

HERITAGE COMMERCE CORP  
Form 10-K  
March 07, 2016

Use these links to rapidly review the document

[TABLE OF CONTENTS1](#)

[TABLE OF CONTENTS2](#)

[Table of Contents](#)

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

---

**FORM 10-K**

---

(MARK ONE)

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

or the fiscal year ended December 31, 2015

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 Number)*

**150 Almaden Boulevard  
San Jose, California 95113**  
*(Address of Principal Executive Offices including Zip Code)*

**(408) 947-6900**  
*(Registrant's Telephone Number, Including Area Code)*  
**Securities registered pursuant to Section 12(b) of the Act:**

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

Title of Each Class	Name of Each Exchange on which Registered
Common Stock, no par value	The NASDAQ Stock Market LLC (NASDAQ Global Select Market)

**Securities registered pursuant to Section 12(g) of the Act: None**

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "small reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer <input type="radio"/>	Accelerated filer <input checked="" type="radio"/>	Non-accelerated filer <input type="radio"/>	Smaller reporting company <input type="radio"/>
		(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 Act). Yes  No

The aggregate market value of the common stock held by non-affiliates of the Registrant as of June 30, 2015, based upon the closing price on that date of \$9.61 per share as reported on the NASDAQ Global Select Market, and 15,578,339 shares held, was approximately \$149.7 million.

As of February 29, 2016, there were 32,121,885 shares of the Registrant's common stock (no par value) outstanding.

## DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A in connection with the 2016 Annual Meeting of Shareholders to be held on May 26, 2016 are incorporated by reference into Part III of this Report. The proxy statement will be filed with the Securities and Exchange Commission not later than 120 days after the Registrant's fiscal year ended December 31, 2015.

Table of Contents

**HERITAGE COMMERCE CORP**  
**INDEX TO ANNUAL REPORT ON FORM 10-K**  
**FOR YEAR ENDED DECEMBER 31, 2015**

		<b>Page</b>
<b><u>PART I.</u></b>		
<u>Item 1.</u>	<u>Business</u>	
<u>Item 1A.</u>	<u>Risk Factors</u>	3
<u>Item 1B.</u>	<u>Unresolved Staff Comments</u>	25
<u>Item 2.</u>	<u>Properties</u>	44
<u>Item 3.</u>	<u>Legal Proceedings</u>	44
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>	46
<b><u>PART II.</u></b>		
<u>Item 5.</u>	<u>Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	46
<u>Item 6.</u>	<u>Selected Financial Data</u>	47
<u>Item 7.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	50
<u>Item 7A.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	51
<u>Item 8.</u>	<u>Financial Statements and Supplementary Data</u>	88
<u>Item 9.</u>	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosures</u>	89
<u>Item 9A.</u>	<u>Controls and Procedures</u>	89
<u>Item 9B.</u>	<u>Other Information</u>	90
<b><u>PART III.</u></b>		
<u>Item 10.</u>	<u>Directors, Executive Officers and Corporate Governance</u>	90
<u>Item 11.</u>	<u>Executive Compensation</u>	91
<u>Item 12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	91
<u>Item 13.</u>	<u>Certain Relationships and Related Transactions and Director Independence</u>	91
<u>Item 14.</u>	<u>Principal Accountant Fees and Services</u>	91
<b><u>PART IV.</u></b>		
<u>Item 15.</u>	<u>Exhibits and Financial Statement Schedules</u>	91
	<u>Signatures</u>	92
	<u>Financial Statements</u>	94
	<u>Exhibit Index</u>	159

Table of Contents

**Cautionary Note Regarding Forward-Looking Statements**

This Report on Form 10-K contains various statements that may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended, Rule 3b-6 promulgated thereunder 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:

local, regional, and national economic conditions and events and their impact on us and our customers;

changes in the financial performance or condition of the Company's customers;

