012	Amount	Percent
(Dollars in thousands)				
Salaries and employee benefits	\$ 11,875	\$ 11,044	\$ 831	8%
Occupancy and equipment	2,096	1,963	133	7%
Professional fees	1,382	1,681	(299)	-18%
Data processing	579	492	87	18%
Low income housing investment losses	611	531	80	15%
Software subscriptions	585	603	(18)	-3%
Insurance expense	508	447	61	14%
FDIC deposit insurance premiums	466	427	39	9%
Correspondent bank charges	343	299	44	15%
Subordinated debt redemption charges	167		167	N/A
Foreclosed assets, net	(251)	220	(471)	-214%
Other	2,809	2,603	206	8%
<b>Total noninterest expense</b>	<b>\$ 21,170</b>	<b>\$ 20,310</b>	<b>\$ 860</b>	<b>4%</b>

The following table indicates the percentage of noninterest expense in each category for the periods indicated:

*Noninterest Expense by Category*

	For The Three Months Ended June 30,			
	2013	Percent of Total	2012	Percent of Total
(Dollars in thousands)				
Salaries and employee benefits	\$ 5,864	56%	\$ 5,377	57%
Occupancy and equipment	1,028	10%	967	10%
Professional fees	400	4%	470	5%
Data processing	327	3%	247	3%
Low income housing investment losses	300	3%	262	3%
Software subscriptions	294	3%	313	3%
Insurance expense	253	2%	224	2%
FDIC deposit insurance premiums	207	2%	202	2%
Correspondent bank charges	179	2%	155	2%
Subordinated debt redemption charges	167	2%		0%
Foreclosed assets, net	(96)	-1%	105	1%
Other	1,466	14%	1,132	12%
<b>Total noninterest expense</b>	<b>\$ 10,389</b>	<b>100%</b>	<b>\$ 9,454</b>	<b>100%</b>

Table of Contents

	For The Six Months Ended June 30,			
	2013	Percent of Total	2012	Percent of Total
	(Dollars in thousands)			
Salaries and employee benefits	\$ 11,875	56%	\$ 11,044	54%
Occupancy and equipment	2,096	10%	1,963	10%
Professional fees	1,382	6%	1,681	8%
Data processing	579	3%	492	3%
Low income housing investment losses	611	3%	531	3%
Software subscriptions	585	3%	603	3%
Insurance expense	508	2%	447	2%
FDIC deposit insurance premiums	466	2%	427	2%
Correspondent bank charges	343	2%	299	2%
Subordinated debt redemption charges	167	1%		0%
Foreclosed assets, net	(251)	-1%	220	1%
Other	2,809	13%	2,603	13%
<b>Total noninterest expense</b>	<b>\$ 21,170</b>	<b>100%</b>	<b>\$ 20,310</b>	<b>100%</b>

Noninterest expense in the second quarter of 2013 was \$10.4 million, an increase from \$9.5 million for the first quarter of 2012. Noninterest expense for the first six months of 2013 was \$21.2 million, compared to \$20.3 million for the first six months of 2012. The increase in noninterest expense from the same periods a year ago was primarily due to increased salaries and employee benefits expense due to annual salary increases and the hiring of additional lending relationship officers, and a \$167,000 charge in the second quarter of 2013 related to the redemption of the floating-rate subordinated debt. Full-time equivalent employees were 191 at June 30, 2013 and 187 at June 30, 2012.

**Income Tax Expense**

The Company computes its provision for income taxes on a monthly basis. The effective tax rate is determined by applying the Company's statutory income tax rates to pre-tax book income as adjusted for permanent differences between pre-tax book income and actual taxable income. These permanent differences include, but are not limited to, increases in the cash surrender value of life insurance policies, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits.

The Company's Federal and state income tax expense for the quarter and six months ended June 30, 2013 was \$1.2 million and \$2.0 million, respectively. The income tax expense was \$1.2 million and \$2.2 million for the same periods in 2012. The following table shows the Company's effective income tax rates for the periods indicated:

	For the Three Months Ended June 30,		For Six Months Ended June 30,	
	2013	2012	2013	2012
Effective income tax rate	29.3%	31.4%	28.8%	31.4%

The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes, tax credits related to investments in low income housing limited partnerships, and tax exempt municipal securities. The Company has net investments of \$1.9 million in low-income housing limited partnerships as of June 30, 2013.

Table of Contents

Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles leading to timing differences between the Company's actual tax liability, and the amount accrued for this liability based on book income. These temporary differences comprise the "deferred" portion of the Company's tax expense or benefit, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as they reverse.

Realization of the Company's deferred tax assets is primarily dependent upon the Company generating sufficient future taxable income to obtain benefit from the reversal of net deductible temporary differences and utilization of tax credit carryforwards and the net operating loss carryforwards for Federal and California state income tax purposes. The amount of deferred tax assets considered realizable is subject to adjustment in future periods based on estimates of future taxable income. Under generally accepted accounting principles a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.

The Company had net deferred tax assets of \$24.6 million and \$19.3 million at June 30, 2013, and December 31, 2012, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at June 30, 2013 and December 31, 2012 will be fully realized in future years.

**FINANCIAL CONDITION**

As of June 30, 2013, total assets increased to \$1.40 billion, compared to \$1.32 billion at June 30, 2012, and decreased from \$1.69 billion at December 31, 2012. Excluding the short-term deposits at the Federal Reserve Bank offsetting the short-term demand deposits from one customer of \$17.0 million at June 30, 2013 and \$271.9 million at December 31, 2012, total assets were \$1.38 billion and \$1.42 billion, respectively. Securities available-for-sale (at fair value) were \$293.8 million at June 30, 2013, a decrease of 25% from \$389.8 million at June 30, 2012, and a decrease of 20% from \$367.9 million at December 31, 2012. Securities held-to-maturity (at amortized cost) were \$81.7 million at June 30, 2013, compared to no securities held-to-maturity at June 30, 2012, and \$51.5 million at December 31, 2012. The total loan portfolio, excluding loans held-for-sale, was \$842.0 million at June 30, 2013, an increase of 5% from \$798.1 million at June 30, 2012, and an increase of 4% from \$812.3 million at December 31, 2012.

Total deposits, excluding the short-term demand deposits from one customer of \$17.0 million at June 30, 2013 and \$271.9 million at December 31, 2012, increased 6% to \$1.17 billion at June 30, 2013, from \$1.10 billion at June 30, 2012 and decreased 3% from \$1.21 billion at December 31, 2012. Subordinated debt decreased to \$9.3 million at June 30, 2013 and December 31, 2012, compared to \$23.7 million at June 30, 2012, as a result of the redemption of \$14 million fixed-rate subordinated debt during the third quarter of 2012.

