

HERITAGE COMMERCE CORP  
Form 10-Q  
May 08, 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 March 31, 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 26,333,368 shares of Common Stock outstanding on April 18, 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>  |                  |
| <u>Consolidated Balance Sheets</u>  | <u>5</u>         |
| <u>Consolidated Statements of Income</u>  | <u>6</u>         |
| <u>Consolidated Statements of Comprehensive Income</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>36</u></b> |
| <b><u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u></b>                            | <b><u>65</u></b> |
| <b><u>Item 4. Controls and Procedures</u></b>   | <b><u>65</u></b> |
| <b><u>PART II. OTHER INFORMATION</u></b>  |                  |
| <b><u>Item 1. Legal Proceedings</u></b>   | <b><u>67</u></b> |
| <b><u>Item 1A. Risk Factors</u></b>   | <b><u>67</u></b> |
| <b><u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u></b>                           | <b><u>67</u></b> |
| <b><u>Item 3. Defaults Upon Senior Securities</u></b>   |                  |

|                |                                |           |
|----------------|--------------------------------|-----------|
|                |                                | <u>67</u> |
| <u>Item 4.</u> | <u>Mine Safety Disclosures</u> | <u>67</u> |
| <u>Item 5.</u> | <u>Other Information</u>       | <u>67</u> |
| <u>Item 6.</u> | <u>Exhibits</u>                | <u>68</u> |
|                | <b><u>SIGNATURES</u></b>       | <u>69</u> |
|                | <b><u>EXHIBIT INDEX</u></b>    | <u>70</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;

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

### 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 Public Company Accounting Oversight Board, 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)**

|   | March 31,<br>2013      | December 31,<br>2012 |
|---|------------------------|----------------------|
|   | (Dollars in thousands) |                      |
| <b>Assets</b>   |                        |                      |
| Cash and due from banks   | \$ 19,779              | \$ 16,520            |
| Interest-bearing deposits in other financial institutions   | 57,090                 | 357,045              |
| Total cash and cash equivalents   | 76,869                 | 373,565              |
| Securities available-for-sale, at fair value  | 346,800                | 367,912              |
| Securities held-to-maturity, at amortized cost (fair value of \$65,659 at March 31, 2013 and \$50,964 at December 31, 2012)   | 68,283                 | 51,472               |
| Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs   | 4,394                  | 3,409                |
| Loans, including deferred fees and costs  | 801,925                | 812,313              |
| Allowance for loan losses   | (19,342)               | (19,027)             |
| Loans, net  | 782,583                | 793,286              |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost  | 10,764                 | 10,728               |
| Company owned life insurance  | 48,774                 | 48,358               |
| Premises and equipment, net   | 7,632                  | 7,469                |
| Intangible assets   | 1,882                  | 2,000                |
| Accrued interest receivable and other assets  | 35,583                 | 35,113               |
| Total assets  | \$ 1,383,564           | \$ 1,693,312         |
| <b>Liabilities and Shareholders' Equity</b>   |                        |                      |
| Liabilities:  |                        |                      |
| Deposits:   |                        |                      |
| Demand, noninterest-bearing   | \$ 397,198             | \$ 727,684           |
| Demand, interest-bearing  | 169,681                | 155,951              |
| Savings and money market  | 286,784                | 272,047              |
| Time deposits under \$100   | 23,835                 | 25,157               |
| Time deposits \$100 and over  | 189,779                | 190,502              |
| Time deposits brokered  | 83,763                 | 97,807               |
| CDARS money market and time deposits  | 15,850                 | 10,220               |
| Total deposits  | 1,166,890              | 1,479,368            |
| Subordinated debt   | 9,279                  | 9,279                |
| Accrued interest payable and other liabilities  | 36,560                 | 34,924               |
| Total liabilities   | 1,212,729              | 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 March 31, 2013 and December 31, 2012 (liquidation preference of \$21,004 at March 31, 2013 and December 31, 2012) | 19,519                 | 19,519               |
| Common stock, no par value; 60,000,000 shares authorized; 26,333,368 shares issued and outstanding at March 31, 2013 and 26,322,147 shares issued and outstanding at December 31, 2012                    | 131,998                | 131,820              |
| Retained earnings   | 17,901                 | 15,721               |



Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|  |              |              |
|--|--------------|--------------|
| Accumulated other comprehensive income     | 1,417        | 2,681        |
| Total shareholders' equity                 | 170,835      | 169,741      |
| Total liabilities and shareholders' equity | \$ 1,383,564 | \$ 1,693,312 |

See notes to consolidated financial statements

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

|  | <b>Three Months Ended<br/>March 31,</b>                  |               |
|--|--|---------------|
|  | <b>2013</b>  | <b>2012</b>   |
|  | <b>(Dollars in thousands,<br/>except per share data)</b> |               |
| <b>Interest income:</b>                                    |  |               |
| Loans, including fees                                      | \$ 10,089  | 10,316        |
| Securities, taxable  | 2,462  | 3,097         |
| Securities, non-taxable                                    | 248  |               |
| Interest-bearing deposits in other financial institutions  | 68   | 36            |
| <b>Total interest income</b>                               | <b>12,867</b>  | <b>13,449</b> |
| <b>Interest expense:</b>                                   |  |               |
| Deposits   | 625  | 716           |
| Subordinated debt  | 88   | 474           |
| Short-term borrowings                                      | 1  |               |
| <b>Total interest expense</b>                              | <b>714</b>   | <b>1,190</b>  |
| Net interest income before provision for loan losses       | 12,153   | 12,259        |
| Provision for loan losses                                  |  | 100           |
| <b>Net interest income after provision for loan losses</b> | <b>12,153</b>  | <b>12,159</b> |
| <b>Noninterest income:</b>                                 |  |               |
| Service charges and fees on deposit accounts               | 577  | 590           |
| Increase in cash surrender value of life insurance         | 416  | 429           |
| Servicing income   | 365  | 460           |
| Gain on sales of SBA loans                                 | 136  | 36            |
| Gain on sales of securities                                | 31   | 27            |
| Other  | 138  | 181           |
| <b>Total noninterest income</b>                            | <b>1,663</b>   | <b>1,723</b>  |
| <b>Noninterest expense:</b>                                |  |               |
| Salaries and employee benefits                             | 6,011  | 5,667         |
| Occupancy and equipment                                    | 1,068  | 996           |
| Professional fees  | 982  | 1,211         |
| Low income housing investment losses                       | 311  | 269           |
| Software subscriptions                                     | 291  | 290           |
| FDIC deposit insurance premiums                            | 259  | 225           |
| Insurance expense  | 254  | 224           |
| Data processing  | 252  | 245           |
| Correspondent bank charges                                 | 164  | 143           |
| Foreclosed assets, net                                     | (155)  | 115           |
| Other  | 1,344  | 1,471         |
| <b>Total noninterest expense</b>                           | <b>10,781</b>  | <b>10,856</b> |
| Income before income taxes                                 | 3,035  | 3,026         |
| Income tax expense   | 855  | 951           |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|   |          |         |
|---|----------|---------|
| Net income  | 2,180    | 2,075   |
| Dividends and discount accretion on preferred stock |          | (1,206) |
| Net income available to common shareholders         | \$ 2,180 | \$ 869  |
| Earnings per common share:                          |          |         |
| Basic   | \$ 0.07  | \$ 0.03 |
| Diluted   | \$ 0.07  | \$ 0.03 |

See notes to consolidated financial statements

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

|  | <b>For the<br/>Three Months Ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2013</b>   | <b>2012</b> |
|  | <b>(Dollars in thousands)</b>                       |             |
| Net income   | \$ 2,180  | \$ 2,075    |
| Other comprehensive income (loss):   |   |             |
| Change in net unrealized holding gains on available-for-sale securities and I/O strips   | (2,164)   | 372         |
| Deferred income taxes  | 909   | (156)       |
| Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity | (14)  |             |
| Deferred income taxes  | 6   |             |
| Reclassification adjustment for (gains) realized in income   | (31)  | (27)        |
| Deferred income taxes  | 13  | 11          |
| Change in unrealized gains (loss) on securities and I/O strips, net of deferred income taxes                                     | (1,281)   | 200         |
| Change in net pension and other benefit plan liability adjustment  | 29  | 57          |
| Deferred income taxes  | (12)  | (24)        |
| Change in pension and other benefit plan liability, net of deferred income taxes   | 17  | 33          |
| Other comprehensive income (loss)  | (1,264)   | 233         |
| Total comprehensive income   | \$ 916  | \$ 2,308    |

See notes to consolidated financial statements

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

Three Months Ended March 31, 2013 and 2012

|   | Preferred Stock |           |          | Common Stock |            | Retained Earnings | Accumulated Other Comprehensive Income | Total Shareholders' Equity |
|---|-----------------|-----------|----------|--------------|------------|-------------------|--|----------------------------|
|   | Shares          | Amount    | Discount | Shares       | Amount     |                   |  |                            |
| (Dollars in thousands)  |                 |           |          |              |            |                   |  |                            |
| <b>Balance, January 1, 2012</b>                                       | 61,004          | \$ 59,365 | \$ (833) | 26,295,001   | \$ 131,172 | \$ 7,172          | \$ 955                                 | \$ 197,831                 |
| Net income  |                 |           |          |              |            | 2,075             |  | 2,075                      |
| Other comprehensive income  |                 |           |          |              |            |                   | 233                                    | 233                        |
| Repurchase of Series A preferred stock                                | (40,000)        | (40,000)  |          |              |            |                   |  | (40,000)                   |
| Series A preferred stock capitalized offering costs                   |                 | 154       |          |              |            | (154)             |  |                            |
| Forfeitures of restricted stock awards                                |                 |           |          | (8,500)      |            |                   |  |                            |
| Amortization of restricted stock awards, net of forfeitures and taxes |                 |           |          |              | 28         |                   |  | 28                         |
| Cash dividends paid 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                    |                 |           |          |              | 102        |                   |  | 102                        |
| <b>Balance, March 31, 2012</b>  | 21,004          | \$ 19,519 | \$       | 26,286,501   | \$ 131,302 | \$ 7,887          | \$ 1,188                               | \$ 159,896                 |
| <b>Balance, January 1, 2013</b>                                       | 21,004          | \$ 19,519 | \$       | 26,322,147   | \$ 131,820 | \$ 15,721         | \$ 2,681                               | \$ 169,741                 |
| Net income  |                 |           |          |              |            | 2,180             |  | 2,180                      |
| Other comprehensive loss  |                 |           |          |              |            |                   | (1,264)                                | (1,264)                    |
| Issuance of restricted stock awards                                   |                 |           |          | 10,000       |            |                   |  |                            |
| Amortization of restricted stock awards, net of forfeitures and taxes |                 |           |          |              | 45         |                   |  | 45                         |
| Stock option expense, net of forfeitures and taxes                    |                 |           |          |              | 129        |                   |  | 129                        |
| Stock options exercised   |                 |           |          | 1,221        | 4          |                   |  | 4                          |
| <b>Balance, March 31, 2013</b>  | 21,004          | \$ 19,519 | \$       | 26,333,368   | \$ 131,998 | \$ 17,901         | \$ 1,417                               | \$ 170,835                 |