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

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

our ability to increase market share and control expenses;

our ability to develop and promote customer acceptance of new products and services in a timely manner;

risks associated with concentrations in real estate related loans;

other than temporary impairment charges to our securities portfolio;

an oversupply of inventory and deterioration in values of California commercial real estate;

a prolonged slowdown in construction activity;

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;

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

changes in inflation, interest rates, and market liquidity which may impact interest margins and impact funding sources;

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;

changes in our capital management policies, including those regarding business combinations, dividends, and share repurchases, among others;

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

## Table of Contents

operational issues stemming from, and/or capital spending necessitated by, the potential need to adapt to industry changes in information technology systems, on which we are highly dependent;

the ability to keep pace with, and implement on a timely basis, technological changes;

the impact of cyber security attacks or other disruptions to the Company's information systems and any resulting compromise of data or disruptions in service;

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

the effect and uncertain impact on the Company of the enactment of the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 and the rules and regulations promulgated by supervisory and oversight agencies implementing the new legislation;

significant changes in applicable laws and regulations, including those concerning taxes, banking and securities;

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 successful integration of the business, employees and operations of Focus Business Bank with the Company and our ability to achieve the projected synergies of this acquisition within expected time frame; and

our success in managing the risks involved in the foregoing factors.

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-K. 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.

## **PART I**

### **ITEM 1 BUSINESS**

#### **General**

Heritage Commerce Corp, a California corporation organized in 1997, is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. We provide a wide range of banking services through Heritage Bank of Commerce, our wholly-owned subsidiary. Heritage Bank of Commerce is a California state-chartered bank headquartered in San Jose, California and has been conducting business since 1994.

Heritage Bank of Commerce is a multi-community independent bank that offers a full range of commercial banking services to small and medium-sized businesses and their owners, managers and employees. We operate through 11 full service branch offices located entirely in the

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

southern and eastern regions of the general San Francisco Bay Area of California in the counties of Santa Clara, Alameda, Contra Costa, and San Benito. Our market includes the headquarters of a number of technology based companies in the region commonly known as "Silicon Valley."

Our lending activities are diversified and include commercial, real estate, construction and land development, consumer and Small Business Administration ("SBA") guaranteed loans. We generally lend

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

### Table of Contents

in markets where we have a physical presence through our branch offices. We attract deposits throughout our market area with a customer-oriented product mix, competitive pricing, and convenient locations. We offer a wide range of deposit products for business banking and retail markets. We offer a multitude of other products and services to complement our lending and deposit services. In addition, Bay View Funding provides factoring financing throughout the United States.

As a bank holding company, Heritage Commerce Corp is subject to the supervision of the Board of Governors of the Federal Reserve System (the "Federal Reserve"). We are required to file with the Federal Reserve reports and other information regarding our business operations and the business operations of our subsidiaries. As a California chartered bank, Heritage Bank of Commerce is subject to primary supervision, periodic examination, and regulation by the Department of Business Oversight Division of Financial Institutions ("DBO"), and by the Federal Reserve, as its primary federal regulator.

### **Recent Acquisitions**

We have grown over the past five years through the acquisitions discussed below, as well as through organic growth.

#### ***Focus Business Bank***

On August 20, 2015, we completed the acquisition of Focus Business Bank ("Focus Bank") for an aggregate transaction value of \$66.6 million. We acquired from Focus Bank total assets, at fair value, of approximately \$438.8 million, loans (including loans held-for-sale) of \$174.8 million, at fair value, and deposits of \$405.1 million, at fair value, and one branch in San Jose, California. We issued approximately 5,456,713 shares of our common stock to Focus Bank shareholders, at an exchange ratio of 1.8235 shares of Heritage Commerce Corp common stock per Focus Bank share.

#### ***Bay View Funding***

On November 1, 2014, Heritage Bank of Commerce acquired CSNK Working Capital Finance Corp, d/b/a "Bay View Funding" ("Bay View Funding") for approximately \$22.5 million. Bay View Funding provides business essential working capital factoring financing to various industries throughout the United States.

Our principal executive office is located at 150 Almaden Boulevard, San Jose, California 95113, telephone number: (408) 947-6900.