Table of Contents

**Securities Portfolio**

The following table reflects the balances for each category of securities at the dates indicated:

	June 30,		December 31,
	2013	2012	2012
(Dollars in thousands)			
<b>Securities available-for-sale (at fair value):</b>			
Agency mortgage-backed securities	\$ 225,397	\$ 325,926	\$ 291,244
Corporate bonds	47,646	23,221	55,588
Trust preferred securities	20,735	40,673	21,080
<b>Total</b>	<b>\$ 293,778</b>	<b>\$ 389,820</b>	<b>\$ 367,912</b>
<b>Securities held-to-maturity (at amortized cost):</b>			
Agency mortgage-backed securities	\$ 14,211	\$	\$ 16,659
Municipals Tax Exempt	67,520		34,813
	<b>\$ 81,731</b>	<b>\$</b>	<b>\$ 51,472</b>

The following table summarizes the weighted average life and weighted average yields of securities at June 30, 2013:

	June 30, 2013							
	Weighted Average Life							
	After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
(Dollars in thousands)								
<b>Securities available-for-sale (at fair value):</b>								
Agency mortgage-backed securities	\$ 170,742	2.63%	\$ 54,655	2.32%	\$	0.00%	\$ 225,397	2.56%
Corporate bonds	2,115	3.41%	45,531	3.18%			47,646	3.19%
Trust preferred securities					20,735	4.87%	20,735	4.87%
	<b>\$ 172,857</b>	<b>2.64%</b>	<b>\$ 100,186</b>	<b>2.71%</b>	<b>\$ 20,735</b>	<b>4.87%</b>	<b>\$ 293,778</b>	<b>2.82%</b>

	June 30, 2013							
	Weighted Average Life							
	After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
(Dollars in thousands)								
<b>Securities held-to-maturity (at amortized cost):</b>								
Agency mortgage-backed securities	\$ 6,824	2.69%	\$	0.00%	\$ 7,387	3.65%	\$ 14,211	3.19%
Municipals Tax Exempt	215	3.53%	4,295	3.82%	63,010	3.84%	67,520	3.83%
	<b>\$ 7,039</b>	<b>2.72%</b>	<b>\$ 4,295</b>	<b>3.82%</b>	<b>\$ 70,397</b>	<b>3.82%</b>	<b>\$ 81,731</b>	<b>3.72%</b>

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

The securities portfolio is the second largest component of the Company's interest-earning assets, and the structure and composition of this portfolio is important to an analysis of the financial condition of the Company. The portfolio serves the following purposes: (i) it provides a source of pledged assets for securing certain deposits and borrowed funds, as may be required by law or by specific agreement with a depositor or lender; (ii) it provides liquidity to even out cash flows from the loan and deposit activities of customers; (iii) it can be used as an interest rate risk management tool, since it provides a

Table of Contents

large base of assets, the maturity and interest rate characteristics of which can be changed more readily than the loan portfolio to better match changes in the deposit base and other funding sources of the Company; and (iv) it is an alternative interest-earning use of funds when loan demand is weak or when deposits grow more rapidly than loans.

The Company's portfolio may include: (i) U.S. Treasury securities and U.S. Government sponsored entities' debt securities for liquidity and pledging; (ii) mortgage-backed securities, which in many instances can also be used for pledging, and which generally enhance the yield of the portfolio; (iii) municipal obligations, which provide tax free income and limited pledging potential; (iv) collateralized mortgage obligations, which generally enhance the yield of the portfolio; and (v) single entity issue trust preferred securities, which generally enhance the yield on the portfolio.

The Company classifies its securities as either available-for-sale or held-to-maturity at the time of purchase. Prior to the third quarter of 2012, the Company's securities were all classified under existing accounting rules as "available-for-sale" to allow flexibility for the management of the portfolio. Accounting guidance requires available-for-sale securities to be marked to fair value with an offset to accumulated other comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available-for-sale securities. The investment securities available-for-sale portfolio totaled \$293.8 million at June 30, 2013, a decrease of 25% from \$389.8 million at June 30, 2012, and a decrease of 20% from \$367.9 million at December 31, 2012. At June 30, 2013, the investment securities available-for-sale portfolio was comprised of \$225.4 million of agency mortgage-backed securities (all issued by U.S. Government sponsored entities), \$47.7 million of corporate bonds, and \$20.7 million of single entity issue trust preferred securities. Due to higher interest rates, there was a pre-tax unrealized loss on securities available-for-sale at June 30, 2013 of (\$880,000), compared to a pre-tax unrealized gain on securities available-for-sale at June 30, 2012 of \$12.3 million, and a pre-tax unrealized gain on securities available-for-sale at December 31, 2012 of \$11.5 million.

The investment securities held-to-maturity portfolio, at amortized cost, totaled \$81.7 million at June 30, 2013, compared to no investment securities held-to-maturity at June 30, 2012, and \$51.5 million at December 31, 2012. At June 30, 2013, the investment securities held-to-maturity portfolio was comprised of \$67.5 million of tax-exempt municipal bonds, and \$14.2 million of agency mortgage-backed securities. During the third quarter of 2012, the Company evaluated its available-for-sale portfolio and reclassified at fair value approximately \$16.4 million of the mortgage-backed securities with higher price volatility and longer maturities to the held-to-maturity category. The related unrealized after-tax gains of \$481,000 at June 30, 2013 remained in accumulated other comprehensive income and will be amortized over the remaining life of the securities as an adjustment of yield, offsetting the related amortization of the premium or accretion of the discount on the transferred securities. No gains or losses were recognized at the time of reclassification. Management considers the held-to-maturity classification of these investment securities to be appropriate based on the Company's positive intent and ability to hold these securities to maturity.

The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities to otherwise mitigate interest rate risk.

**Loans**

The Company's loans represent the largest portion of invested assets, substantially greater than the securities portfolio or any other asset category, and the quality and diversification of the loan portfolio is an important consideration when reviewing the Company's financial condition.

Gross loans, excluding loans held-for-sale, represented 60% of total assets at June 30, 2013 and June 30, 2012, and 48% of total assets at December 31, 2012. Gross loans, excluding loans held-for-sale, represented 61% and 57% of total assets, excluding the short-term deposits at the Federal

Table of Contents

Reserve Bank offsetting the short-term demand deposits from one customer at June 30, 2013 and December 31, 2012, respectively. The ratio of loans to deposits decreased to 70.81% at June 30, 2013 from 72.37% at June 30, 2012 and increased from 54.91% at December 31, 2012. The loan to deposit ratio was 71.84% and 67.27%, excluding the short-term demand deposits from one customer at June 30, 2013 and December 31, 2012, respectively.

**Loan Distribution**

The Loan Distribution table that follows sets forth the Company's gross loans, excluding loans held-for-sale, outstanding and the percentage distribution in each category at the dates indicated:

	June 30, 2013		June 30, 2012		December 31, 2012	
	Balance	% of Total	Balance	% of Total	Balance	% of Total
(Dollars in thousands)						
Commercial	\$ 383,068	46%	\$ 384,260	48%	\$ 375,469	46%
Real estate:						
Commercial and residential	370,620	44%	333,048	42%	354,934	44%
Land and construction	26,705	3%	19,822	2%	22,352	3%
Home equity	48,667	6%	47,813	6%	43,865	5%
Consumer	13,097	1%	13,024	2%	15,714	2%
Total loans	842,157	100%	797,967	100%	812,334	100%
Deferred loan (fees) costs, net	(207)		139		(21)	
Loans, including deferred fees and costs	841,950	100%	798,106	100%	812,313	100%
Allowance for loan losses	(19,342)		(20,023)		(19,027)	
Loans, net	\$ 822,608		\$ 778,083		\$ 793,286	

The Company's loan portfolio is concentrated in commercial loans, primarily manufacturing, wholesale, and services, and commercial real estate, with the balance in land development and construction and home equity and consumer loans. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 53% of its gross loans were secured by real property at June 30, 2013, compared to 50% at June 30, 2012, and 52% at December 31, 2012. While no specific industry concentration is considered significant, the Company's lending operations are located in areas that are dependent on the technology and real estate industries and their supporting companies.

The Company has established concentration limits in its loan portfolio for commercial real estate loans, commercial loans, construction loans and unsecured lending, among others. All loan types are within established limits. The Company underwrites to the historical cash flow of the borrowers to determine debt service and stress tests the debt service under higher interest rate scenarios. Financial and performance covenants are used in commercial lending to allow the Company to react to a borrower's deteriorating financial condition should that occur.

The Company's commercial loans are made for working capital, financing the purchase of equipment or for other business purposes. Commercial loans include loans with maturities ranging from thirty days to one year and "term loans" with maturities normally ranging from one to five years. Short-term business loans are generally intended to finance current transactions and typically provide for periodic principal payments, with interest payable monthly. Term loans normally provide for floating interest rates, with monthly payments of both principal and interest.