See notes to consolidated financial statements

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

|   | <b>Three Months Ended<br/>March 31,</b> |               |
|---|---|---------------|
|   | <b>2013</b>                             | <b>2012</b>   |
|   | <b>(Dollars in thousands)</b>           |               |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |   |               |
| Net income  | \$ 2,180                                | \$ 2,075      |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |               |
| Amortization of discounts and premiums on securities                              | 756                                     | 533           |
| Gain on sales of securities available-for-sale                                    | (31)                                    | (27)          |
| Gain on sales of SBA loans  | (136)                                   | (36)          |
| Proceeds from sale of SBA loans originated for sale                               | 1,774                                   | 632           |
| Net change in SBA loans originated for sale                                       | (2,643)                                 | (4,621)       |
| Provision for loan losses   |   | 100           |
| Increase in cash surrender value of life insurance                                | (416)                                   | (429)         |
| Depreciation and amortization   | 177                                     | 195           |
| Amortization of intangible assets   | 118                                     | 123           |
| Gains on sale of foreclosed assets, net   | (198)                                   | (31)          |
| Stock option expense, net   | 129                                     | 102           |
| Amortization of restricted stock awards, net                                      | 45                                      | 28            |
| Effect of changes in:   |   |               |
| Accrued interest receivable and other assets                                      | (88)                                    | 818           |
| Accrued interest payable and other liabilities                                    | 1,806                                   | (609)         |
| <br>Net cash provided by (used in) operating activities                           | <br>3,473                               | <br>(1,147)   |
| <br><b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                  |   |               |
| Purchase of securities available-for-sale   | (8,334)                                 | (19,943)      |
| Purchase of securities held-to-maturity   | (18,433)                                |               |
| Maturities/paydowns/calls of securities available-for-sale                        | 23,056                                  | 18,858        |
| Maturities/paydowns/calls of securities held-to-maturity                          | 1,429                                   |               |
| Proceeds from sale of securities available-for-sale                               | 3,530                                   | 2,280         |
| Net change in loans   | 10,690                                  | 5,239         |
| Change in Federal Home Loan Bank and Federal Reserve Bank stock                   | (36)                                    | (3)           |
| Purchase of premises and equipment  | (340)                                   | (98)          |
| Proceeds from sale of foreclosed assets   | 743                                     | 188           |
| Proceeds from sale of other loans transferred to held-for-sale                    |   | 220           |
| Purchases of company owned life insurance   |   | (250)         |
| <br>Net cash provided by investing activities                                     | <br>12,305                              | <br>6,491     |
| <br><b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                  |   |               |
| Net change in deposits  | (312,478)                               | 30,822        |
| Repayment of preferred stock  |   | (40,000)      |
| Payment of cash dividends preferred stock   |   | (373)         |
| Exercise of stock options   | 4                                       |               |
| <br>Net cash used in financing activities   | <br>(312,474)                           | <br>(9,551)   |
| <br>Net decrease in cash and cash equivalents                                     | <br>(296,696)                           | <br>(4,207)   |
| Cash and cash equivalents, beginning of period                                    | 373,565                                 | 72,872        |
| <br>Cash and cash equivalents, end of period                                      | <br>\$ 76,869                           | <br>\$ 68,665 |
| <br>Supplemental disclosures of cash flow information:                            |   |               |
| Interest paid   | \$ 709                                  | \$ 1,557      |
| Income taxes paid   | 1,025                                   | 800           |
| Supplemental schedule of non-cash investing activity:                             |   |               |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|   |    |       |    |        |
|---|----|-------|----|--------|
| Due to broker for securities purchased            | \$ | 3,351 | \$ | 11,921 |
| 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**

**March 31, 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 months ended March 31, 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)****March 31, 2013****(Unaudited)****1) Basis of Presentation (Continued)**

statement that reports net income or in the financial statement notes. For AOCI items that 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 warrants, using the treasury stock method. The common stock warrant was antidilutive at March 31, 2013 and 2012. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

|   | <b>For the Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2013</b>                                     | <b>2012</b> |
|   | <b>(Dollars in thousands)</b>                   |             |
| Net income available to common shareholders                                       | \$ 2,180  | \$ 869      |
| Less: net income allocated to Series C Preferred Stock                            | 382   | 153         |
| Net income allocated to common shareholders                                       | \$ 1,798  | \$ 716      |
| Weighted average common shares outstanding for basic earnings per common share    | 26,329,343                                      | 26,289,334  |
| Dilutive effect of stock options outstanding, using the the treasury stock method | 49,114  | 27,220      |
| Shares used in computing diluted earnings per common share                        | 26,378,457                                      | 26,316,554  |
| Basic earnings per share  | \$ 0.07   | \$ 0.03     |
| Diluted earnings per share  | \$ 0.07   | \$ 0.03     |

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 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 March 31, 2013 and 2012                                     |  |   |          |
|---|--|--|---|----------|
|   | Unrealized<br>Gains on<br>Available-<br>for-Sale<br>Securities<br>and I/O<br>Strips(1) | Unamortized<br>Unrealized<br>Gain on<br>Available-<br>for-Sale<br>Securities<br>Reclassified<br>to Held-to-<br>Maturity(1) | Defined<br>Benefit<br>Pension<br>Plan<br>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          | (1,255)  |  | (24)  | (1,279)  |
| Amounts reclassified from other comprehensive income (loss), net of taxes | (18)   | (8)  | 41  | 15       |
| Net current period other comprehensive income (loss), net of taxes        | (1,273)  | (8)  | 17  | (1,264)  |
| Ending balance March 31, 2013, net of taxes                               | \$ 6,614   | \$ 489   | \$ (5,686)  | \$ 1,417 |
| Beginning balance January 1, 2012, net of taxes                           | \$ 6,210   | \$   | \$ (5,255)  | \$ 955   |
| Other comprehensive income (loss) before reclassification, net of taxes   | 216  |  | (8)   | 208      |
| Amounts reclassified from other comprehensive income (loss), net of taxes | (16)   |  | 41  | 25       |
| Net current period other comprehensive income, net of taxes               | 200  |  | 33  | 233      |
| Ending balance March 31, 2012, net of taxes                               | \$ 6,410   | \$   | \$ (5,222)  | \$ 1,188 |

(1) Amounts in parenthesis indicate debits.

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2013

(Unaudited)

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

| Details About AOCI Components  | Amounts<br>Reclassified<br>from AOCI(1)<br>For the Three<br>Months Ended<br>March 31,<br>2013      2012<br>(Dollars in<br>thousands) |         | Affected Line Item Where<br>Net Income is Presented |
|--|--|---------|---|
| Unrealized gains on available-for-sale securities and I/O strips   | \$ 31  | \$ 27   | Realized gains on sale of securities                |
|  | (13)   | (11)    | Income tax expense                                  |
|  | 18   | 16      | Net of tax  |
| Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity | 14   |         | Interest income on taxable securities               |
|  | (6)  |         | Income tax expense                                  |
|  | 8  |         | Net of tax  |
| Amortization of defined benefit pension plan items(2)  |  |         |   |
| Prior service cost   |  | (7)     |   |
| Actuarial losses   | (71)   | (63)    |   |
|  | (71)   | (70)    | Income before income tax                            |
|  | 30   | 29      | Income tax expense                                  |
|  | (41)   | (41)    | Net of tax  |
| Total reclassification for the period  | \$ (15)  | \$ (25) |   |

(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)****March 31, 2013****(Unaudited)****4) Securities**

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

| <b>March 31, 2013</b>                 | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|---------------------------------------|---------------------------|---------------------------------------|--|-------------------------------------|
| <b>(Dollars in thousands)</b>         |                           |                                       |  |                                     |
| <b>Securities available-for-sale:</b> |                           |                                       |  |                                     |
| Agency mortgage-backed securities     | \$ 262,710                | \$ 8,444                              | \$ (77)                                | \$ 271,077                          |
| Corporate bonds                       | 53,681                    | 1,269                                 | (58)                                   | 54,892                              |
| Trust preferred securities            | 20,789                    | 150                                   | (108)                                  | 20,831                              |
| <b>Total</b>                          | <b>\$ 337,180</b>         | <b>\$ 9,863</b>                       | <b>\$ (243)</b>                        | <b>\$ 346,800</b>                   |

|                                     |                  |             |                   |                  |
|-------------------------------------|------------------|-------------|-------------------|------------------|
| <b>Securities held-to-maturity:</b> |                  |             |                   |                  |
| Agency mortgage-backed securities   | \$ 15,185        | \$ 6        | \$ (298)          | \$ 14,893        |
| Municipals tax exempt               | 53,098           | 1           | (2,333)           | 50,766           |
| <b>Total</b>                        | <b>\$ 68,283</b> | <b>\$ 7</b> | <b>\$ (2,631)</b> | <b>\$ 65,659</b> |

| <b>December 31, 2012</b>              | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>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 March 31, 2013, the Company held 320 securities (169 available-for-sale and 151 held-to-maturity), of which 143 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 fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not intend to sell any securities with an unrealized loss and does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2013****(Unaudited)****4) Securities (Continued)**

value. The Company does not consider these securities to be other-than-temporarily impaired at March 31, 2013.

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 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 amortized cost and estimated fair values of securities as March 31, 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.

|                                   | <b>Available-for-sale</b>     |                             |
|-----------------------------------|-------------------------------|-----------------------------|
|                                   | <b>Amortized Cost</b>         | <b>Estimated Fair Value</b> |
|                                   | <b>(Dollars in thousands)</b> |                             |
| Due after one through five years  | \$ 924                        | \$ 963                      |
| Due after five through ten years  | 52,757                        | 53,929                      |
| Due after ten years               | 20,789                        | 20,831                      |
| Agency mortgage-backed securities | \$ 262,710                    | 271,077                     |
| <b>Total</b>                      | <b>\$ 337,180</b>             | <b>\$ 346,800</b>           |

|                                   | <b>Held-to-maturity</b>       |                             |
|-----------------------------------|-------------------------------|-----------------------------|
|                                   | <b>Amortized Cost</b>         | <b>Estimated Fair Value</b> |
|                                   | <b>(Dollars in thousands)</b> |                             |
| Due after five through ten years  | \$ 1,085                      | \$ 1,060                    |
| Due after ten years               | 52,013                        | 49,706                      |
| Agency mortgage-backed securities | 15,185                        | 14,893                      |
| <b>Total</b>                      | <b>\$ 68,283</b>              | <b>\$ 65,659</b>            |

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2013****(Unaudited)****5) Loans**

Loans were as follows:

|   | <b>March 31,<br/>2013</b>     | <b>December 31,<br/>2012</b> |
|---|-------------------------------|------------------------------|
|   | <b>(Dollars in thousands)</b> |                              |
| <b>Loans held-for-investment:</b>           |                               |                              |
| Commercial                                  | \$ 356,688                    | \$ 375,469                   |
| <b>Real estate:</b>                         |                               |                              |
| Commercial and residential                  | 361,340                       | 354,934                      |
| Land and construction                       | 24,611                        | 22,352                       |
| Home equity                                 | 45,347                        | 43,865                       |
| Consumer                                    | 14,036                        | 15,714                       |
| <br>  |                               |                              |
| Loans                                       | 802,022                       | 812,334                      |
| Deferred loan origination (fees) costs, net | (97)                          | (21)                         |
| <br>  |                               |                              |
| Loans, including deferred fees and costs    | 801,925                       | 812,313                      |
| Allowance for loan losses                   | (19,342)                      | (19,027)                     |
| <br>  |                               |                              |
| Loans, net                                  | \$ 782,583                    | \$ 793,286                   |

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

|                                    | <b>Three Months Ended March 31, 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                        | (840)                                    |                    |                 | (840)        |
| Recoveries                         | 1,150                                    | 5                  |                 | 1,155        |
| <br>                               |  |                    |                 |              |
| Net recoveries                     | 310                                      | 5                  |                 | 315          |
| Provision (credit) for loan losses | (721)                                    | 731                | (10)            |              |
| <br>                               |  |                    |                 |              |
| Balance, end of period             | \$ 12,455                                | \$ 6,770           | \$ 117          | \$ 19,342    |

|                              | <b>Three Months Ended March 31, 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                  | (910)                                    | (45)               |                 | (955)        |
| Recoveries                   | 461                                      |                    |                 | 461          |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|                                    |           |          |        |           |
|------------------------------------|-----------|----------|--------|-----------|
| Net charge-offs                    | (449)     | (45)     | (494)  |           |
| Provision (credit) for loan losses | 968       | (884)    | 16     | 100       |
| Balance, end of period             | \$ 13,734 | \$ 6,409 | \$ 163 | \$ 20,306 |



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2013****(Unaudited)****5) Loans (Continued)**