At December 31, 2015, we had consolidated assets of \$2.36 billion, deposits of \$2.06 billion and shareholders' equity of \$245.4 million.

When we use "we", "us", "our" or the "Company", we mean the Company on a consolidated basis with Heritage Bank of Commerce. When we refer to "HCC" or the "holding company", we are referring to Heritage Commerce Corp on a standalone basis. When we use "HBC", we mean Heritage Bank of Commerce on a standalone basis.

The Internet address of the Company's website is "<http://www.heritagecommercecorp.com>." The Company makes available free of charge through the Company's website, the Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports. The Company makes these reports available on its website on the same day they appear on the Securities and Exchange Commission's ("SEC") website.



Table of Contents

**Heritage Bank of Commerce**

Heritage Bank of Commerce ("HBC") is a California state-chartered bank headquartered in San Jose, California. It was incorporated in November 1993 and opened for business in January 1994. HBC operates through eleven full service branch offices. The locations of HBC's current offices are:

San Jose:	Administrative Office Main Branch 150 Almaden Boulevard San Jose, CA 95113	Los Gatos:	Branch Office 15575 Los Gatos Boulevard Suite B Los Gatos, CA 95032
Danville:	Branch Office 387 Diablo Road Danville, CA 94526	Morgan Hill:	Branch Office 18625 Sutter Boulevard Suite 100 Morgan Hill, CA 95037
Fremont:	Branch Office 3137 Stevenson Boulevard Fremont, CA 94538	Pleasanton:	Branch Office 300 Main Street Pleasanton, CA 94566
Gilroy:	Branch Office 7598 Monterey Street Suite 110 Gilroy, CA 95020	Sunnyvale:	Branch Office 333 W. El Camino Real Suite 150 Sunnyvale, CA 94087
Hollister:	Branch Office 351 Tres Pinos Road Suite 102A Hollister, CA 95023	Walnut Creek:	Branch Office 101 Ygnacio Valley Road Suite 100 Walnut Creek, CA 94596
Los Altos:	Branch Office 419 South San Antonio Road Los Altos, CA 94022		

***Bay View Funding***

Bay View Funding provides business-essential working capital factoring financing to various industries throughout the United States. Bay View Funding's administrative offices are located at 2933 Bunker Hill Lane, Santa Clara, CA 95054.

***Lending Activities***

Our commercial loan portfolio is comprised of operating secured and unsecured loans advanced for working capital, equipment purchases and other business purposes. Generally short-term loans have maturities ranging from thirty days to one year, and "term loans" have maturities 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 generally provide for floating or fixed interest rates, with monthly payments of both principal and interest. Repayment of secured and unsecured commercial loans depends substantially on the borrower's underlying business, financial condition and cash flows, as well as the sufficiency of the collateral. Compared to real estate, the collateral may be more difficult to monitor, evaluate and sell. It may also depreciate more rapidly than real estate. Such risks can be significantly affected by economic conditions. HBC's commercial loans, except for the factored receivables at Bay View Funding, are primarily originated for locally-oriented commercial activities in communities where HBC has a physical presence through its branch offices.

Table of Contents

HBC actively engages in SBA lending. HBC has been designated as an SBA Preferred Lender since 1999.

Our factoring receivables portfolio is originated by Bay View Funding. Factored receivables are receivables that have been transferred by the originating organization and typically have not been subject to previous collection efforts. These receivables are acquired from a variety of companies, including but not limited to service providers, transportation companies, manufacturers, distributors, wholesalers, apparel companies, advertisers, and temporary staffing companies.