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender

Table of Contents

Program. The Company regularly makes such guaranteed loans (collectively referred to as "SBA loans"). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold the Company retains the servicing rights for the sold portion. During the first three months and the first six months of 2013, loans were sold resulting in a gain on sale of SBA loans of \$134,000 and \$270,000 respectively.

As of June 30, 2013, commercial and residential real estate mortgage loans of \$370.6 million consist primarily of adjustable and fixed rate loans secured by deeds of trust on commercial and residential property. The real estate mortgage loans at June 30, 2013 consist of \$187.1 million, or 50%, of commercial owner occupied properties, \$182.7 million, or 49%, of commercial investment properties, and \$768,000, or 1% in residential properties. Properties securing the commercial real estate mortgage loans are generally located in the Company's primary market, which is the Greater San Francisco Bay Area.

The Company's commercial real estate loans consist primarily of loans based on the borrower's cash flow and are secured by deeds of trust on commercial and residential property to provide a secondary source of repayment. The Company generally restricts real estate term loans to no more than 75% of the property's appraised value or the purchase price of the property during the initial underwriting of the credit, depending on the type of property and its utilization. The Company offers both fixed and floating rate loans. Maturities on real estate mortgage loans are generally between five and ten years (with amortization ranging from fifteen to twenty-five years and a balloon payment due at maturity); however, SBA and certain other real estate loans that can be sold in the secondary market may be granted for longer maturities.

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Land and construction loans increased \$6.9 million to \$26.7 million, at June 30, 2013, from \$19.8 million, at June 30, 2012, and increased \$4.3 million from \$22.4 million, at December 31, 2012.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 70% loan to value ratio. Home equity lines are reviewed at least semiannually, with specific emphasis on loans with a loan to value ratio greater than 70% and loans that were underwritten from mid-2005 through 2008, when real estate values were at the peak in the cycle. The Company takes measures to work with customers to reduce line commitments and minimize potential losses. There have been no adverse classifications to date as a result of the review.

Additionally, the Company makes consumer loans for the purpose of financing automobiles, various types of consumer goods, and other personal purposes. Consumer loans generally provide for the monthly payment of principal and interest. Most of the Company's consumer loans are secured by the personal property being purchased or, in the instances of home equity loans or lines, real property.

With certain exceptions, state chartered banks are permitted to make extensions of credit to any one borrowing entity up to 15% of the bank's capital and reserves for unsecured loans and up to 25% of the bank's capital and reserves for secured loans. For HBC, these lending limits were \$27.5 million and \$45.8 million at June 30, 2013, respectively.

***Loan Maturities***

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale) as of June 30, 2013. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall Street Journal. As of June 30, 2013, approximately 62% of the Company's loan portfolio consisted of floating interest rate loans.

	Due in One Year or Less	Over One Year But Less than Five Years	Over Five Years	Total
(Dollars in thousands)				
Commercial	\$ 274,946	\$ 40,802	\$ 67,320	\$ 383,068
Real estate:				
Commercial and residential	90,513	171,767	108,340	370,620
Land and construction	26,205	500		26,705
Home equity	45,855	1,534	1,278	48,667
Consumer	12,310	702	85	13,097
<b>Loans</b>	<b>\$ 449,829</b>	<b>\$ 215,305</b>	<b>\$ 177,023</b>	<b>\$ 842,157</b>
Loans with variable interest rates	\$ 398,315	\$ 56,432	\$ 71,297	\$ 526,044
Loans with fixed interest rates	51,514	158,873	105,726	316,113
<b>Loans</b>	<b>\$ 449,829</b>	<b>\$ 215,305</b>	<b>\$ 177,023</b>	<b>\$ 842,157</b>

**Loan Servicing**

As of June 30, 2013 and 2012, \$143.1 million and \$160.6 million, respectively, in SBA loans were serviced by the Company for others. Activity for loan servicing rights was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2013	2012	2013	2012
(Dollars in thousands)				
Beginning of period balance	\$ 670	\$ 730	\$ 709	\$ 792
Additions	29	106	58	115
Amortization	(68)	(56)	(136)	(127)
<b>End of period balance</b>	<b>\$ 631</b>	<b>\$ 780</b>	<b>\$ 631</b>	<b>\$ 780</b>

Loan servicing rights are included in accrued interest receivable and other assets on the unaudited consolidated balance sheets and reported net of amortization. There was no valuation allowance as of June 30, 2013 and 2012, as the fair value of the assets was greater than the carrying value.

Activity for the I/O strip receivable was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2013	2012	2013	2012
(Dollars in thousands)				
Beginning of period balance	\$ 1,777	\$ 2,113	\$ 1,786	\$ 2,094
Unrealized holding gain (loss)	(51)	27	(60)	46
<b>End of period balance</b>	<b>\$ 1,726</b>	<b>\$ 2,140</b>	<b>\$ 1,726</b>	<b>\$ 2,140</b>

Table of Contents

*Credit Quality*

Financial institutions generally have a certain level of exposure to credit quality risk, and could potentially receive less than a full return of principal and interest if a debtor becomes unable or unwilling to repay. Since loans are the most significant assets of the Company and generate the largest portion of its revenues, the Company's management of credit quality risk is focused primarily on loan quality. Banks have generally suffered their most severe earnings declines as a result of customers' inability to generate sufficient cash flow to service their debts and/or downturns in national and regional economies and declines in overall asset values including real estate. In addition, certain debt securities that the Company may purchase have the potential of declining in value if the obligor's financial capacity to repay deteriorates.

The Company's policies and procedures identify market segments, set goals for portfolio growth or contraction, and establish limits on industry and geographic credit concentrations. In addition, these policies establish the Company's underwriting standards and the methods of monitoring ongoing credit quality. The Company's internal credit risk controls are centered in underwriting practices, credit granting procedures, training, risk management techniques, and familiarity with loan customers as well as the relative diversity and geographic concentration of our loan portfolio.

The Company's credit risk may also be affected by external factors such as the level of interest rates, employment, general economic conditions, real estate values, and trends in particular industries or geographic markets. As an independent community bank serving a specific geographic area, the Company must contend with the unpredictable changes in the general California market and, particularly, primary local markets. The Company's asset quality has suffered in the past from the impact of national and regional economic recessions, consumer bankruptcies, and depressed real estate values.

Nonperforming assets are comprised of the following: loans and loans held-for-sale for which the Company is no longer accruing interest; restructured loans which have been current under six months; loans 90 days or more past due and still accruing interest (although they are generally placed on nonaccrual when they become 90 days past due, unless they are both well-secured and in the process of collection); and foreclosed assets. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued. Loans may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. Foreclosed assets consist of properties acquired by foreclosure or similar means that management is offering or will offer for sale.

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

### Table of Contents

The following table summarizes the Company's nonperforming assets at the dates indicated:

	June 30,		December 31,
	2013	2012	2012
(Dollars in thousands)			
Nonaccrual loans held-for-sale	\$	\$ 177	\$
Nonaccrual loans held-for-investment	13,868	12,890	17,335
Restructured and loans over 90 days past due and still accruing	510	1,665	859
<b>Total nonperforming loans</b>	<b>14,378</b>	<b>14,732</b>	<b>18,194</b>
Foreclosed assets	659	3,098	1,270
<b>Total nonperforming assets</b>	<b>\$ 15,037</b>	<b>\$ 17,830</b>	<b>\$ 19,464</b>
Nonperforming assets as a percentage of loans plus other real estate owned plus nonaccrual loans held-for-sale plus foreclosed assets	1.78%	2.22%	2.39%
Nonperforming assets as a percentage of total assets	1.07%	1.35%	1.15%

Nonperforming assets were \$15.0 million, or 1.07% of total assets, at June 30, 2013, compared to \$17.8 million, or 1.35% of total assets at June 30, 2012, and \$19.5 million, or 1.15% of total assets at December 31, 2012. Nonperforming assets to total assets were 1.09% at June 30, 2013 and 1.37% at December 31, 2012, excluding the short-term deposits at the Federal Reserve Bank offsetting the short-term demand deposits from one customer. Included in total nonperforming assets were foreclosed assets of \$659,000 at June 30, 2013, compared to \$3.1 million at June 30, 2012, and \$1.3 million at December 31, 2012.