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>March 31, 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>               |                               |                    |                  |                   |
| Ending allowance balance attributable to loans: |                               |                    |                  |                   |
| Individually evaluated for impairment           | \$ 2,031                      | \$ 977             | \$ 18            | \$ 3,026          |
| Collectively evaluated for impairment           | 10,424                        | 5,793              | 99               | 16,316            |
| <b>Total allowance balance</b>                  | <b>\$ 12,455</b>              | <b>\$ 6,770</b>    | <b>\$ 117</b>    | <b>\$ 19,342</b>  |
| <b>Loans:</b>                                   |                               |                    |                  |                   |
| Individually evaluated for impairment           | \$ 8,128                      | \$ 10,112          | \$ 141           | \$ 18,381         |
| Collectively evaluated for impairment           | 348,560                       | 421,186            | 13,895           | 783,641           |
| <b>Total loan balance</b>                       | <b>\$ 356,688</b>             | <b>\$ 431,298</b>  | <b>\$ 14,036</b> | <b>\$ 802,022</b> |

|   | <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>               |                               |                    |                  |                   |
| Ending allowance balance attributable to loans: |                               |                    |                  |                   |
| 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> |

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2013****(Unaudited)****5) Loans (Continued)**

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of March 31, 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.

|  | March 31, 2013                 |                        |  | December 31, 2012              |                        |  |
|--|--------------------------------|------------------------|--|--------------------------------|------------------------|--|
|  | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance<br>for Loan<br>Losses<br>Allocated | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance<br>for Loan<br>Losses<br>Allocated |
| (Dollars in thousands)                   |                                |                        |  |                                |                        |  |
| With no related allowance recorded:      |                                |                        |  |                                |                        |  |
| Commercial                               | \$ 3,939                       | \$ 3,939               | \$   | \$ 7,829                       | \$ 6,978               | \$   |
| Real estate:                             |                                |                        |  |                                |                        |  |
| Commercial and residential               | 3,622                          | 3,622                  |  | 2,755                          | 2,741                  |  |
| Land and construction                    | 2,177                          | 2,177                  |  | 2,310                          | 2,223                  |  |
| Home Equity                              | 2,137                          | 2,137                  |  | 2,141                          | 2,141                  |  |
| Total with no related allowance recorded | 11,875                         | 11,875                 |  | 15,035                         | 14,083                 |  |
| With an allowance recorded:              |                                |                        |  |                                |                        |  |
| Commercial                               | 4,272                          | 4,189                  | 2,031  | 3,678                          | 3,182                  | 1,963  |
| Real estate:                             |                                |                        |  |                                |                        |  |
| Commercial and residential               | 1,882                          | 1,882                  | 683  | 3,183                          | 1,937                  | 465  |
| Home Equity                              | 294                            | 294                    | 294  | 295                            | 295                    | 295  |
| Consumer                                 | 141                            | 141                    | 18   | 147                            | 147                    | 17   |
| Total with an allowance recorded         | 6,589                          | 6,506                  | 3,026  | 7,303                          | 5,561                  | 2,740  |
| Total                                    | \$ 18,464                      | \$ 18,381              | \$ 3,026                                     | \$ 22,338                      | \$ 19,644              | \$ 2,740                                     |

The following tables present interest recognized and cash-basis interest earned on impaired loans for the periods indicated:

|   | Three Months Ended March 31, 2013 |                                  |   |                |          |           |
|---|-----------------------------------|----------------------------------|---|----------------|----------|-----------|
|   | Commercial                        | Commercial<br>and<br>Residential | Real Estate<br>Land and<br>Construction | Home<br>Equity | Consumer | Total     |
| (Dollars in thousands)                      |                                   |                                  |   |                |          |           |
| Average of impaired loans during the period | \$ 9,145                          | \$ 5,090                         | \$ 2,200                                | \$ 2,434       | \$ 144   | \$ 19,013 |
| Interest income during impairment           | \$                                | \$                               | \$                                      | \$             | \$       | \$        |
| Cash-basis interest earned                  | \$                                | \$                               | \$                                      | \$             | \$       | \$        |



Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2013

(Unaudited)

## 5) Loans (Continued)

Three Months Ended March 31, 2012

Real Estate

Commercial

|  | Commercial | Commercial<br>and<br>Residential | Land and<br>Construction | Home<br>Equity | Consumer | Total |
|--|------------|----------------------------------|--------------------------|----------------|----------|-------|
|--|------------|----------------------------------|--------------------------|----------------|----------|-------|

(Dollars in thousands)

|   |           |          |          |       |       |           |
|---|-----------|----------|----------|-------|-------|-----------|
| Average of impaired loans during the period | \$ 11,450 | \$ 2,773 | \$ 3,002 | \$ 16 | \$ 11 | \$ 17,252 |
| 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:

|   | March 31,<br>2013      | March 31,<br>2012 | December 31,<br>2012 |
|---|------------------------|-------------------|----------------------|
|   | (Dollars in thousands) |                   |                      |
| Nonaccrual loans held-for-sale                                  | \$                     | \$ 184            | \$                   |
| Nonaccrual loans held-for-investment                            | 16,115                 | 14,005            | 17,335               |
| Restructured and loans over 90 days past due and still accruing | 549                    | 2,155             | 859                  |
| Total nonperforming loans                                       | \$ 16,664              | \$ 16,344         | \$ 18,194            |
| Other restructured loans  | \$ 1,717               | \$ 431            | \$ 1,450             |
| Impaired loans, excluding loans held-for-sale                   | \$ 18,381              | \$ 16,591         | \$ 19,644            |

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

|                            | March 31, 2013         |  |          | December 31, 2012 |  |          |
|----------------------------|------------------------|--|----------|-------------------|--|----------|
|                            | Nonaccrual             | Restructured<br>and<br>Loans Over<br>90 Days<br>Past Due<br>and<br>Still<br>Accruing | Total    | Nonaccrual        | Restructured<br>and<br>Loans Over<br>90 Days<br>Past Due<br>and<br>Still<br>Accruing | Total    |
|                            | (Dollars in thousands) |  |          |                   |  |          |
| Commercial                 | \$ 5,863               | \$ 549   | \$ 6,412 | \$ 7,852          | \$ 859   | \$ 8,711 |
| Real estate:               |                        |  |          |                   |  |          |
| Commercial and residential | 5,503                  |  | 5,503    | 4,676             |  | 4,676    |
| Land and construction      | 2,177                  |  | 2,177    | 2,223             |  | 2,223    |
| Home equity                | 2,431                  |  | 2,431    | 2,437             |  | 2,437    |
| Consumer                   | 141                    |  | 141      | 147               |  | 147      |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|       |    |        |    |     |    |        |    |        |    |     |    |        |
|-------|----|--------|----|-----|----|--------|----|--------|----|-----|----|--------|
| Total | \$ | 16,115 | \$ | 549 | \$ | 16,664 | \$ | 17,335 | \$ | 859 | \$ | 18,194 |
|-------|----|--------|----|-----|----|--------|----|--------|----|-----|----|--------|

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2013****(Unaudited)****5) Loans (Continued)**

The following table presents the aging of past due loans as of March 31, 2013 by class of loans:

|                               | March 31, 2013              |                             |                                   |                   |                       |                   |
|-------------------------------|-----------------------------|-----------------------------|-----------------------------------|-------------------|-----------------------|-------------------|
|                               | 30 - 59<br>Days<br>Past Due | 60 - 89<br>Days<br>Past Due | 90 Days or<br>Greater<br>Past Due | Total<br>Past Due | Loans Not<br>Past Due | Total             |
|                               | (Dollars in thousands)      |                             |                                   |                   |                       |                   |
| Commercial                    | \$ 1,445                    | \$ 646                      | \$ 4,368                          | \$ 6,459          | \$ 350,229            | \$ 356,688        |
| Real estate:                  |                             |                             |                                   |                   |                       |                   |
| Commercial and<br>residential |                             |                             | 3,485                             | 3,485             | 357,855               | 361,340           |
| Land and construction         |                             |                             | 69                                | 69                | 24,542                | 24,611            |
| Home equity                   | 87                          |                             | 2,043                             | 2,130             | 43,217                | 45,347            |
| Consumer                      | 103                         |                             |                                   | 103               | 13,933                | 14,036            |
| <b>Total</b>                  | <b>\$ 1,635</b>             | <b>\$ 646</b>               | <b>\$ 9,965</b>                   | <b>\$ 12,246</b>  | <b>\$ 789,776</b>     | <b>\$ 802,022</b> |

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

|                               | December 31, 2012           |                             |                                   |                   |                       |                   |
|-------------------------------|-----------------------------|-----------------------------|-----------------------------------|-------------------|-----------------------|-------------------|
|                               | 30 - 59<br>Days<br>Past Due | 60 - 89<br>Days<br>Past Due | 90 Days or<br>Greater<br>Past Due | Total<br>Past Due | Loans Not<br>Past Due | Total             |
|                               | (Dollars in thousands)      |                             |                                   |                   |                       |                   |
| Commercial                    | \$ 1,699                    | \$ 355                      | \$ 5,120                          | \$ 7,174          | \$ 368,295            | \$ 375,469        |
| Real estate:                  |                             |                             |                                   |                   |                       |                   |
| Commercial and<br>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 \$12,246,000 and \$14,932,000 at March 31, 2013 and December 31, 2012, respectively, of which \$11,267,000 and \$12,020,000 were on nonaccrual. At March 31, 2013, there were also \$4,848,000 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)**

**March 31, 2013**

**(Unaudited)**

**5) Loans (Continued)**

*Credit Quality Indicators*

Concentrations of credit risk arise when a number of clients 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 March 31, 2013 or December 31, 2012.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2013****(Unaudited)****5) Loans (Continued)**

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

|                            | March 31, 2013         |                  |                   | December 31, 2012 |                  |                   |
|----------------------------|------------------------|------------------|-------------------|-------------------|------------------|-------------------|
|                            | Nonclassified          | Classified       | Total             | Nonclassified     | Classified       | Total             |
|                            | (Dollars in thousands) |                  |                   |                   |                  |                   |
| Commercial                 | \$ 340,372             | \$ 16,316        | \$ 356,688        | \$ 355,440        | \$ 20,029        | \$ 375,469        |
| Real estate:               |                        |                  |                   |                   |                  |                   |
| Commercial and residential | 351,911                | 9,429            | 361,340           | 345,045           | 9,889            | 354,934           |
| Land and construction      | 22,433                 | 2,178            | 24,611            | 18,858            | 3,494            | 22,352            |
| Home equity                | 42,591                 | 2,756            | 45,347            | 41,187            | 2,678            | 43,865            |
| Consumer                   | 13,656                 | 380              | 14,036            | 15,321            | 393              | 15,714            |
| <b>Total</b>               | <b>\$ 770,963</b>      | <b>\$ 31,059</b> | <b>\$ 802,022</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 March 31, 2013 was \$3,662,000, which included \$1,396,000 of nonaccrual loans and \$2,266,000 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 \$920,000 and \$1,152,000 in specific reserves were established with respect to these loans as of March 31, 2013 and December 31, 2012, respectively. As of March 31, 2013 and December 31, 2012, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

There were no loans modified as troubled debt restructuring during the three months ended March 31, 2013. The following table presents loans by class modified as troubled debt restructurings during the three month period ended March 31, 2012:

|              | During the Three Months Ended<br>March 31, 2012 |   |  |
|--------------|---|---|--|
|              | Number<br>of<br>Contracts                       | Pre-modification<br>Outstanding<br>Recorded<br>Investment | Post-modification<br>Outstanding<br>Recorded<br>Investment |
|              | (Dollars in thousands)                          |   |  |
| Commercial   | 2   | \$ 412  | \$ 412   |
| <b>Total</b> | <b>2</b>  | <b>\$ 412</b>   | <b>\$ 412</b>  |

The troubled debt restructurings described above increased the allowance for loan losses by \$27,000 through the allocation of specific reserves, and resulted in no net charge-offs during the three month period ended March 31, 2012.



Table of Contents

**HERITAGE COMMERCE CORP**

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

**March 31, 2013**

**(Unaudited)**

**5) Loans (Continued)**

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 ended March 31, 2013 or 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.