The commercial real estate loan portfolio is comprised of loans secured by commercial real estate. These loans are generally advanced based on the borrower's cash flow, and the underlying collateral provides a secondary source of payment. HBC generally restricts real estate term loans to no more than 75% of the property's appraised value or the purchase price of the property, depending on the type of property and its utilization. HBC offers both fixed and floating rate loans. Maturities on such loans are generally restricted to between five and ten years (with amortization ranging from fifteen to twenty-five years and a balloon payment due at maturity, and amortization of thirty years on loans secured by apartments); however, SBA and certain real estate loans that can be sold in the secondary market may be advanced for longer maturities. Commercial real estate loans typically involve large balances to single borrowers or groups of related borrowers. Since payments on these loans are often dependent on the successful operation or management of the properties, as well as the business and financial condition of the borrower, repayment of such loans may be subject to adverse conditions in the real estate market, adverse economic conditions or changes in applicable government regulations. If the cash flow from the project decreases, or if leases are not obtained or renewed, the borrower's ability to repay the loan may be impaired.

We make commercial construction loans for rental properties, commercial buildings and homes built by developers on speculative, undeveloped property. We also make construction loans for homes built by owner occupants. The terms of commercial construction loans are made in accordance with our loan policy. Advances on construction loans are made in accordance with a schedule reflecting the cost of construction, but are generally limited to a 75% loan-to-completed-appraised-value ratio. Repayment of construction loans on non-residential properties is normally expected from the property's eventual rental income, income from the borrower's operating entity or the sale of the subject property. In the case of income-producing property, repayment is usually expected from permanent financing upon completion of construction. At times we provide the permanent mortgage financing on our construction loans on income-producing property. Construction loans are interest-only loans during the construction period, which typically do not exceed 18 months. If HBC provides permanent financing the short-term loan converts to permanent, amortizing financing following the completion of construction. Generally, before making a commitment to fund a construction loan, we require an appraisal of the property by a state-certified or state-licensed appraiser. We review and inspect properties before disbursement of funds during the term of the construction loan. The repayment of construction loans is dependent upon the successful and timely completion of the construction of the subject property, as well as the sale of the property to third parties or the availability of permanent financing upon completion of all improvements. Construction loans expose us to the risk that improvements will not be completed on time, and in accordance with specifications and projected costs. Construction delays, the financial impairment of the builder, interest rate increases or economic downturn may further impair the borrower's ability to repay the loan. In addition, the borrower may not be able to obtain permanent financing or ultimate sale or rental of the property may not occur as anticipated. HBC utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or permanent mortgage financing prior to making the construction loan.

Our home equity line portfolio is comprised of home equity lines of credit to customers in our markets. Home equity lines of credit are underwritten in a manner such that they result in credit risk that is substantially similar to that of residential mortgage loans. Nevertheless, home equity lines of credit have greater credit risk than residential mortgage loans because they are often secured by mortgages that are

Table of Contents

subordinated to the existing first mortgage on the property, which we may or may not hold, and they are not covered by private mortgage insurance coverage.

The consumer loan portfolio is composed of miscellaneous consumer loans including loans for financing automobiles, various consumer goods and other personal purposes. Consumer loans are generally secured. Repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan, and the remaining deficiency may not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections are dependent on the borrower's continued financial stability, which can be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

As of December 31, 2015, the percentage of our total loans for each of the principal areas in which we directed our lending activities were as follows: (i) commercial and industrial 41% (including SBA loans and factored receivables); (ii) real estate secured loans 46%; (iii) land and construction loans 6%; and (iv) consumer (including home equity) 7%. While no specific industry concentration is considered significant, our lending operations are located in market areas dependent on technology and real estate industries and their supporting companies.

***Investments***

Our investment policy is established by the Board of Directors. The general investment strategies are developed and authorized by our Finance and Investment Committee of the Board of Directors. The investment policy is reviewed annually by the Finance and Investment Committee, and any changes to the policy are subject to approval by the full Board of Directors. The overall objectives of the investment policy are to maintain a portfolio of high quality and diversified investments to maximize interest income over the long term and to minimize risk, to provide collateral for borrowings, and to provide additional earnings when loan production is low. The policy dictates that investment decisions take into consideration the safety of principal, liquidity requirements and interest rate risk management. All securities transactions are reported to the Board of Directors' Finance and Investment Committee on a monthly basis.