### ***Allowance for Loan Losses***

The allowance for loan losses is an estimate of probable incurred losses in the loan portfolio. Loans are charged-off against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance for loan losses. Management's methodology for estimating the allowance balance consists of several key elements, which include specific allowances on individual impaired loans and the formula driven allowances on pools of loans with similar risk characteristics. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off.

Specific allowances are established for impaired loans. Management considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the loan agreement, including scheduled interest payments. Loans for which the terms have been modified with a concession granted, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. When a loan is considered to be impaired, the amount of impairment is measured based on the fair value of the collateral less costs to sell if the loan is collateral dependent, or on the present value of expected future cash flows or values that are observable in the secondary market. If the measure of the impaired loans is less than the investment in the loan, the deficiency will be charged off against the allowance for loan losses if the amount is a confirmed loss, or, alternatively, a specific allocation within the allowance will be established. Loans that are considered impaired are specifically excluded from the formula portion of the allowance for loan losses analysis.

Table of Contents

The estimated loss factors for pools of loans that are not impaired are based on determining the probability of default and loss given default for loans within each segment of the portfolio, adjusted for significant factors that, in management's judgment, affect collectability as of the evaluation date. The Company's historical delinquency experience and loss experience are utilized to determine the probability of default and loss given default for segments of the portfolio where the Company has experienced losses in the past. For segments of the portfolio where the Company has no significant prior loss experience, the Company uses quantifiable observable industry data to determine the probability of default and loss given default.

Loans that demonstrate a weakness for which there is a possibility of loss if the weakness is not corrected, are categorized as "classified." Classified assets include all loans considered as substandard, substandard-nonaccrual, and doubtful and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate), and foreclosed assets. The principal balance of classified assets, net of SBA guarantees, was \$23.8 million at June 30, 2013, \$54.9 million at June 30, 2012, and \$36.8 million at December 31, 2012. Included in classified assets at June 30, 2012 were \$177,000 of loans held-for-sale. There were no loans held-for-sale included in classified assets at June 30, 2013 and December 31, 2012. Loans held-for-sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses. Reducing classified assets will continue to be a focus for executive management, the lending staff and the Company's Special Assets Department.

It is the policy of management to maintain the allowance for loan losses at a level adequate for risks inherent in the loan portfolio. On an ongoing basis, we have engaged an outside firm to perform independent credit reviews of our loan portfolio. The Federal Reserve Bank of San Francisco and the California Department of Financial Institutions also review the allowance for loan losses as an integral part of the examination process. Based on information currently available, management believes that the allowance for loan losses is adequate. However, the loan portfolio can be adversely affected if California economic conditions and the real estate market in the Company's market area were to further weaken. Also, any weakness of a prolonged nature in the technology industry would have a negative impact on the local market. The effect of such events, although uncertain at this time, could result in an increase in the level of nonperforming loans and increased loan losses, which could adversely affect the Company's future growth and profitability. No assurance of the ultimate level of credit losses can be given with any certainty.

The following tables summarize the Company's loan loss experience, as well as provisions and charges to the allowance for loan losses and certain pertinent ratios for the periods indicated:

	Three Months Ended June 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 12,455	\$ 6,770	\$ 117	\$ 19,342
Charge-offs	(119)	(56)		(175)
Recoveries	188	257		445
Net recoveries	69	201		270
Provision (credit) for loan losses	287	(583)	26	(270)
Balance, end of period	\$ 12,811	\$ 6,388	\$ 143	\$ 19,342
<b>RATIOS:</b>				
Net recoveries to average loans(1)	0.03%	0.10%	0.00%	0.13%
Allowance for loan losses to total loans(1)	1.52%	0.76%	0.02%	2.30%
Allowance for loan losses to nonperforming loans	89.10%	44.43%	0.99%	134.52%

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

<b>Three Months Ended June 30, 2012</b>				
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
<b>(Dollars in thousands)</b>				
Balance, beginning of period	\$ 13,734	\$ 6,409	\$ 163	\$ 20,306
Charge-offs	(1,280)	(101)		(1,381)
Recoveries	60	223		283
Net (charge-offs) recoveries	(1,220)	122		(1,098)
Provision (credit) for loan losses	864	8	(57)	815
Balance, end of period	\$ 13,378	\$ 6,539	\$ 106	\$ 20,023
<b>RATIOS:</b>				
Net charge-offs (recoveries) to average loans(1)	0.62%	-0.06%	0.00%	0.56%
Allowance for loan losses to total loans(1)	1.68%	0.82%	0.01%	2.51%
Allowance for loan losses to nonperforming loans	90.81%	44.39%	0.72%	135.92%

(1) Average loans and total loans exclude loans held-for-sale.

<b>Six Months Ended June 30, 2013</b>				
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
<b>(Dollars in thousands)</b>				
Balance, beginning of period	\$ 12,866	\$ 6,034	\$ 127	\$ 19,027
Charge-offs	(959)	(56)		(1,015)
Recoveries	1,338	262		1,600
Net recoveries	379	206		585
Provision (credit) for loan losses	(434)	148	16	(270)
Balance, end of period	\$ 12,811	\$ 6,388	\$ 143	\$ 19,342
<b>RATIOS:</b>				
Net recoveries to average loans(1)	0.10%	0.05%	0.00%	0.15%
Allowance for loan losses to total loans(1)	1.52%	0.76%	0.02%	2.30%
Allowance for loan losses to nonperforming loans	89.10%	44.43%	0.99%	134.52%

<b>Six Months Ended June 30, 2012</b>				
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
<b>(Dollars in thousands)</b>				
Balance, beginning of period	\$ 13,215	\$ 7,338	\$ 147	\$ 20,700
Charge-offs	(2,190)	(146)		(2,336)
Recoveries	521	223		744
Net (charge-offs) recoveries	(1,669)	77		(1,592)
Provision (credit) for loan losses	1,832	(876)	(41)	915
Balance, end of period	\$ 13,378	\$ 6,539	\$ 106	\$ 20,023

**RATIOS:**

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Net charge-offs (recoveries) to average loans(1)	0.44%	-0.02%	0.00%	0.41%
Allowance for loan losses to total loans(1)	1.68%	0.82%	0.01%	2.51%
Allowance for loan losses to nonperforming loans	90.81%	44.39%	0.72%	135.92%

---

(1)

Average loans and total loans exclude loans held-for-sale.

The following table provides a summary of the allocation of the allowance for loan losses for specific class at the dates indicated. The allocation presented should not be interpreted as an indication

Table of Contents

that charges to the allowance for loan losses will be incurred in these amounts or proportions, or that the portion of the allowance allocated to each category represents the total amount available for charge-offs that may occur within these classes.