The Company had net deferred tax assets of \$20,237,000, and \$19,264,000, at March 31, 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 March 31, 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

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2013

(Unaudited)

## 7) Benefit Plans (Continued)

there are no Plan assets. The following table presents the amount of periodic cost recognized for the periods indicated:

|  | Three Months<br>Ended<br>March 31, |        |
|--|------------------------------------|--------|
|  | 2013                               | 2012   |
|  | (Dollars in<br>thousands)          |        |
| Components of net periodic benefit cost: |                                    |        |
| Service cost                             | \$ 304                             | \$ 294 |
| Interest cost                            | 196                                | 193    |
| Amortization of prior service cost       |                                    | 7      |
| Amortization of net actuarial loss       | 71                                 | 63     |
| Net periodic benefit cost                | \$ 571                             | \$ 557 |

*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:

|   | March 31, 2013         | December 31, 2012 |
|---|------------------------|-------------------|
|   | (Dollars in thousands) |                   |
| Change in projected benefit obligation            |                        |                   |
| Projected benefit obligation at beginning of year | \$ 4,717               | \$ 4,525          |
| Interest cost                                     | 44                     | 185               |
| Actuarial gain                                    | 3                      | 7                 |
| Projected benefit obligation at end of period     | \$ 4,764               | \$ 4,717          |

Amounts recognized in accumulated other comprehensive income at March 31, 2013 and December 31, 2012 consist of the following:

|                                      | March 31, 2013         | December 31, 2012 |
|--------------------------------------|------------------------|-------------------|
|                                      | (Dollars in thousands) |                   |
| Net actuarial loss                   | \$ 669                 | \$ 624            |
| Prior transition obligation          | 1,665                  | 1,685             |
| Accumulated other comprehensive loss | \$ 2,334               | \$ 2,309          |

Table of Contents

**HERITAGE COMMERCE CORP**

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

**March 31, 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. The Company did not repurchase the related warrant that was issued to the U.S. Treasury, and the warrant remains outstanding as of the date of this report.

*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).

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.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2013****(Unaudited)****9) Fair Value (Continued)*****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<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) |
| (Dollars in thousands)            |            |   |   |
| Assets at March 31, 2013:         |            |   |   |
| Available-for-sale securities:    |            |   |   |
| Agency mortgage-backed securities | \$ 271,077 |   | \$ 271,077  |
| Corporate bonds                   | 54,892     |   | 54,892  |
| Trust preferred securities        | 20,831     |   | 20,831  |
| I/O strip receivables             | 1,777      |   | 1,777   |
| 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 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.

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2013

(Unaudited)

## 9) Fair Value (Continued)

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 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<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) |
| (Dollars in thousands)              |          |   |   |
| Assets at March 31, 2013:           |          |   |   |
| Impaired loans held-for-investment: |          |   |   |
| Commercial                          | \$ 2,982 |   | \$ 2,982  |
| Real estate:                        |          |   |   |
| Commercial and residential          | 3,217    |   | 3,217   |
| Land and construction               | 1,685    |   | 1,685   |
| Consumer                            | 122      |   | 122   |
|                                     | \$ 8,006 |   | \$ 8,006  |
| Foreclosed assets:                  |          |   |   |
| Commercial                          | \$ 81    |   | \$ 81   |
| Land and construction               | 657      |   | 657   |
|                                     | \$ 738   |   | \$ 738  |
| Assets at December 31, 2012:        |          |   |   |
| 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  |
| Foreclosed assets:                  |          |   |   |
| 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)****March 31, 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>March 31, 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 | \$ 11,032                     | \$ 11,912                |
| Book value of impaired loans held-for-investment carried at cost       | 7,349                         | 7,732                    |
| <b>Total impaired loans held-for-investment</b>                        | <b>\$ 18,381</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 | \$ 11,032                     | \$ 11,912                |
| Specific valuation allowance   | (3,026)                       | (2,740)                  |
| <b>Impaired loans held-for-investment carried at fair value, net</b>   | <b>\$ 8,006</b>               | <b>\$ 9,172</b>          |

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were \$18,381,000 at March 31, 2013, after partial charge-offs of \$83,000 in the first three months of 2013. In addition, these loans had a specific valuation allowance of \$3,026,000 at March 31, 2013. Impaired loans held-for-investment totaling \$11,032,000 at March 31, 2013 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining \$7,349,000 of impaired loans were carried at cost at March 31, 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 three months of 2013 on impaired loans held-for-investment carried at fair value at March 31, 2013 resulted in an additional provision for loan losses of \$757,000.

Foreclosed assets measured at fair value less costs to sell, had a carrying amount of \$738,000, with no valuation allowance at March 31, 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.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2013****(Unaudited)****9) Fair Value (Continued)**

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

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:

|                                     | Fair Value | Valuation Techniques | March 31, 2013   |                          |
|-------------------------------------|------------|----------------------|--|--------------------------|
|                                     |            |                      | Unobservable Inputs  | Range (Weighted Average) |
| (Dollars in thousands)              |            |                      |  |                          |
| Impaired loans held-for-investment: |            |                      |  |                          |
| Commercial                          | \$ 2,982   | Market Approach      | Discount adjustment for differences between comparable sales | 0% to 3%<br>(2%)         |
| Real estate:                        |            |                      |  |                          |
| Commercial and residential          | 3,217      | Market Approach      | Discount adjustment for differences between comparable sales | 0% to 13%<br>(1%)        |
| Land and construction               | 1,685      | Market Approach      | Discount adjustment for differences between comparable sales | 1% to 4%<br>(2%)         |
| Foreclosed assets:                  |            |                      |  |                          |
| Land and construction               | 657        | Market Approach      | Discount adjustment for differences between comparable sales | 1% to 16%<br>(7%)        |

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



Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|                            |       | comparable sales |  |                |
|----------------------------|-------|------------------|--|----------------|
| Real estate:               |       |                  |  |                |
| 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%) |

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2013****(Unaudited)****9) Fair Value (Continued)**

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 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 March 31, 2013 are as follows:

|   | Carrying<br>Amounts | Quoted Prices in<br>Active Markets<br>for<br>Identical Assets<br>(Level 1) | Estimated Fair Value                                      |  | Total      |
|---|---------------------|--|---|--|------------|
|   |                     |  | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |            |
| (Dollars in thousands)                              |                     |  |   |  |            |
| <b>Assets:</b>                                      |                     |  |   |  |            |
| Cash and cash equivalents                           | \$ 76,869           | \$ 76,869  | \$  | \$   | \$ 76,869  |
| Securities available-for-sale                       | 346,800             |  | 346,800   |  | 346,800    |
| Securities held-to-maturity                         | 68,283              |  | 65,659  |  | 65,659     |
| Loans (including loans held-for-sale),<br>net       | 786,977             |  | 4,394   | 783,126  | 787,520    |
| FHLB and FRB stock                                  | 10,764              |  |   |  | N/A        |
| Accrued interest receivable                         | 4,309               |  | 1,919   | 2,390  | 4,309      |
| Loan servicing rights and I/O strips<br>receivables | 2,447               |  | 4,680   |  | 4,680      |
| <b>Liabilities:</b>                                 |                     |  |   |  |            |
| Time deposits                                       | \$ 302,476          | \$   | \$ 303,282  | \$   | \$ 303,282 |
| Other deposits                                      | 864,414             |  | 864,414   |  | 864,414    |
| Subordinated debt                                   | 9,279               |  |   | 5,400  | 5,400      |
| Accrued interest payable                            | 281                 |  | 281   |  | 281        |

30

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2013****(Unaudited)****9) Fair Value (Continued)**

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

|   | Carrying<br>Amounts | Quoted Prices<br>in<br>Active Markets<br>for<br>Identical Assets<br>(Level 1) | Estimated Fair Value                                      |  | Total      |
|---|---------------------|---|---|--|------------|
|   |                     |   | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(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<br>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<br>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 fair value of loans held-for-sale is estimated based upon binding contracts and quotes from third party investors 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 cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

Table of Contents

**HERITAGE COMMERCE CORP**

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

**March 31, 2013**

**(Unaudited)**

**9) Fair Value (Continued)**

***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)****March 31, 2013****(Unaudited)****10) Equity Plan**

The Company has an Amended and Restated 2004 Equity Plan (the "Equity 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. As of March 31, 2013, there are 349,071 shares available for future grants under the Equity Plan.

Stock option activity under the Equity Plan is as follows:

|                                | Number<br>of Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life (Years) | Aggregate<br>Intrinsic<br>Value |
|--------------------------------|---------------------|--|---|---------------------------------|
| <b>Total Stock Options</b>     |                     |  |   |                                 |
| Outstanding at January 1, 2013 | 1,314,347           | \$ 12.90                                 |   |                                 |
| Granted                        | 15,000              | \$ 6.51                                  |   |                                 |
| Exercised                      | (1,221)             | \$ 3.57                                  |   |                                 |
| Forfeited or expired           | (4,159)             | \$ 4.96                                  |   |                                 |
| Outstanding at March 31, 2013  | 1,323,967           | \$ 12.80                                 | 5.6   | \$ 794,000                      |
| Vested or expected to vest     | 1,257,769           |  | 5.6   | \$ 755,000                      |
| Exercisable at March 31, 2013  | 1,011,067           |  | 4.6   | \$ 484,000                      |

As of March 31, 2013, there was \$1,066,000 of total unrecognized compensation cost related to nonvested stock options granted under the Equity Plan. That cost is expected to be recognized over a weighted-average period of approximately 2.79 years.

Restricted stock activity under the Equity Plan is as follows:

|                                     | Number<br>of Shares | Weighted<br>Average<br>Grant Date<br>Fair Value |
|-------------------------------------|---------------------|---|
| <b>Total Restricted Stock Award</b> |                     |   |
| Nonvested shares at January 1, 2013 | 88,000              | \$ 5.74   |
| Granted                             | 10,000              | \$ 6.51   |
| Vested                              |                     | \$  |
| Forfeited                           |                     | \$  |
| Nonvested shares at March 31, 2013  | 98,000              | \$ 5.82   |

As of March 31, 2013, there was \$266,000 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the Equity Plan. The cost is expected to be recognized over a weighted-average period of approximately 11 months.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2013****(Unaudited)****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 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. 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 qualifies for Tier 1 capital treatment. 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 \$15,000,000,000 of assets; however, under proposed rules implementing Basel III trust preferred securities would lose eligibility for Tier 1 capital over a ten year period. Therefore, our trust preferred securities will continue to be eligible to be treated as Tier 1 capital, subject to other rules and limitations.

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>March 31,<br/>2013</b>     | <b>December 31,<br/>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% (3.86% at March 31, 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% (3.68% at March 31, 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)**

**March 31, 2013**

**(Unaudited)**

**12) Loss Contingencies**

The Company's policy is to accrue for legal costs associated with both asserted and unasserted claims when it 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. During the first quarter of 2013, a legal claim was asserted on this matter and the Company accrued an additional \$266,000 for additional legal costs that are expected to be incurred to defend this matter. 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.

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 March 31, 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 March 31, 2013, net income was \$2.2 million, compared to \$2.1 million for the three months ended March 31, 2012. Net income available to common shareholders was \$2.2 million, or \$0.07 per average diluted common share for the three months ended March 31, 2013. After accrued dividends and discount accretion on preferred stock of \$1.2 million, net income available to shareholders was \$869,000, or \$0.03 per average common share for the three months ended March 31, 2012. Beginning in the second quarter of 2012, there were no dividends or discount accretion on preferred stock, following the redemption of the Company's \$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. The Company's annualized return on average assets was 0.61% and annualized return on average equity was 5.20% for the three months ended March 31, 2013, compared to 0.64% and 4.43%, respectively, for the three months ended March 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 \$24.3 million at March 31, 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.



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

### Table of Contents

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

The net interest margin was 3.71% for the first quarter of 2013, compared to 4.06% for the first quarter of 2012. The decline in the net interest margin for the first quarter of 2013 was primarily due to the increased short-term deposits at the Federal Reserve Bank as a result of the aforementioned short-term demand deposits of one customer. The net interest margin for the first quarter of 2013 was also impacted by a decline in loan and security yields, partially offset by a lower cost of funds. Excluding the impact to the net interest margin as a result of the large short-term demand deposits from one customer, and favorable benefit on the repayment of interest income from paid-off nonaccrual loans, the net interest margin was 3.78% for the first quarter of 2013.

Net interest income was \$12.2 million for the first quarter of 2013, compared to \$12.3 million for the first quarter of 2012, primarily due to a lower net interest margin.

The Company did not record a provision for loan losses in the first quarter of 2013 because of the loan recoveries and the reduced credit risk from the reduction in nonperforming assets and classified assets at March 31, 2013. The loan loss provision for the first quarter of 2012 was \$100,000.