***Sources of Funds***

Deposits traditionally have been our primary source of funds for our investment and lending activities. We also are able to borrow from the Federal Home Loan Bank of San Francisco and the Federal Reserve Bank of San Francisco to supplement cash flow needs. Our additional sources of funds are scheduled loan payments, maturing investments, loan repayments, income on other earning assets, and the proceeds of loan sales and securities sales.

Interest rates, maturity terms, service fees and withdrawal penalties are established on a periodic basis. Deposit rates and terms are based primarily on current operating strategies and market interest rates, liquidity requirements and our deposit growth goals.

We offer a wide range of deposit products for retail and business banking markets including checking accounts, interest-bearing transaction accounts, savings accounts, time deposits and retirement accounts. Our branch network enables us to attract deposits from throughout our market area with a customer-oriented product mix, competitive pricing, and convenient locations. HBC joined the Certificate of Deposit Account Registry Service (CDARS®) program in August 2008, which enables our local customers to obtain expanded FDIC insurance coverage on their deposits.

***Other Banking Services***

We offer a multitude of other products and services to complement our lending and deposit services. These include cashier's checks, traveler's checks, bank-by-mail, ATMs, night depositories, safe deposit

Table of Contents

boxes, direct deposit, automated payroll services, electronic funds transfers, online banking, online bill pay, homeowner association services, and other customary banking services. HBC currently operates ATMs at five different locations. In addition, we have established a convenient customer service group accessible by toll-free telephone to answer questions and promote a high level of customer service. HBC does not have a trust department. In addition to the traditional financial services offered, HBC offers remote deposit capture, automated clearing house origination, electronic data interchange and check imaging. HBC continues to investigate products and services that it believes addresses the growing needs of its customers and to analyze other markets for potential expansion opportunities.

**Correspondent Banks**

Correspondent bank deposit accounts are maintained to enable the Company to transact types of activity that it would otherwise be unable to perform or would not be cost effective due to the size of the Company or volume of activity. The Company has utilized several correspondent banks to process a variety of transactions.

**Competition**

The banking and financial services business in California generally, and in the Company's market areas specifically, is highly competitive. The industry continues to consolidate and unregulated competitors have entered banking markets with products targeted at highly profitable customer segments. Many larger unregulated competitors are able to compete across geographic boundaries, and provide customers with meaningful alternatives to most significant banking services and products. These consolidation trends are likely to continue. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the consolidation among financial service providers.

With respect to commercial bank competitors, the business is dominated by a relatively small number of major banks that operate a large number of offices within our geographic footprint. For the combined Santa Clara, Alameda and Contra Costa county region, the three counties within which the Company operates, the top three institutions are all multi-billion dollar entities with an aggregate of 268 offices that control a combined 56.54% of deposit market share based on June 30, 2015 FDIC market share data. HBC ranks sixteenth with 0.76% share of total deposits based on June 30, 2015 market share data. These banks have, among other advantages, the ability to finance wide-ranging advertising campaigns and to allocate their resources to regions of highest yield and demand. Larger banks are seeking to expand lending to small businesses, which are traditionally community bank customers. They can also offer certain services that we do not offer directly, but may offer indirectly through correspondent institutions. By virtue of their greater total capitalization, these banks also have substantially higher lending limits than we do. For customers whose needs exceed our legal lending limit, we arrange for the sale, or "participation," of some of the balances to financial institutions that are not within our geographic footprint.

In addition to other large regional banks and local community banks, our competitors include savings institutions, securities and brokerage companies, asset management groups, mortgage banking companies, credit unions, finance and insurance companies, internet-based companies, and money market funds. In recent years, we have also witnessed increased competition from specialized companies that offer wholesale finance, credit card, and other consumer finance services, as well as services that circumvent the banking system by facilitating payments via the internet, wireless devices, prepaid cards, or other means. Technological innovations have lowered traditional barriers of entry and enabled many of these companies to compete in financial services markets. Such innovation has, for example, made it possible for non-depository institutions to offer customers automated transfer payment services that previously were considered traditional banking products. In addition, many customers now expect a choice of delivery channels, including telephone and smart phones, mail, personal computer, ATMs, self-service branches, and/or in-store branches.