**Allocation of Allowance for Loan Losses**

	June 30,					
	2013		2012		December 31, 2012	
	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans
(Dollars in thousands)						
Commercial	\$ 12,811	46%	\$ 13,378	48%	\$ 12,866	46%
Real estate:						
Commercial and residential	4,949	44%	5,492	42%	4,609	44%
Land and construction	280	3%	478	2%	399	3%
Home equity	1,159	6%	569	6%	1,026	5%
Consumer	143	1%	106	2%	127	2%
<b>Total</b>	<b>\$ 19,342</b>	<b>100%</b>	<b>\$ 20,023</b>	<b>100%</b>	<b>\$ 19,027</b>	<b>100%</b>

The allowance for loan losses totaled \$19.3 million, or 2.30% of total loans at June 30, 2013, compared to \$20.0 million, or 2.51% of total loans at June 30, 2012, and \$19.0 million, or 2.34% of total loans at December 31, 2012. Loan charge-offs reflect the realization of losses in the portfolio that were partially recognized previously through the provision for loan losses. The Company had net recoveries of \$270,000, or 0.13% of average loans, for the second quarter of 2013, compared to net charge-offs of \$1.1 million, or 0.56% of average loans, for the second quarter of 2012, and net charge-offs of \$766,000, or 0.38% of average loans, for the fourth quarter of 2012. The allowance for loan losses related to the commercial portfolio decreased \$55,000 at June 30, 2013 from December 31, 2012, as a result of a credit to the provision for loan losses of \$434,000 and net recoveries of \$379,000. The decrease in the allowance for loan losses was primarily due to improved risk grading and credit metrics on commercial loans, as well as a decline in historical charge-off levels. The allowance for loan losses related to the real estate portfolio increased \$354,000 at June 30, 2013 from December 31, 2012, as a result of a provision for loan losses of \$148,000 and net recoveries of \$206,000. The increase in the allowance for loan losses was primarily due to an increase in the allowance for loan losses on impaired real estate loans, partially offset by improved risk grading and credit metrics on non-impaired real estate loans, as well as a decline in historical charge-off levels.

**Deposits**

The composition and cost of the Company's deposit base are important components in analyzing the Company's net interest margin and balance sheet liquidity characteristics, both of which are discussed in greater detail in other sections herein. The Company's liquidity is impacted by the volatility of deposits or other funding instruments or, in other words, by the propensity of that money to leave the institution for rate-related or other reasons. Deposits can be adversely affected if economic conditions in California, and the Company's market area in particular, continue to weaken. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed \$100,000, as customers with balances of that magnitude are typically more rate-sensitive than customers with smaller balances.

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

### Table of Contents

The following table summarizes the distribution of deposits and the percentage of distribution in each category of deposits for the periods indicated:

	June 30, 2013		June 30, 2012		December 31, 2012	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
(Dollars in thousands)						
Demand, noninterest-bearing	\$ 407,516	34%	\$ 367,937	33%	\$ 727,684	49%
Demand, interest-bearing	171,027	14%	148,777	13%	155,951	10%
Savings and money market	295,336	25%	290,867	26%	272,047	18%
Time deposits under \$100	23,062	2%	28,009	3%	25,157	2%
Time deposits \$100 and over	197,718	17%	164,056	15%	190,502	13%
Time deposits brokered	76,800	6%	97,680	9%	97,807	7%
CDARS money market and time deposits	17,580	2%	5,427	1%	10,220	1%
<b>Total deposits</b>	<b>\$ 1,189,039</b>	<b>100%</b>	<b>\$ 1,102,753</b>	<b>100%</b>	<b>\$ 1,479,368</b>	<b>100%</b>

The Company obtains deposits from a cross-section of the communities it serves. The Company's business is not generally seasonal in nature. The Company is not dependent upon funds from sources outside the United States. Less than 9% of deposits at June 30, 2013, 5% at June 30, 2012, and 6% at December 31, 2012 were from public sources.

Deposits totaled \$1.19 billion at June 30, 2013, compared to \$1.10 billion at June 30, 2012, and \$1.48 billion at December 31, 2012. Late in the fourth quarter of 2012, the Company received short-term demand deposits in the amount of \$467.5 million from one customer for specific transactions. Of this amount, \$195.6 million was subsequently withdrawn, for a net outstanding balance of \$271.9 million at December 31, 2012. The outstanding balance of the short-term demand deposits was \$17.0 million at June 30, 2013. Total deposits, excluding brokered deposits and short-term demand deposits from one customer of \$17.0 million at June 30, 2013 and \$271.9 million at December 31, 2012, were \$1.10 billion at June 30, 2013, compared to \$1.01 billion at June 30, 2012, and \$1.11 billion at December 31, 2012.

Noninterest-bearing demand deposits (excluding the short-term demand deposits from one customer) increased \$22.6 million, or 6%, to \$390.5 million at June 30, 2013, from \$367.9 million at June 30, 2012, and decreased \$65.3 million, or 14%, from \$455.8 million at December 31, 2012. At June 30, 2013, the Company had \$108.4 million (at fair value) of securities pledged for \$98.0 million in certificates of deposits from the State of California. At June 30, 2012, the Company had \$56.8 million of securities pledged for \$50.0 million in certificates of deposits from the State of California. At December 31, 2012, the Company had \$95.3 million (at fair value) of securities pledged for \$85.0 million in certificates of deposits from the State of California. At June 30, 2013, brokered deposits decreased \$20.9 million, or 21%, to \$76.8 million, compared to \$97.7 million at June 30, 2012, and decreased \$21.0 million, or 21%, from \$97.8 million at December 31, 2012.

CDARS deposits were comprised of \$9.0 million of money market accounts and \$8.6 million of time deposits at June 30, 2013. All of the \$5.4 million of CDARS deposits at June 30, 2012 were time deposits. CDARS deposits were comprised of \$5.0 million of money market accounts and \$5.2 million of time deposits at December 31, 2012.

Table of Contents

The following table indicates the contractual maturity schedule of the Company's time deposits of \$100,000 and over, and all CDARS time deposits and brokered deposits as of June 30, 2013:

	Balance	% of Total
	(Dollars in thousands)	
Three months or less	\$ 121,316	43%
Over three months through six months	61,412	22%
Over six months through twelve months	54,197	19%
Over twelve months	46,227	16%
<b>Total</b>	<b>\$ 283,152</b>	<b>100%</b>

The Company focuses primarily on providing and servicing business deposit accounts that are frequently over \$100,000 in average balance per account. As a result, certain types of business clients that the Company serves typically carry average deposits in excess of \$100,000. The account activity for some account types and client types necessitates appropriate liquidity management practices by the Company to help ensure its ability to fund deposit withdrawals.

**Return on Equity and Assets**

The following table indicates the ratios for return on average assets and average equity, and average equity to average assets for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Annualized return on average assets	0.82%	0.81%	0.71%	0.72%
Annualized return on average tangible assets	0.82%	0.81%	0.71%	0.72%
Annualized return on average equity	6.53%	6.61%	5.88%	5.44%
Annualized return on average tangible equity	6.60%	6.71%	5.94%	5.52%
Average equity to average assets ratio	12.49%	12.23%	12.12%	13.29%

**Off-Balance Sheet Arrangements**

In the normal course of business, the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in the contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, but are not reflected on the Company's consolidated balance sheets. Total unused commitments to extend credit were \$349.4 million at June 30, 2013, compared to \$298.9 million at June 30, 2012 and \$308.9 million at December 31, 2012. Unused commitments represented 41%, 37%, and 38% of outstanding gross loans at June 30, 2013 and 2012, and December 31, 2012, respectively.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no certainty that

Table of Contents

lines of credit and letters of credit will ever be fully utilized. The following table presents the Company's commitments to extend credit for the periods indicated:

	June 30,					
	2013		2012		December 31, 2012	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)					
Unused lines of credit and commitments to make loans	\$ 5,683	\$ 330,870	\$ 15,375	\$ 272,191	\$ 8,410	\$ 291,191
Standby letters of credit	2,775	10,030	2,200	9,103	2,200	7,051
	\$ 8,458	\$ 340,900	\$ 17,575	\$ 281,294	\$ 10,610	\$ 298,242

***Liquidity and Asset/Liability Management***

Liquidity refers to the Company's ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely and cost effective fashion. At various times the Company requires funds to meet short-term cash requirements brought about by loan growth or deposit outflows, the purchase of assets, or liability repayments. An integral part of the Company's ability to manage its liquidity position appropriately is the Company's large base of core deposits, which are generated by offering traditional banking services in its service area and which have historically been a stable source of funds. To manage liquidity needs properly, cash inflows must be timed to coincide with anticipated outflows or sufficient liquidity resources must be available to meet varying demands. The Company manages liquidity to be able to meet unexpected sudden changes in levels of its assets or deposit liabilities without maintaining excessive amounts of balance sheet liquidity. Excess balance sheet liquidity can negatively impact the Company's interest margin. In order to meet short-term liquidity needs the Company utilizes overnight Federal funds purchase arrangements and other borrowing arrangements with correspondent banks, solicits brokered deposits if cost effective deposits are not available from local sources and maintains collateralized lines of credit with the FHLB and FRB. In addition, the Company can raise cash for temporary needs by selling securities under agreements to repurchase and selling securities available-for-sale.