Noninterest income was \$1.7 million for both the first quarter of 2013 and the first quarter of 2012.

Noninterest expense for the first quarter of 2013 was \$10.8 million, compared to \$10.9 million for the first quarter of 2012.

Income tax expense for the first quarter ended March 31, 2013 was \$855,000, compared to \$951,000 for the first quarter of 2012.

The efficiency ratio was 78.03% for the first quarter of 2013, compared to 77.64% for the first quarter of 2012.

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 7% to \$423.7 million at March 31, 2013, from \$454.5 million at March 31, 2012, and decreased 43% 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 \$24.3 million at March 31, 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 12% to \$399.3 million at March 31, 2013, from \$454.5 million at March 31, 2012, and decreased 15% from \$469.6 million at December 31, 2012.

Securities held-to-maturity, at amortized cost, were \$68.3 million at March 31, 2013, compared to no securities held-to-maturity at March 31, 2012. Securities held-to-maturity, at amortized cost, were \$51.5 million at December 31, 2012.

Total loans, excluding loans held-for-sale, increased \$45.0 million, or 6%, to \$801.9 million at March 31, 2013, compared to \$756.9 million at March 31, 2012, and decreased \$10.4 million, or 1%, from \$812.3 million at December 31, 2012.

Nonperforming assets were \$17.4 million, or 1.26% of total assets at March 31, 2013, compared to \$19.5 million or 1.49% of total assets at March 31, 2012, and \$19.5 million, or 1.15% of total assets at December 31, 2012. Nonperforming assets were 1.28% of total assets at March 31, 2013, compared to 1.37% of total assets at December 31, 2012, excluding the

short-term deposits

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

### Table of Contents

of \$24.3 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 42% to \$31.2 million at March 31, 2013 from \$54.2 million at March 31, 2012, and decreased 15% from \$36.8 million at December 31, 2012.

Net recoveries totaled \$315,000 for the first quarter of 2013, compared to net charge-offs of \$494,000 for the first quarter of 2012, and net charge-offs of \$766,000 for the fourth quarter of 2012.

The allowance for loan losses at March 31, 2013 was \$19.3 million, or 2.41% of total loans, representing 116.07% of nonperforming loans (there were no nonaccrual loans in loans held-for-sale at March 31, 2013). The allowance for loan losses at March 31, 2012 was \$20.3 million, or 2.68% of total loans, representing 125.66% of nonperforming loans excluding 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 \$24.3 million at March 31, 2013 and \$271.9 million at December 31, 2012, were \$1.06 billion at March 31, 2013, compared to \$995.5 million at March 31, 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 20.92% at March 31, 2013, compared to 19.89% at March 31, 2012, and 17.63% at December 31, 2012. The ratio of noncore funding to total assets was 21.29% at March 31, 2013 and 21.00% at December 31, 2012, excluding the short-term deposits of \$24.3million and \$271.9 million, respectively, at the Federal Reserve Bank offsetting the short-term demand deposits from one customer.

The loan to deposit ratio was 68.72% at March 31, 2013, compared to 70.07% at March 31, 2012, and 54.91% at December 31, 2012. The loan to deposit ratio was 70.19% at March 31, 2013 and 67.27% at December 31, 2012, excluding the \$24.3 million and \$271.9 million, respectively, of short-term demand deposits from one customer.

Capital ratios exceed regulatory requirements for a well-capitalized financial institution, both on a consolidated basis and at the bank level at March 31, 2013:

| <b>Capital Ratios</b> | <b>Heritage<br/>Commerce Corp</b> | <b>Heritage<br/>Bank of Commerce</b> | <b>Well-Capitalized<br/>Financial Institution<br/>Regulatory Guidelines</b> |
|-----------------------|-----------------------------------|--------------------------------------|---|
| Total Risk-Based      | 16.7%                             | 15.9%                                | 10.0%   |
| Tier 1 Risk-Based     | 15.5%                             | 14.6%                                | 6.0%  |
| Leverage              | 11.5%                             | 10.9%                                | 5.0%  |

### **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 \$83.8 million in brokered deposits at March 31, 2013, compared to \$84.7 million at March 31, 2012, and \$97.8 million at December 31,

Table of Contents

2012. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators decreased to \$20.2 million at March 31, 2013, compared to \$30.6 million at March 31 2012, and \$21.4 million at December 31, 2012. Certificates of deposit from the State of California totaled \$85.0 million at March 31, 2013, compared to \$50.0 million at March 31, 2012, and \$85.0 million at December 31, 2012. Total deposits at March 31, 2013 were \$1.17 billion, compared to \$1.08 billion at March 31, 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 \$24.3 million at March 31, 2013 and \$271.9 million at December 31, 2012) increased to \$829.3 million at March 31, 2013, an increase of \$36.7 million, or 5% from \$792.6 million at March 31, 2012, and decreased \$54.5 million, or 6%, 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 \$15.9 million at March 31, 2013, compared to \$6.2 million at March 31, 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 March 31, 2013, we had \$76.9 million in cash and cash equivalents and approximately \$328.9 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 \$276.9 million in unpledged securities available at March 31, 2013. Our loan to deposit ratio decreased to 68.72% at March 31, 2013, compared to 70.07% at March 31, 2012, and 54.91% at December 31, 2012. The loan to deposit ratio was 70.19% at March 31, 2013 and 67.27% at December 31, 2012, excluding the \$24.3 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 6% to \$801.9 million at March 31, 2013, from \$756.9 million at March 31, 2012, and decreased 1% from \$812.3 million at December 31, 2012. The loan portfolio remains well diversified with commercial and industrial ("C&I") loans accounting for 44% of the total loan portfolio at March 31, 2013. Commercial and residential real estate loans accounted for 45% of the total loan portfolio at March 31, 2013, of which 51% were owner-occupied by businesses. Consumer and home equity loans accounted for 8% of the total loan portfolio, and land and construction loans accounted for the remaining 3% of the total loan portfolio at March 31, 2013. The yield on the loan portfolio was 5.13% for the first quarter of 2013, compared to 5.41% for the first quarter of 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).

Table of Contents

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 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. The Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. Noninterest expense for the first quarter of 2013 decreased to \$10.8 million, compared to \$10.9 million for the same period in 2012.

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. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report.

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 variable-rate subordinated debt outstanding at March 31, 2013. The Company is current with respect to interest accrued on trust preferred subordinated debt securities as of March 31, 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.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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, 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<br>March 31, 2013 |                                |                           | For the Three Months Ended<br>March 31, 2012 |                                |                           |
|--|--|--------------------------------|---------------------------|--|--------------------------------|---------------------------|
|  | Average<br>Balance                           | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate | Average<br>Balance                           | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate |
| (Dollars in thousands)   |  |                                |                           |  |                                |                           |
| <b>Assets:</b>   |  |                                |                           |  |                                |                           |
| Loans, gross(1)  | \$ 798,131                                   | \$ 10,089                      | 5.13%                     | \$ 767,288                                   | \$ 10,316                      | 5.41%                     |
| Securities taxable   | 385,707                                      | 2,462                          | 2.59%                     | 389,919                                      | 3,097                          | 3.19%                     |
| Securities tax exempt(2)   | 40,552                                       | 382                            | 3.82%                     |  |                                |                           |
| Federal funds sold and interest-bearing deposits in other financial institutions   | 116,947                                      | 68                             | 0.24%                     | 55,991                                       | 36                             | 0.26%                     |
| <b>Total interest earning assets</b>   | <b>1,341,337</b>                             | <b>13,001</b>                  | <b>3.93%</b>              | <b>1,213,198</b>                             | <b>13,449</b>                  | <b>4.46%</b>              |
| Cash and due from banks  | 23,555                                       |                                |                           | 20,987                                       |                                |                           |
| Premises and equipment, net  | 7,521  |                                |                           | 7,978  |                                |                           |
| Intangible assets  | 1,954  |                                |                           | 2,441  |                                |                           |
| Other assets   | 68,561                                       |                                |                           | 67,381                                       |                                |                           |
| <b>Total assets</b>  | <b>\$ 1,442,928</b>                          |                                |                           | <b>\$ 1,311,985</b>                          |                                |                           |
| <b>Liabilities and shareholders' equity:</b>                                       |  |                                |                           |  |                                |                           |
| <b>Deposits:</b>   |  |                                |                           |  |                                |                           |
| Demand, noninterest-bearing  | \$ 461,108                                   |                                |                           | \$ 347,291                                   |                                |                           |
| Demand, interest-bearing   | 164,402                                      | 59                             | 0.15%                     | 142,650                                      | 52                             | 0.15%                     |
| Savings and money market   | 283,229                                      | 120                            | 0.17%                     | 288,202                                      | 166                            | 0.23%                     |
| Time deposits under \$100  | 24,596                                       | 23                             | 0.38%                     | 28,223                                       | 38                             | 0.54%                     |
| Time deposits \$100 and over   | 190,273                                      | 203                            | 0.43%                     | 169,694                                      | 256                            | 0.61%                     |
| Time deposits brokered   | 92,063                                       | 219                            | 0.96%                     | 6,262  | 3                              | 0.19%                     |
| CDARS money market and time deposits   | 11,475                                       | 1                              | 0.04%                     | 84,730                                       | 201                            | 0.95%                     |
| <b>Total interest-bearing deposits</b>   | <b>766,038</b>                               | <b>625</b>                     | <b>0.33%</b>              | <b>719,761</b>                               | <b>716</b>                     | <b>0.40%</b>              |
| <b>Total deposits</b>  | <b>1,227,146</b>                             | <b>625</b>                     | <b>0.21%</b>              | <b>1,067,052</b>                             | <b>716</b>                     | <b>0.27%</b>              |
| Subordinated debt  | 9,279  | 88                             | 3.85%                     | 23,702                                       | 474                            | 8.04%                     |
| Short-term borrowings  | 85   | 1                              | 4.77%                     | 39   |                                | N/A                       |
| <b>Total interest-bearing liabilities</b>  | <b>775,402</b>                               | <b>714</b>                     | <b>0.37%</b>              | <b>743,502</b>                               | <b>1,190</b>                   | <b>0.64%</b>              |
| Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds | 1,236,510                                    | 714                            | 0.23%                     | 1,090,793                                    | 1,190                          | 0.44%                     |
| Other liabilities  | 36,535                                       |                                |                           | 32,671                                       |                                |                           |
| <b>Total liabilities</b>   | <b>1,273,045</b>                             |                                |                           | <b>1,123,464</b>                             |                                |                           |
| Shareholders' equity   | 169,883                                      |                                |                           | 188,521                                      |                                |                           |
| <b>Total liabilities and shareholders' equity</b>                                  | <b>\$ 1,442,928</b>                          |                                |                           | <b>\$ 1,311,985</b>                          |                                |                           |
| <b>Net interest income(2) / margin</b>   |  |                                |                           |  |                                |                           |
|  |  | 12,287                         | 3.71%                     | 12,259                                       |                                | 4.06%                     |
| Less tax equivalent adjustment(2)  |  | (134)                          |                           |  |                                |                           |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Net interest income

\$ 12,153

\$ 12,259

- 
- (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.