One of the measures we analyze for liquidity is our loan to deposit ratio. Our loan to deposit ratio was 70.81% at June 30, 2013, compared to 72.37% at June 30, 2012, and 54.91% at December 31, 2012. The loan to deposit ratio was 71.84% at June 30, 2013 and 67.27% at December 31, 2012, excluding the \$17.0 million and \$271.9 million, respectively, of short-term demand deposits from one customer.

***FHLB and FRB Borrowings and Available Lines of Credit***

The Company has off-balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. The Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. The Company had no overnight borrowings from the FHLB at June 30, 2013, June 30, 2012 and December 31, 2012. The Company had \$228.8 million of loans pledged to the FHLB as collateral on an available line of credit of \$112.5 million at June 30, 2013.

The Company can also borrow from FRB's discount window. The Company had \$223.9 million of loans pledged to the FRB as collateral on an available line of credit of \$162.6 million at June 30, 2013, none of which was outstanding.

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

### Table of Contents

At June 30, 2013, the Company had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at June 30, 2013, June 30, 2012, and December 31, 2012.

The Company may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase at June 30, 2013, June 30, 2012, and December 31, 2012.

The following table summarizes the Company's borrowings under its Federal funds purchased, security repurchase arrangements and lines of credit for the periods indicated:

	June 30, 2013	June 30, 2012	December 31, 2012
(Dollars in thousands)			
Average balance year-to-date	\$	\$ 1,582	\$
Average interest rate year-to-date	N/A	0.22%	N/A
Maximum month-end balance during the quarter	\$	\$ 27,000	\$
Average rate at period-end	N/A	N/A	N/A

### **Capital Resources**

The Company uses a variety of measures to evaluate capital adequacy. Management reviews various capital measurements on a regular basis and takes appropriate action to ensure that such measurements are within established internal and external guidelines. The external guidelines, which are issued by the Federal Reserve Board and the FDIC, establish a risk-adjusted ratio relating capital to different categories of assets and off-balance sheet exposures. There are two categories of capital under the Federal Reserve Board and FDIC guidelines: Tier 1 and Tier 2 Capital. Our Tier 1 Capital currently consists of total shareholders' equity (excluding accumulated other comprehensive income or loss) and the proceeds from the issuance of trust preferred securities (trust preferred securities are counted only up to a maximum of 25% of Tier 1 capital), less goodwill and other intangible assets and disallowed deferred tax assets. Our Tier 2 Capital includes the allowances for loan losses and off-balance sheet credit losses.

In July 2013, the Federal banking regulators approved a final rule to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and to address relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The final rule strengthens the definition of regulatory capital, increases risk-based capital requirements, makes selected changes to the calculation of risk-weighted assets, and adjusts the prompt corrective action thresholds. Community banking organizations, such as the Company and the Bank, become subject to the new rule on January 1, 2015 and certain provisions of the new rule will be phased in over the period of 2015 through 2019. The final rule:

Permits banking organizations that had less than \$15 billion in total consolidated assets as of December 31, 2009, or were mutual holding companies as of May 19, 2010, to include in Tier 1 capital trust preferred securities and cumulative perpetual preferred stock that were issued and included in Tier 1 capital prior to May 19, 2010, subject to a limit of 25% of Tier 1 capital elements, excluding any non-qualifying capital instruments and after all regulatory capital deductions and adjustments have been applied to Tier 1 capital.

Establishes new qualifying criteria for regulatory capital, including new limitations on the inclusion of deferred tax assets and mortgage servicing rights.

Requires a minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5%.

Increases the minimum Tier 1 capital to risk-weighted assets ratio requirement from 4% to 6%.

Table of Contents

Retains the minimum total capital to risk-weighted assets ratio requirement of 8%.

Establishes a minimum leverage ratio requirement of 4%.

Retains the existing regulatory capital framework for 1-4 family residential mortgage exposures.

Permits banking organizations that are not subject to the advanced approaches rule, such as the Company and the Bank, to retain, through a one-time election, the existing treatment for most accumulated other comprehensive income, such that unrealized gains and losses on securities available for sale will not affect regulatory capital amounts and ratios.

Implements a new capital conservation buffer requirement for a banking organization to maintain a common equity capital ratio more than 2.5% above the minimum common equity Tier 1 capital, Tier 1 capital and total risk-based capital ratios in order to avoid limitations on capital distributions, including dividend payments, and certain discretionary bonus payments. The capital conservation buffer requirement will be phased in beginning on January 1, 2016 at 0.625% and will be fully phased in at 2.50% by January 1, 2019. A banking organization with a buffer of less than the required amount would be subject to increasingly stringent limitations on such distributions and payments as the buffer approaches zero. The new rule also generally prohibits a banking organization from making such distributions or payments during any quarter if its eligible retained income is negative and its capital conservation buffer ratio was 2.5% or less at the end of the previous quarter. The eligible retained income of a banking organization is defined as its net income for the four calendar quarters preceding the current calendar quarter, based on the organization's quarterly regulatory reports, net of any distributions and associated tax effects not already reflected in net income.

Increases capital requirements for past-due loans, high volatility commercial real estate exposures, and certain short-term commitments and securitization exposures.

Expands the recognition of collateral and guarantors in determining risk-weighted assets.

Removes references to credit ratings consistent with the Dodd-Frank Act and establishes due diligence requirements for securitization exposures.

Management is currently evaluating the provisions of the final rule and their expected impact on the Company and the Bank.

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of the consolidated Company:

	June 30,		December 31,	
	2013	2012	2012	
	(Dollars in thousands)			
<b>Capital components:</b>				
Tier 1 Capital	\$ 166,820	\$ 165,974	\$ 157,947	
Tier 2 Capital	13,885	13,033	13,254	
Total risk-based capital	\$ 180,705	\$ 179,007	\$ 171,201	
Risk-weighted assets	\$ 1,105,051	\$ 1,035,545	\$ 1,054,394	
Average assets for capital purposes	\$ 1,350,489	\$ 1,302,189	\$ 1,378,011	



Table of Contents

				Well-Capitalized Regulatory Requirements	Minimum Regulatory Requirements
<b>Capital ratios:</b>					
Total risk-based capital	16.4%	17.3%	16.2%	10.00%	8.00%
Tier 1 risk-based capital	15.1%	16.0%	15.0%	6.00%	4.00%
Leverage(1)	12.4%	12.7%	11.5%	N/A	4.00%

(1)

Tier 1 capital divided by quarterly average assets (excluding goodwill, other intangible assets and disallowed deferred tax assets).

The table above presents the capital ratios of the consolidated Company computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements for bank holding companies.

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of HBC:

	June 30,		December 31,	
	2013	2012	2012	
	(Dollars in thousands)			
<b>Capital components:</b>				
Tier 1 Capital	\$ 158,552	\$ 154,480	\$ 147,742	
Tier 2 Capital	13,911	13,024	13,262	
Total risk-based capital	\$ 172,463	\$ 167,504	\$ 161,004	
Risk-weighted assets	\$ 1,107,207	\$ 1,034,804	\$ 1,055,061	
Average assets for capital purposes	\$ 1,352,479	\$ 1,301,471	\$ 1,378,238	

				Well-Capitalized Regulatory Requirements	Minimum Regulatory Requirements
<b>Capital ratios:</b>					
Total risk-based capital	15.6%	16.2%	15.3%	10.00%	8.00%
Tier 1 risk-based capital	14.3%	14.9%	14.0%	6.00%	4.00%
Leverage(1)	11.7%	11.9%	10.7%	5.00%	4.00%

(1)

Tier 1 capital divided by quarterly average assets (excluding goodwill, other intangible assets and disallowed deferred tax assets).

The table above presents the capital ratios of HBC computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements under the FDIC's prompt corrective action authority.

Due primarily to the redemption of the \$14 million fixed-rate subordinated debt in the third quarter of 2012, the Company's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio at June 30, 2013 decreased to 16.4%, 15.1%, and 12.4%, compared to 17.3%, 16.0%, and 12.7% at June 30, 2012, respectively. The Company's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio were 16.2%, 15.0%, and 11.5% at December 31, 2012, respectively. Due primarily to a distribution from HBC to HCC to provide cash of \$15 million for the redemption of the fixed-rate subordinated debt in the third quarter of 2012, HBC's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio at June 30, 2013 decreased to 15.6%, 14.3%, and 11.7%, compared to 16.2%, 14.9%, and 11.9% at

June 30, 2012, respectively. HBC's total risk-based

Table of Contents

capital ratio, Tier 1 risk-based capital ratio, and leverage ratio were 15.3%, 14.0%, and 10.7% at December 31, 2012, respectively. At June 30, 2013, the Company's and HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under prompt corrective action provisions.

At June 30, 2013, the Company had total shareholders' equity of \$167.6 million, including \$19.5 million in preferred stock, \$132.1 million in common stock, \$20.7 million in retained earnings, and (\$4.7) million of accumulated other comprehensive loss. The components of other comprehensive loss, net of taxes, at June 30, 2013 include the following: an unrealized loss on available-for-sale securities of (\$507,000); the remaining unamortized gain on securities available-for-sale transferred to held-to-maturity of \$481,000; a liability adjustment on the supplemental executive retirement plan of (\$3.3) million; a liability adjustment on the split dollar insurance contracts of (\$2.4) million; and an unrealized gain on interest-only strip from SBA loans of \$1.0 million.

***Mandatory Redeemable Cumulative Trust Preferred Securities***

To enhance regulatory capital and to provide liquidity, the Company, through unconsolidated subsidiary grantor trusts, issued the following mandatory redeemable cumulative trust preferred securities of subsidiary grantor trusts: In the first quarter of 2000, the Company issued \$7.0 million principal amount of 10.875% fixed-rate subordinated debt due on March 8, 2030, and common securities of \$217,000 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2000, the Company issued \$7.0 million principal amount of 10.60% fixed-rate subordinated debt due on September 7, 2030, and common securities of \$206,000 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2001, the Company issued \$5.2 million aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on July 31, 2031 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2002, the Company issued \$4.1 million of aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on September 26, 2032 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. The subordinated debt is recorded as a component of long-term debt and includes the value of the common stock issued by the trusts to the Company. The common stock is recorded as other assets for the amount issued. Under applicable regulatory guidelines, the trust preferred securities currently qualify as Tier I capital. The subsidiary trusts are not consolidated in the Company's consolidated financial statements. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, certain trust preferred securities will no longer be eligible to be included as Tier 1 capital for regulatory purposes. The trust preferred securities continued to be eligible for Tier 1 capital under Dodd-Frank for bank holding companies with less than \$15 billion of assets.

During the third quarter of 2012, the Company redeemed its 10.875% fixed-rate subordinated debentures in the amount of \$7 million issued to Heritage Capital Trust I and the Company's 10.600% fixed-rate subordinated debentures in the amount of \$7 million issued to Heritage Statutory Trust I. The related trust securities issued by Capital Trust I and Statutory Trust I were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved.

On June 5, 2013, the Company provided notice to the trustee that it intends to redeem the Company's Floating Rate Junior Subordinated Debentures due July 31, 2031 in the amount of \$5 million issued to Heritage Statutory Trust II and the Company's Floating Rate Junior Subordinated Debentures due September 26, 2032, in the amount of \$4 million issued to Heritage Statutory Trust III (collectively referred to as the "Floating-Rate Sub Debt"). The \$5 million Floating-Rate Sub Debt was redeemed on July 31, 2013. The \$4 million Floating-Rate Sub Debt will be redeemed on September 26, 2013. Additionally, the Company will pay its regularly scheduled interest payments on the Floating-Rate Sub Debt totaling approximately \$90,000 on the respective redemption dates. The Company used available cash and proceeds from a \$9 million distribution from the Bank for the redemption. The Company incurred a total charge of \$167,000 in the second quarter of 2013, representing the agency

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

### Table of Contents

origination fees associated with the Floating-Rate Sub Debt. On an annual basis, the redemption of the Floating-Rate Sub Debt will eliminate approximately \$360,000 in interest expense.

The Company's and HBC's June, 2013 regulatory capital ratios and pro forma capital ratios including the redemption of the \$9 million Floating-Rate Sub Debt and the \$9 million cash contribution from HBC are detailed in the tables below. The Company's and HBC's pro forma June 30, 2013 regulatory capital ratios all significantly exceed the well-capitalized requirements.

	Actual June 30, 2013	Pro Forma June 30, 2013 Excluding Sub Debt(1)	Well-Capitalized Regulatory Requirements
<b>Heritage Commerce Corp:</b>			
Total risk-based capital ratio	16.4%	15.5%	10.0%
Tier 1 risk-based capital ratio	15.1%	14.3%	6.0%
Leverage ratio	12.4%	11.7%	N/A

(1) Assumes redemption of \$9 million Floating-Rate Sub Debt at June 30, 2013.

	Actual June 30, 2013	Pro Forma June 30, 2013 Excluding Sub Debt(2)	Well-Capitalized Regulatory Requirements
<b>Heritage Bank of Commerce:</b>			
Total risk-based capital ratio	15.6%	14.8%	10.0%
Tier 1 risk-based capital ratio	14.3%	13.5%	6.0%
Leverage ratio	11.7%	11.1%	5.0%

(2) Assumes HBC \$9 million distribution at June 30, 2013.

### ***U.S. Treasury Capital Purchase Program***

The Company received \$40 million in November 2008 through the issuance of its Series A Preferred Stock and a warrant to purchase 462,963 shares of its common stock to the Treasury through the U.S. Treasury Capital Purchase Program. The Series A Preferred Stock qualifies as a component of Tier 1 capital.

On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve, the Company repurchased all of the Series A Preferred Stock and paid the related accrued and unpaid dividends. The repurchase of the Series A Preferred Stock will save \$2.0 million in annual dividends. On June 12, 2013, the Company completed the repurchase of the common stock warrant for \$140,000.

### ***Series C Preferred Stock***

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of newly issued Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon a subsequent transfer of the Series C Preferred stock to third parties not affiliates with the holder in a widely dispersed offering. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

Table of Contents

**Market Risk**

Market risk is the risk of loss of future earnings, fair values, or future cash flows that may result from changes in the price of a financial instrument. The value of a financial instrument may change as a result of changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market risk sensitive instruments. Market risk is attributed to all market risk sensitive financial instruments, including securities, loans, deposits and borrowings, as well as the Company's role as a financial intermediary in customer-related transactions. The objective of market risk management is to avoid excessive exposure of the Company's earnings and equity to loss and to reduce the volatility inherent in certain financial instruments.