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 March 31,<br/>2013 vs. 2012</b> |                         |                       |
|--|---|-------------------------|-----------------------|
|  | <b>Increase (Decrease) Due to</b>                     |                         |                       |
|  | <b>Change In:</b>                                     |                         |                       |
|  | <b>Average<br/>Volume</b>                             | <b>Average<br/>Rate</b> | <b>Net<br/>Change</b> |
|  | <b>(Dollars in thousands)</b>                         |                         |                       |
| <b>Income from interest earning assets:</b>                                      |   |                         |                       |
| Loans, gross   | \$ 383  | \$ (610)                | \$ (227)              |
| Securities taxable   | (28)  | (607)                   | (635)                 |
| Securities tax exempt  | 382   |                         | 382                   |
| Federal funds sold and interest-bearing deposits in other financial institutions | 35  | (3)                     | 32                    |
| <b>Total interest income from interest earnings assets</b>                       | <b>772</b>  | <b>(1,220)</b>          | <b>(448)</b>          |
| <b>Expense on interest-bearing liabilities:</b>                                  |   |                         |                       |
| Demand, interest-bearing   | 6   | 1                       | 7                     |
| Savings and money market   | (1)   | (45)                    | (46)                  |
| Time deposits under \$100  | (3)   | (12)                    | (15)                  |
| Time deposits \$100 and over   | 23  | (76)                    | (53)                  |
| Time deposits brokered   | 204   | 12                      | 216                   |
| CDARS money market and time deposits   | (7)   | (193)                   | (200)                 |
| Subordinated debt  | (137)   | (249)                   | (386)                 |
| Short-term borrowings  | 1   |                         | 1                     |
| <b>Total interest expense on interest-bearing liabilities</b>                    | <b>86</b>   | <b>(562)</b>            | <b>(476)</b>          |
| <b>Net interest income</b>   | <b>\$ 686</b>   | <b>\$ (658)</b>         | <b>\$ 28</b>          |

The Company's net interest margin expressed as a percentage of average earning assets was 3.71% for the first quarter of 2013, compared to 4.06% for the first quarter of 2012. The decline in the net interest margin for the first quarter of 2013 was primarily due to the increased short-term deposits at the Federal Reserve Bank as a result of the aforementioned short-term demand deposits of one customer. The net interest margin for the first quarter of 2013 was also impacted by a decline in loan and securities yields, partially offset by a lower cost of funds. Excluding the impact to the net interest margin as a result of the large short-term demand deposits from one customer, and favorable benefit on the repayment of interest income from paid-off nonaccrual loans, the net interest margin was 3.78% for the first quarter of 2013.

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.

Table of Contents**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 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.

The Company did not record a provision for loan losses in the first quarter of 2013 because of the net loan recoveries during the period and the reduced credit risk from the reduction in nonperforming assets and classified assets. The provision for loan losses for the first quarter of 2012 was \$100,000.

The allowance for loan losses totaled \$19.3 million, or 2.41% of total loans at March 31, 2013, compared to \$20.3 million, or 2.68% of total loans at March 31, 2012, and \$19.0 million, or 2.34% of total loans at December 31, 2012. The decrease in the allowance for loan losses at March 31, 2013, compared to March 31, 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 \$315,000 for the first quarter of 2013, compared to net charge-offs of \$494,000 for the first 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<br>Months Ended<br>March 31, |                 | Increase<br>(decrease)<br>2013 versus 2012 |            |
|--|--|-----------------|--|------------|
|  | 2013                                       | 2012            | Amount                                     | Percent    |
| (Dollars in thousands)                             |  |                 |  |            |
| Service charges and fees on deposit accounts       | \$ 577                                     | \$ 590          | \$ (13)                                    | -2%        |
| Increase in cash surrender value of life insurance | 416  | 429             | (13)                                       | -3%        |
| Servicing income                                   | 365  | 460             | (95)                                       | -21%       |
| Gain on sales of SBA loans                         | 136  | 36              | 100  | 278%       |
| Gain on sales of securities                        | 31   | 27              | 4  | 15%        |
| Other  | 138  | 181             | (43)                                       | -24%       |
| <b>Total noninterest income</b>                    | <b>\$ 1,663</b>                            | <b>\$ 1,723</b> | <b>\$ (60)</b>                             | <b>-3%</b> |

Noninterest income for the first quarter of 2013 remained relatively flat at \$1.7 million, compared to the same period in 2012.

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 quarter ended March 31, 2013, SBA loan sales resulted in a \$136,000 gain, compared to a \$36,000 gain on sales of SBA loans for the quarter ended March 31, 2012. The servicing assets that result from the sales of SBA loans with servicing

Table of Contents

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 March 31, |           | Increase (decrease) 2013 versus 2012 |         |
|--------------------------------------|--------------------------------------|-----------|--------------------------------------|---------|
|                                      | 2013                                 | 2012      | Amount                               | Percent |
| (Dollars in thousands)               |                                      |           |                                      |         |
| Salaries and employee benefits       | \$ 6,011                             | \$ 5,667  | \$ 344                               | 6%      |
| Occupancy and equipment              | 1,068                                | 996       | 72                                   | 7%      |
| Professional fees                    | 982                                  | 1,211     | (229)                                | -19%    |
| Low income housing investment losses | 311                                  | 269       | 42                                   | 16%     |
| Software subscriptions               | 291                                  | 290       | 1                                    | 0%      |
| FDIC deposit insurance premiums      | 259                                  | 225       | 34                                   | 15%     |
| Insurance expense                    | 254                                  | 224       | 30                                   | 13%     |
| Data processing                      | 252                                  | 245       | 7                                    | 3%      |
| Correspondent bank charges           | 164                                  | 143       | 21                                   | 15%     |
| Foreclosed assets, net               | (155)                                | 115       | (270)                                | -235%   |
| Other                                | 1,344                                | 1,471     | (127)                                | -9%     |
| Total noninterest expense            | \$ 10,781                            | \$ 10,856 | \$ (75)                              | -1%     |

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 March 31, |                  |           |                  |
|--------------------------------------|--------------------------------------|------------------|-----------|------------------|
|                                      | 2013                                 | Percent of Total | 2012      | Percent of Total |
| (Dollars in thousands)               |                                      |                  |           |                  |
| Salaries and employee benefits       | \$ 6,011                             | 56%              | \$ 5,667  | 52%              |
| Occupancy and equipment              | 1,068                                | 10%              | 996       | 9%               |
| Professional fees                    | 982                                  | 9%               | 1,211     | 11%              |
| Low income housing investment losses | 311                                  | 3%               | 269       | 3%               |
| Software subscriptions               | 291                                  | 3%               | 290       | 3%               |
| FDIC deposit insurance premiums      | 259                                  | 2%               | 225       | 2%               |
| Insurance expense                    | 254                                  | 2%               | 224       | 2%               |
| Data processing                      | 252                                  | 2%               | 245       | 2%               |
| Correspondent bank charges           | 164                                  | 2%               | 143       | 1%               |
| Foreclosed assets, net               | (155)                                | -1%              | 115       | 1%               |
| Other                                | 1,344                                | 12%              | 1,471     | 14%              |
| Total noninterest expense            | \$ 10,781                            | 100%             | \$ 10,856 | 100%             |

Noninterest expense in the first quarter of 2013 was \$10.8 million, a decrease from \$10.9 million for the first quarter of 2012. The decrease in noninterest expense for the first quarter of 2013 was primarily due to a gain on the disposition of foreclosed assets and lower professional fees, partially

Table of Contents

offset by higher health insurance premiums and other salaries and employee benefits costs. Full-time equivalent employees were 188 at March 31, 2013 and 189 at March 31, 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 ended March 31, 2013 was \$855,000, compared to \$951,000 for the quarter ended March 31, 2012. The following table shows the Company's effective income tax rates for the periods indicated:

|                           | <b>For the Three<br/>Months Ended<br/>March 31,</b> |             |
|---------------------------|---|-------------|
|                           | <b>2013</b>   | <b>2012</b> |
| Effective income tax rate | 28.2%   | 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 \$2.2 million in low-income housing limited partnerships as of March 31, 2013.

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.

Table of Contents

The Company had net deferred tax assets of \$20.2 million and \$19.3 million at March 31, 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 March 31, 2013 and December 31, 2012 will be fully realized in future years.

**FINANCIAL CONDITION**

As of March 31, 2013, total assets increased to \$1.38 billion, compared to \$1.31 billion at March 31, 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 \$24.3 million at March 31, 2013 and \$271.9 million at December 31, 2012, total assets were \$1.36 billion and \$1.42 billion, respectively. Securities available-for-sale (at fair value) were \$346.8 million at March 31, 2013, a decrease of 10% from \$385.8 million at March 31, 2012, and a decrease of 6% from \$367.9 million at December 31, 2012. Securities held-to-maturity (at amortized cost) were \$68.3 million at March 31, 2013, compared to no securities held-to-maturity at March 31, 2012, and \$51.5 million at December 31, 2012. The total loan portfolio, excluding loans held-for-sale, was \$801.9 million at March 31, 2013, an increase of 6% from \$756.9 million at March 31, 2012, and a decrease of 1% from \$812.3 million at December 31, 2012.

Total deposits, excluding the short-term demand deposits from one customer of \$24.3 million at March 31, 2013 and \$271.9 million at December 31, 2012, increased 6% to \$1.14 billion at March 31, 2013, from \$1.08 billion at March 31, 2012 and decreased 5% from \$1.21 billion at December 31, 2012. Subordinated debt decreased to \$9.3 million at March 31, 2013 and December 31, 2012, compared to \$23.7 million at March 31, 2012, as a result of the redemption of \$14 million fixed-rate subordinated debt during the third quarter of 2012.

*Securities Portfolio*

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

|   | March 31,         |                   | December 31,      |
|---|-------------------|-------------------|-------------------|
|   | 2013              | 2012              | 2012              |
| (Dollars in thousands)                                  |                   |                   |                   |
| <b>Securities available-for-sale (at fair value):</b>   |                   |                   |                   |
| Agency mortgage-backed securities                       | \$ 271,077        | \$ 340,181        | \$ 291,244        |
| Corporate bonds   | 54,892            | 10,636            | 55,588            |
| Trust preferred securities                              | 20,831            | 35,009            | 21,080            |
| <b>Total</b>  | <b>\$ 346,800</b> | <b>\$ 385,826</b> | <b>\$ 367,912</b> |
| <b>Securities held-to-maturity (at amortized cost):</b> |                   |                   |                   |
| Agency mortgage-backed securities                       | \$ 15,185         | \$                | \$ 16,659         |
| Municipals Tax Exempt                                   | 53,098            |                   | 34,813            |
|   | <b>\$ 68,283</b>  | <b>\$</b>         | <b>\$ 51,472</b>  |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

The following table summarizes the weighted average life and weighted average yields of securities at March 31, 2013:

|  | March 31, 2013<br>Weighted Average Life |       |                                       |       |                    |       |            |       |
|--|---|-------|---------------------------------------|-------|--------------------|-------|------------|-------|
|  | After One<br>and Within<br>Five Years   |       | After Five<br>and Within<br>Ten Years |       | After<br>Ten Years |       | Total      |       |
|  | Amount                                  | Yield | Amount                                | Yield | Amount             | Yield | Amount     | Yield |
| (Dollars in thousands)                         |   |       |                                       |       |                    |       |            |       |
| Securities available-for-sale (at fair value): |   |       |                                       |       |                    |       |            |       |
| Agency mortgage-backed securities              | \$ 216,999                              | 2.48% | \$ 49,911                             | 2.31% | \$ 4,167           | 2.51% | \$ 271,077 | 2.45% |
| Corporate bonds                                | 963                                     | 2.45% | 53,929                                | 3.26% |                    |       | 54,892     | 3.25% |
| Trust preferred securities                     |   |       |                                       |       | 20,831             | 4.92% | 20,831     | 4.92% |
|  | \$ 217,962                              | 2.48% | \$ 103,840                            | 2.80% | \$ 24,998          | 4.52% | \$ 346,800 | 2.72% |

|  | March 31, 2013<br>Weighted Average Life |       |                                       |       |                    |       |           |       |
|--|---|-------|---------------------------------------|-------|--------------------|-------|-----------|-------|
|  | After One<br>and Within<br>Five Years   |       | After Five<br>and Within<br>Ten Years |       | After<br>Ten Years |       | Total     |       |
|  | Amount                                  | Yield | Amount                                | Yield | Amount             | Yield | Amount    | Yield |
| (Dollars in thousands)                           |   |       |                                       |       |                    |       |           |       |
| Securities held-to-maturity (at amortized cost): |   |       |                                       |       |                    |       |           |       |
| Agency mortgage-backed securities                | \$ 12,307                               | 2.51% |                                       |       | \$ 2,878           | 2.81% | \$ 15,185 | 2.56% |
| Municipals Tax Exempt                            |   |       | 8,180                                 | 3.81% | 44,918             | 3.76% | 53,098    | 3.77% |
|  | \$ 12,307                               | 2.51% | \$ 8,180                              | 3.81% | \$ 47,796          | 3.71% | \$ 68,283 | 3.50% |

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 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 \$346.8 million at March 31, 2013, a decrease of 10% from \$385.8 million at March 31, 2012, and a decrease of 6% from \$367.9 million at December 31, 2012. At March 31, 2013, the investment securities available-for-sale portfolio was

Table of Contents

comprised of \$271.1 million of agency mortgage-backed securities (all issued by U.S. Government sponsored entities), \$54.9 million of corporate bonds, and \$20.8 million of single entity issue trust preferred securities.

The investment securities held-to-maturity portfolio, at amortized cost, totaled \$68.3 million at March 31, 2013, compared to no investment securities held-to-maturity at March 31, 2012, and \$51.5 million at December 31, 2012. At March 31, 2013, the investment securities held-to-maturity portfolio was comprised of \$53.1 million of tax-exempt municipal bonds, and \$15.2 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 Company transferred these securities to mitigate possible negative impacts on its regulatory capital under the proposed Basel III capital guidelines as the Company has the intent and ability to hold these securities to maturity. The related unrealized after-tax gains of \$489,000 at March 31, 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 58% of total assets at March 31, 2013 and March 31, 2012, and 48% of total assets at December 31, 2012. Gross loans, excluding loans held-for-sale, represented 59% and 57% of total assets, excluding the short-term deposits at the Federal Reserve Bank offsetting the short-term demand deposits from one customer at March 31, 2013 and December 31, 2012, respectively. The ratio of loans to deposits decreased to 68.75% at March 31, 2013 from 70.07% at March 31, 2012 and 54.91% at December 31, 2012. The loan to deposit ratio was 70.19% and 67.27%, excluding the short-term demand deposits from one customer at March 31, 2013 and December 31, 2012, respectively.

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

### Table of Contents

#### **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:

|   | March 31, 2013    |             | March 31, 2012    |             | December 31, 2012 |             |
|---|-------------------|-------------|-------------------|-------------|-------------------|-------------|
|   | Balance           | % of Total  | Balance           | % of Total  | Balance           | % of Total  |
| (Dollars in thousands)                          |                   |             |                   |             |                   |             |
| Commercial                                      | \$ 356,688        | 44%         | \$ 357,906        | 47%         | \$ 375,469        | 46%         |
| Real estate:                                    |                   |             |                   |             |                   |             |
| Commercial and residential                      | 361,340           | 45%         | 319,914           | 42%         | 354,934           | 44%         |
| Land and construction                           | 24,611            | 3%          | 18,583            | 3%          | 22,352            | 3%          |
| Home equity                                     | 45,347            | 6%          | 48,444            | 6%          | 43,865            | 5%          |
| Consumer  | 14,036            | 2%          | 11,810            | 2%          | 15,714            | 2%          |
| <b>Total loans</b>                              | <b>802,022</b>    | <b>100%</b> | <b>756,657</b>    | <b>100%</b> | <b>812,334</b>    | <b>100%</b> |
| Deferred loan (fees) costs, net                 | (97)              |             | 237               |             | (21)              |             |
| <b>Loans, including deferred fees and costs</b> | <b>801,925</b>    | <b>100%</b> | <b>756,894</b>    | <b>100%</b> | <b>812,313</b>    | <b>100%</b> |
| Allowance for loan losses                       | (19,342)          |             | (20,306)          |             | (19,027)          |             |
| <b>Loans, net</b>                               | <b>\$ 782,583</b> |             | <b>\$ 736,588</b> |             | <b>\$ 793,286</b> |             |

The decrease of \$18.8 million in the commercial loan portfolio from December 31, 2012 to March 31, 2013, was primarily due to a reduction in the utilization of lines of credit.

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, 54% of its gross loans were secured by real property at March 31, 2013, compared to 51% at March 31, 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 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



Table of Contents

servicing rights for the sold portion. During the first quarter of 2013, loans were sold resulting in a gain on sale of SBA loans of \$136,000.

As of March 31, 2013, commercial and residential real estate mortgage loans of \$361.3 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 March 31, 2013 consist of \$184.4 million, or 51%, of commercial owner occupied properties, \$173.9 million, or 48%, of commercial investment properties, and \$3.0 million, 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 \$6.0 million to \$24.6 million, at March 31, 2013, from \$18.6 million, at March 31, 2012, and increased \$2.2 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 \$27.9 million and \$46.4 million at March 31, 2013, respectively.

***Loan Maturities***

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale) as of March 31, 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 generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

Street Journal. As of March 31, 2013, approximately 63% of the Company's loan portfolio consisted of floating interest rate loans.

|                                    | Due in<br>One Year<br>or Less | Over One<br>Year But<br>Less than<br>Five Years | Over<br>Five Years | Total             |
|------------------------------------|-------------------------------|---|--------------------|-------------------|
| (Dollars in thousands)             |                               |   |                    |                   |
| Commercial                         | \$ 244,513                    | \$ 43,861                                       | \$ 68,314          | \$ 356,688        |
| Real estate:                       |                               |   |                    |                   |
| Commercial and residential         | 100,986                       | 164,816   | 95,538             | 361,340           |
| Land and construction              | 24,111                        | 500   |                    | 24,611            |
| Home equity                        | 42,340                        | 1,640   | 1,367              | 45,347            |
| Consumer                           | 13,259                        | 689   | 88                 | 14,036            |
| <b>Loans</b>                       | <b>\$ 425,209</b>             | <b>\$ 211,506</b>                               | <b>\$ 165,307</b>  | <b>\$ 802,022</b> |
| Loans with variable interest rates | \$ 375,860                    | \$ 56,360                                       | \$ 70,093          | \$ 502,313        |
| Loans with fixed interest rates    | 49,349                        | 155,146   | 95,214             | 299,709           |
| <b>Loans</b>                       | <b>\$ 425,209</b>             | <b>\$ 211,506</b>                               | <b>\$ 165,307</b>  | <b>\$ 802,022</b> |

**Loan Servicing**

As of March 31, 2013 and 2012, \$146.7 million and \$162.7 million, respectively, in SBA loans were serviced by the Company for others. Activity for loan servicing rights was as follows:

|                              | For the Three<br>Months Ended<br>March 31, |               |
|------------------------------|--|---------------|
|                              | 2013                                       | 2012          |
| (Dollars<br>in thousands)    |  |               |
| Beginning of period balance  | \$ 709                                     | \$ 792        |
| Additions                    | 29   | 10            |
| Amortization                 | (68)                                       | (72)          |
| <b>End of period balance</b> | <b>\$ 670</b>                              | <b>\$ 730</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 March 31, 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<br>Months Ended<br>March 31, |                 |
|--------------------------------|--|-----------------|
|                                | 2013                                       | 2012            |
| (Dollars<br>in thousands)      |  |                 |
| Beginning of period balance    | \$ 1,786                                   | \$ 2,094        |
| Unrealized holding gain (loss) | (9)  | 19              |
| <b>End of period balance</b>   | <b>\$ 1,777</b>                            | <b>\$ 2,113</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.

Table of Contents

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

|   | March 31,              |           | December 31, |
|---|------------------------|-----------|--------------|
|   | 2013                   | 2012      | 2012         |
|   | (Dollars in thousands) |           |              |
| Nonaccrual loans held-for-sale  | \$                     | \$ 184    | \$           |
| Nonaccrual loans held-for-investment  | 16,115                 | 14,005    | 17,335       |
| Restructured and loans over 90 days past due and still accruing   | 549                    | 2,155     | 859          |
| Total nonperforming loans   | 16,664                 | 16,344    | 18,194       |
| Foreclosed assets   | 738                    | 3,167     | 1,270        |
| Total nonperforming assets  | \$ 17,402              | \$ 19,511 | \$ 19,464    |
| Nonperforming assets as a percentage of loans plus other real estate owned plus nonaccrual loans held-for-sale plus foreclosed assets | 2.17%                  | 2.57%     | 2.39%        |
| Nonperforming assets as a percentage of total assets  | 1.26%                  | 1.49%     | 1.15%        |

Nonperforming assets were \$17.4 million, or 1.26% of total assets, at March 31, 2013, compared to \$19.5 million, or 1.49% of total assets at March 31, 2012, and \$19.5 million, or 1.15% of total assets at December 31, 2012. Nonperforming assets to total assets were 1.28% at March 31, 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 \$738,000 at March 31, 2013, compared to \$3.2 million at March 31, 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 collectibility 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 \$31.2 million at March 31, 2013, \$54.2 million at March 31, 2012, and \$36.8 million at December 31, 2012. Included in classified assets at March 31, 2012 were \$184,000 of loans held-for-sale. There were no loans held-for-sale included in classified assets at March 31, 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 March 31, 2013 |             |          |           |
|--|-----------------------------------|-------------|----------|-----------|
|  | Commercial                        | Real Estate | Consumer | Total     |
|  | (Dollars in thousands)            |             |          |           |
| Balance, beginning of period                     | \$ 12,866                         | \$ 6,034    | \$ 127   | \$ 19,027 |
| Charge-offs                                      | (840)                             |             |          | (840)     |
| Recoveries                                       | 1,150                             | 5           |          | 1,155     |
| Net recoveries                                   | 310                               | 5           |          | 315       |
| Provision (credit) for loan losses               | (721)                             | 731         | (10)     |           |
| Balance, end of period                           | \$ 12,455                         | \$ 6,770    | \$ 117   | \$ 19,342 |
| <b>RATIOS:</b>                                   |                                   |             |          |           |
| Net recoveries to average loans(1)               | 0.16%                             | 0.00%       | 0.00%    | 0.16%     |
| Allowance for loan losses to total loans(1)      | 1.55%                             | 0.84%       | 0.02%    | 2.41%     |
| Allowance for loan losses to nonperforming loans | 74.74%                            | 40.63%      | 0.70%    | 116.07%   |

Table of Contents

| <b>Three Months Ended March 31, 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                                      | (910)             | (45)               |                 | (955)        |
| Recoveries                                       | 461               |                    |                 | 461          |
| Net charge-offs                                  | (449)             | (45)               |                 | (494)        |
| Provision (credit) for loan losses               | 968               | (884)              | 16              | 100          |
| Balance, end of period                           | \$ 13,734         | \$ 6,409           | \$ 163          | \$ 20,306    |
| <b>RATIOS:</b>                                   |                   |                    |                 |              |
| Net charge-offs to average loans(1)              | 0.24%             | 0.02%              | 0.00%           | 0.26%        |
| Allowance for loan losses to total loans(1)      | 1.81%             | 0.85%              | 0.02%           | 2.68%        |
| Allowance for loan losses to nonperforming loans | 84.03%            | 39.21%             | 1.00%           | 124.24%      |

(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 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**

|                               | <b>March 31,</b> |   |                  |   |                          |   |
|-------------------------------|------------------|---|------------------|---|--------------------------|---|
|                               | <b>2013</b>      |   | <b>2012</b>      |   | <b>December 31, 2012</b> |   |
|                               | <b>Allowance</b> | <b>Percent of Loans in each category to total loans</b> | <b>Allowance</b> | <b>Percent of Loans in each category to total loans</b> | <b>Allowance</b>         | <b>Percent of Loans in each category to total loans</b> |
| <b>(Dollars in thousands)</b> |                  |   |                  |   |                          |   |
| Commercial                    | \$ 12,455        | 44%   | \$ 13,734        | 47%   | \$ 12,866                | 46%   |
| Real estate:                  |                  |   |                  |   |                          |   |
| Commercial and residential    | 5,394            | 45%   | 5,449            | 42%   | 4,609                    | 44%   |
| Land and construction         | 273              | 3%  | 431              | 3%  | 399                      | 3%  |
| Home equity                   | 1,103            | 6%  | 529              | 6%  | 1,026                    | 5%  |
| Consumer                      | 117              | 2%  | 163              | 2%  | 127                      | 2%  |
| <b>Total</b>                  | <b>\$ 19,342</b> | <b>100%</b>   | <b>\$ 20,306</b> | <b>100%</b>   | <b>\$ 19,027</b>         | <b>100%</b>   |

The allowance for loan losses totaled \$19.3 million, or 2.41% of total loans at March 31, 2013, compared to \$20.3 million, or 2.68% of total loans at March 31, 2012, \$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 \$315,000, or 0.16% of average loans, for the first quarter of 2013, compared to net charge-offs of \$494,000, or 0.26% of average loans, for the first 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 \$411,000 during the three months ended March 31, 2013 from December 31, 2012, as a result of a credit to the provision for loan losses of \$721,000 and net recoveries of \$310,000. 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.