**Interest Rate Management**

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company's market risk exposure is primarily that of interest rate risk, and it has established policies and procedures to monitor and limit earnings and balance sheet exposure to changes in interest rates. The Company does not engage in the trading of financial instruments, nor does the Company have exposure to currency exchange rates.

The principal objective of interest rate risk management (often referred to as "asset/liability management") is to manage the financial components of the Company in a manner that will optimize the risk/reward equation for earnings and capital in relation to changing interest rates. The Company's exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximizing income. Management realizes certain risks are inherent, and that the goal is to identify and manage the risks. Management uses two methodologies to manage interest rate risk: (i) a standard GAP analysis; and (ii) an interest rate shock simulation model.

The planning of asset and liability maturities is an integral part of the management of an institution's net interest margin. To the extent maturities of assets and liabilities do not match in a changing interest rate environment, the net interest margin may change over time. Even with perfectly matched repricing of assets and liabilities, risks remain in the form of prepayment of loans or securities or in the form of delays in the adjustment of rates of interest applying to either earning assets with floating rates or to interest bearing liabilities. The Company has generally been able to control its exposure to changing interest rates by maintaining primarily floating interest rate loans and a majority of its time certificates with relatively short maturities.

Interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Varying interest rate environments can create unexpected changes in prepayment levels of assets and liabilities, which may have a significant effect on the net interest margin and are not reflected in the interest sensitivity analysis table. Because of these factors, an interest sensitivity GAP report may not provide a complete assessment of the exposure to changes in interest rates.

The Company uses modeling software for asset/liability management in order to simulate the effects of potential interest rate changes on the Company's net interest margin, and to calculate the estimated fair values of the Company's financial instruments under different interest rate scenarios. The program imports current balances, interest rates, maturity dates and repricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company's interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Company's investment, loan, deposit and borrowed funds portfolios. These rate projections can be shocked (an immediate and parallel change in all base rates, up or down)

Table of Contents

and ramped (an incremental increase or decrease in rates over a specified time period), based on current trends and econometric models or stable economic conditions (unchanged from current actual levels).

The following table sets forth the estimated changes in the Company's annual net interest income that would result from the designated instantaneous parallel shift in interest rates noted, as of June 30, 2013. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

	<b>Increase/(Decrease) in Estimated Net Interest Income</b>	
	<b>Amount</b>	<b>Percent</b>
	<b>(Dollars in thousands)</b>	
<b>Change in Interest Rates (basis points)</b>		
+400	\$ 10,687	21.7%
+300	\$ 7,948	16.2%
+200	\$ 5,140	10.4%
+100	\$ 2,381	4.8%
0	\$	0.0%
-100	\$ (4,221)	-8.6%
-200	\$ (8,695)	-17.7%

This data does not reflect any actions that we may undertake in response to changes in interest rates such as changes in rates paid on certain deposit accounts based on local competitive factors, which could reduce the actual impact on net interest income.

As with any method of gauging interest rate risk, there are certain shortcomings inherent to the methodology noted above. The model assumes interest rate changes are instantaneous parallel shifts in the yield curve. In reality, rate changes are rarely instantaneous. The use of the simplifying assumption that short-term and long-term rates change by the same degree may also misstate historic rate patterns, which rarely show parallel yield curve shifts. Further, the model assumes that certain assets and liabilities of similar maturity or period to repricing will react in the same way to changes in rates. In reality, certain types of financial instruments may react in advance of changes in market rates, while the reaction of other types of financial instruments may lag behind the change in general market rates. Additionally, the methodology noted above does not reflect the full impact of annual and lifetime restrictions on changes in rates for certain assets, such as adjustable rate loans. When interest rates change, actual loan prepayments and actual early withdrawals from certificates may deviate significantly from the assumptions used in the model. Finally, this methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan clients' ability to service their debt. All of these factors are considered in monitoring the Company's exposure to interest rate risk.

**ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information concerning quantitative and qualitative disclosure or market risk called for by Item 305 of Regulation S-K is included as part of Item 2 above.

**ITEM 4 CONTROLS AND PROCEDURES****Disclosure Control and Procedures**

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the

Table of Contents

effectiveness of the design and operation of the Company's disclosure controls and procedures as of June 30, 2013. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded the Company's disclosure controls were effective as of June 30, 2013, the period covered by this report on Form 10-Q.

During the three and six months ended June 30, 2013, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to affect, our internal controls over financial reporting.

Table of Contents

**Part II OTHER INFORMATION**

**ITEM 1 LEGAL PROCEEDINGS**

The Company is involved in certain legal actions arising from normal business activities. Management, based upon the advice of legal counsel, believes the ultimate resolution of all pending legal actions will not have a material effect on the financial statements of the Company.

**ITEM 1A RISK FACTORS**

In addition to the other information set forth in this Report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2012, which could materially affect our business, financial condition and/or operating results. There were no material changes from risk factors previously disclosed in our 2012 Annual Report on Form 10-K. The risk factors identified are in addition to those contained in any other cautionary statements, written or oral, which may be made or otherwise addressed in connection with a forward-looking statement or contained in any of our subsequent filings with the Securities and Exchange Commission.

**ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None

**ITEM 3 DEFAULTS UPON SENIOR SECURITIES**

None

**ITEM 4 MINE SAFETY DISCLOSURES**

None

**ITEM 5 OTHER INFORMATION**

None

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

### Table of Contents

#### **ITEM 6 EXHIBITS**

<b>Exhibit</b>	<b>Description</b>
3.1	Heritage Commerce Corp Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 4, 2010)
3.2	Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp as filed with the California Secretary of State on June 1, 2010 (incorporated by reference to Exhibit 3.1 to the Registrant's Registration Statement on Form S-1 filed July 23, 2010).
3.3	Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 28, 2013)
4.1	Certificate of Determination for Series C Convertible Perpetual Preferred Stock (incorporated by reference to the Registrant's Form 8-K filed on June 22, 2010)
12.1	Calculation of Ratio of Earnings to Fixed Charges and Ratio of Earnings to Fixed Charges and Preferred Stock Dividends
31.1	Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350
32.2	Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350
101.INS	XBRL Instance Document, furnished herewith
101.SCH	XBRL Taxonomy Extension Schema Document, furnished herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, furnished herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, furnished herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, furnished herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, furnished herewith

Table of Contents

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 7, 2013

Heritage Commerce Corp (Registrant)

/s/ WALTER T. KACZMAREK

---

Walter T. Kaczmarek  
*Chief Executive Officer*

Date: August 7, 2013

/s/ LAWRENCE D. MCGOVERN

---

Lawrence D. McGovern  
*Chief Financial Officer*

79

---

Table of Contents

**EXHIBIT INDEX**

<b>Exhibit</b>	<b>Description</b>
3.1	Heritage Commerce Corp Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 4, 2010)
3.2	Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp as filed with the California Secretary of State on June 1, 2010 (incorporated by reference to Exhibit 3.1 to the Registrant's Registration Statement on Form S-1 filed July 23, 2010).
3.3	Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 28, 2013)
4.1	Certificate of Determination for Series C Convertible Perpetual Preferred Stock (incorporated by reference to the Registrant's Form 8-K filed on June 22, 2010)
12.1	Calculation of Ratio of Earnings to Fixed Charges and Ratio of Earnings to Fixed Charges and Preferred Stock Dividends
31.1	Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350
32.2	Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350
101.INS	XBRL Instance Document, furnished herewith
101.SCH	XBRL Taxonomy Extension Schema Document, furnished herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, furnished herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, furnished herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, furnished herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, furnished herewith