Table of Contents

The allowance for loan losses related to the real estate portfolio increased \$736,000 during the three months ended March 31, 2013 from December 31, 2012, as a result of a provision for loan losses of \$731,000 and net recoveries of \$5,000. 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.

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

|                                      | March 31, 2013 |            | March 31, 2012 |            | December 31, 2012 |            |
|--------------------------------------|----------------|------------|----------------|------------|-------------------|------------|
|                                      | Balance        | % to Total | Balance        | % to Total | Balance           | % to Total |
| (Dollars in thousands)               |                |            |                |            |                   |            |
| Demand, noninterest-bearing          | \$ 397,198     | 34%        | \$ 356,618     | 33%        | \$ 727,684        | 49%        |
| Demand, interest-bearing             | 169,681        | 15%        | 144,022        | 13%        | 155,951           | 10%        |
| Savings and money market             | 286,784        | 25%        | 292,009        | 27%        | 272,047           | 18%        |
| Time deposits under \$100            | 23,835         | 2%         | 27,949         | 2%         | 25,157            | 2%         |
| Time deposits \$100 and over         | 189,779        | 16%        | 168,726        | 16%        | 190,502           | 13%        |
| Time deposits brokered               | 83,763         | 7%         | 84,728         | 8%         | 97,807            | 7%         |
| CDARS money market and time deposits | 15,850         | 1%         | 6,198          | 1%         | 10,220            | 1%         |
| Total deposits                       | \$ 1,166,890   | 100%       | \$ 1,080,250   | 100%       | \$ 1,479,368      | 100%       |

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 8% of deposits at March 31, 2013, 5% at March 31, 2012, and 6% at December 31, 2012 were from public sources.

Deposits totaled \$1.17 billion at March 31, 2013, compared to \$1.08 billion at March 31, 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 \$24.3 million at March 31, 2013. Total deposits, excluding brokered deposits and short-term demand deposits from one customer of \$24.3 million at March 31, 2013 and \$271.9 million at December 31, 2012, were \$1.06 billion at March 31, 2013, compared to \$995.5 million at March 31, 2012, and \$1.11 billion at December 31, 2012.

Noninterest-bearing demand deposits (excluding the short-term demand deposits from one customer) increased \$16.3 million, or 5%, to \$372.9 million at March 31, 2013, from \$356.6 million at March 31, 2012, and decreased \$82.9 million, or 18%, from \$455.8 million at December 31, 2012. At

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

### Table of Contents

March 31, 2013, the Company had \$99.0 million (at fair value) of securities pledged for \$85.0 million in certificates of deposits from the State of California. At March 31, 2012, the Company had \$56.5 million (at fair value) of securities pledged for \$50.0 million in certificates of deposits with 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 March 31, 2013, brokered deposits decreased \$965,000, or 1%, to \$83.8 million, compared to \$84.7 million at March 31, 2012, and decreased \$14.0 million, or 14%, from \$97.8 million at December 31, 2012.

CDARS deposits were comprised of \$10.8 million of money market accounts and \$5.1 million of time deposits at March 31, 2013. All of the \$6.2 million of CDARS deposits at March 31, 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.

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 March 31, 2013:

|                                       | Balance                | % of Total  |
|---------------------------------------|------------------------|-------------|
|                                       | (Dollars in thousands) |             |
| Three months or less                  | \$ 79,933              | 29%         |
| Over three months through six months  | 98,121                 | 35%         |
| Over six months through twelve months | 49,443                 | 18%         |
| Over twelve months                    | 51,144                 | 18%         |
| <b>Total</b>                          | <b>\$ 278,641</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<br>March 31, |        |
|--|---------------------------------|--------|
|  | 2013                            | 2012   |
| Annualized return on average assets          | 0.61%                           | 0.64%  |
| Annualized return on average tangible assets | 0.61%                           | 0.64%  |
| Annualized return on average equity          | 5.20%                           | 4.43%  |
| Annualized return on average tangible equity | 5.26%                           | 4.48%  |
| Average equity to average assets ratio       | 11.77%                          | 14.37% |

### ***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 \$333.7 million at March 31, 2013, as compared to \$294.2 million at March 31, 2012 and \$308.9 million at December 31, 2012. Unused commitments represented 42%,

Table of Contents

39%, and 38% of outstanding gross loans at March 31, 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 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:

|  | March 31,              |               |            |               |                   |               |
|--|------------------------|---------------|------------|---------------|-------------------|---------------|
|  | 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 | \$ 7,635               | \$ 315,869    | \$ 14,267  | \$ 269,839    | \$ 8,410          | \$ 291,191    |
| Standby letters of credit                            | 2,775                  | 7,424         | 2,291      | 7,852         | 2,200             | 7,051         |
|  | \$ 10,410              | \$ 323,293    | \$ 16,558  | \$ 277,691    | \$ 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 68.72% at March 31, 2013, compared to 70.07% at March 31, 2012, and 54.91% at December 31, 2012. The loan to deposit ratio was 70.19% at March 31, 2013 and 67.27% at December 31, 2012, excluding the \$24.3 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 March 31, 2013, March 31, 2012 and December 31, 2012. The Company had \$225.7 million of loans pledged to the FHLB as collateral on an available line of credit of \$112.6 million at March 31, 2013.

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

### Table of Contents

The Company can also borrow from FRB's discount window. The Company had \$221.1 million of loans pledged to the FRB as collateral on an available line of credit of \$161.3 million at March 31, 2013, none of which was outstanding.

At March 31, 2013, the Company had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at March 31, 2013, March 31, 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 March 31, 2013, March 31, 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:

|  | March 31,              |      | December 31, |
|--|------------------------|------|--------------|
|  | 2013                   | 2012 | 2012         |
|  | (Dollars in thousands) |      |              |
| Average balance year-to-date                 | \$                     | \$   | \$           |
| Average interest rate year-to-date           | N/A                    | N/A  | N/A          |
| Maximum month-end balance during the quarter | \$                     | \$   | \$           |
| 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.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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

|                                     | March 31,    |              | December 31, |        |   |  |
|-------------------------------------|--------------|--------------|--------------|--------|---|--|
|                                     | 2013         | 2012         | 2012         | 2012   |   |  |
| (Dollars in thousands)              |              |              |              |        |   |  |
| <b>Capital components:</b>          |              |              |              |        |   |  |
| Tier 1 Capital                      | \$ 163,200   | \$ 162,701   | \$ 157,947   |        |   |  |
| Tier 2 Capital                      | 13,248       | 12,334       | 13,254       |        |   |  |
| Total risk-based capital            | \$ 176,448   | \$ 175,035   | \$ 171,201   |        |   |  |
| Risk-weighted assets                | \$ 1,053,602 | \$ 978,513   | \$ 1,054,394 |        |   |  |
| Average assets for capital purposes | \$ 1,418,020 | \$ 1,283,316 | \$ 1,378,011 |        |   |  |
|                                     |              |              |              |        | <b>Well-Capitalized<br/>Regulatory<br/>Requirements</b> | <b>Minimum<br/>Regulatory<br/>Requirements</b> |
| <b>Capital ratios:</b>              |              |              |              |        |   |  |
| Total risk-based capital            | 16.7%        | 17.9%        | 16.2%        | 10.00% |   | 8.00%  |
| Tier 1 risk-based capital           | 15.5%        | 16.6%        | 15.0%        | 6.00%  |   | 4.00%  |
| Leverage(1)                         | 11.5%        | 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:

|                                     | March 31,    |              | December 31, |        |   |  |
|-------------------------------------|--------------|--------------|--------------|--------|---|--|
|                                     | 2013         | 2012         | 2012         | 2012   |   |  |
| (Dollars in thousands)              |              |              |              |        |   |  |
| <b>Capital components:</b>          |              |              |              |        |   |  |
| Tier 1 Capital                      | \$ 154,302   | \$ 153,285   | \$ 147,742   |        |   |  |
| Tier 2 Capital                      | 13,275       | 12,361       | 13,262       |        |   |  |
| Total risk-based capital            | \$ 167,577   | \$ 165,646   | \$ 161,004   |        |   |  |
| Risk-weighted assets                | \$ 1,055,799 | \$ 980,708   | \$ 1,055,061 |        |   |  |
| Average assets for capital purposes | \$ 1,419,570 | \$ 1,285,488 | \$ 1,378,238 |        |   |  |
|                                     |              |              |              |        | <b>Well-Capitalized<br/>Regulatory<br/>Requirements</b> | <b>Minimum<br/>Regulatory<br/>Requirements</b> |
| <b>Capital ratios:</b>              |              |              |              |        |   |  |
| Total risk-based capital            | 15.9%        | 16.9%        | 15.3%        | 10.00% |   | 8.00%  |
| Tier 1 risk-based capital           | 14.6%        | 15.6%        | 14.0%        | 6.00%  |   | 4.00%  |
| Leverage(1)                         | 10.9%        | 11.9%        | 10.7%        | 5.00%  |   | 4.00%  |

(1)

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

Table of Contents

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 March 31, 2013 decreased to 16.7%, 15.5%, and 11.5%, compared to 17.9%, 16.6%, and 12.7% at March 31, 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 March 31, 2013 decreased to 15.9%, 14.6%, and 10.9%, compared to 16.9%, 15.6%, and 11.9% at March 31, 2012, respectively. HBC's total risk-based 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 March 31, 2013, the Company's and HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under prompt corrective action provisions.

At March 31, 2013, the Company had total shareholders' equity of \$170.8 million, including \$19.5 million in preferred stock, \$132.0 million in common stock, \$17.9 million in retained earnings, and \$1.4 million of accumulated other comprehensive income. The components of other comprehensive income, net of taxes, at March 31, 2013 include the following: an unrealized gain on available-for-sale securities of \$6.1 million; a liability adjustment on the supplemental executive retirement plan of (\$2.3) million; a liability adjustment on the split dollar insurance contracts of (\$3.4) 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; however, under proposed rules implementing Basel III trust preferred securities would lose eligibility for Tier 1 capital over a ten year period.

Table of Contents

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.

***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. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report.

***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.

**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



Table of Contents

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) 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 March 31, 2013. Computations of prospective effects of hypothetical interest rate changes are based on

Table of Contents

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)<br/>in Estimated Net<br/>Interest Income</b> |                |
|--|---|----------------|
|  | <b>Amount</b>   | <b>Percent</b> |
|  | <b>(Dollars in thousands)</b>                                       |                |
| <b>Change in Interest Rates (basis points)</b> |   |                |
| +400   | \$ 12,104   | 25.9%          |
| +300   | \$ 9,308  | 19.9%          |
| +200   | \$ 6,201  | 13.3%          |
| +100   | \$ 2,880  | 6.2%           |
| 0  | \$  | 0.0%           |
| -100   | \$ (4,275)  | -9.2%          |
| -200   | \$ (7,495)  | -16.0%         |

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 effectiveness of the design and operation of the Company's disclosure controls and procedures as of March 31, 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

Table of Contents

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 March 31, 2013, the period covered by this report on Form 10-Q.

During the three months ended March 31, 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 Registration Statement Form S-1 filed on July 23, 2010)   |
| 4.1            | Warrant to Purchase Common Stock dated November 21, 2008 (incorporated by reference to Exhibit 4.2 to the Registrant's Form 8-K filed on November 26, 2008)  |
| 4.2            | 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: May 8, 2013

Heritage Commerce Corp (Registrant)

/s/ WALTER T. KACZMAREK

---

Walter T. Kaczmarek  
*Chief Executive Officer*

Date: May 8, 2013

/s/ LAWRENCE D. MCGOVERN

---

Lawrence D. McGovern  
*Chief Financial Officer*

69

---

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 Registration Statement Form S-1 filed on July 23, 2010)   |
| 4.1            | Warrant to Purchase Common Stock dated November 21, 2008 (incorporated by reference to Exhibit 4.2 to the Registrant's Form 8-K filed on November 26, 2008)  |
| 4.2            | 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   |