Table of Contents

Strong competition for deposits and loans among financial institutions and non-banks alike affects interest rates and other terms on which financial products are offered to customers. Mergers between financial institutions have placed additional pressure on other banks within the industry to remain competitive by streamlining operations, reducing expenses, and increasing revenues. Competition has also intensified due to Federal and state interstate banking laws enacted in the mid-1990's, which permit banking organizations to expand into other states. The relatively large and expanding California market has been particularly attractive to out of state institutions. The Gramm-Leach-Bliley Act of 1999 has made it possible for full affiliations to occur between banks and securities firms, insurance companies, and other financial companies, and has also intensified competitive conditions.

In order to compete with the other financial service providers, the Company principally relies upon community-oriented, personalized service, local promotional activities, personal relationships established by officers, directors, and employees with its customers, and specialized services tailored to meet its customers' needs. Our "preferred lender" status with the Small Business Administration allows us to approve SBA loans faster than many of our competitors. In those instances where the Company is unable to accommodate a customer's needs, the Company seeks to arrange for such loans on a participation basis with other financial institutions or to have those services provided in whole or in part by its correspondent banks. See Item 1 "*Business Correspondent Banks.*"

**Economic Conditions, Government Policies, Legislation, and Regulation**

The Company's profitability, like most financial institutions, is primarily dependent on interest rate differentials. In general, the difference between the interest rates paid by HBC on interest-bearing liabilities, such as deposits and other borrowings, and the interest rates received by HBC on interest earning assets, such as loans extended to customers and securities held in the investment portfolio, will comprise the major portion of the Company's earnings. These rates are highly sensitive to many factors that are beyond the control of the Company and HBC, such as inflation, recession and unemployment, and the impact which future changes in domestic and foreign economic conditions might have on the Company cannot be predicted.

The Company's business is also influenced by the monetary and fiscal policies of the federal government and the policies of regulatory agencies, particularly the Board of Governors of the Federal Reserve Board. The Federal Reserve implements national monetary policies (with objectives such as curbing inflation and combating recession) through its open-market operations in U.S. Government securities by adjusting the required level of reserves for depository institutions subject to its reserve requirements, and by varying the target Federal funds and discount rates applicable to borrowings by depository institutions. The actions of the Federal Reserve in these areas influence the growth of bank loans, investments, and deposits and also affect interest earned on interest earning assets and paid on interest bearing liabilities. The nature and impact of any future changes in monetary and fiscal policies on the Company cannot be predicted.

From time to time, federal and state legislation is enacted which may have the effect of materially increasing the cost of doing business, limiting or expanding permissible activities, or affecting the competitive balance between banks and other financial services providers.

In addition, the various bank regulatory agencies often adopt new rules and regulations and policies to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations or changes in policy may be enacted or the extent to which the business of the Company would be affected thereby.

The Company cannot predict whether or when potential legislation will be enacted and, if enacted, the effect that it, or any implemented regulations and supervisory policies, would have on our financial condition or results of operations. In addition, the outcome of any examination, litigation or investigation

Table of Contents

initiated by state or federal authorities may result in necessary changes in our operations and increased compliance costs.

***The Dodd-Frank Wall Street Reform and Consumer Protection Act***

The Dodd-Frank Wall Street Reform and Consumer Protection Act financial reform legislation ("Dodd-Frank"), significantly revised and expanded the rulemaking, supervisory and enforcement authority of the federal bank regulatory agencies. Dodd-Frank followed the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009 in response to the economic downturn and financial industry instability. Dodd-Frank authorized the creation of the Consumer Financial Protection Bureau ("CFPB") responsible for consumer protection in the financial services industry. Certain provisions of Dodd-Frank will significantly impact, or already are affecting, our operations and expenses, including, for example, changes in Federal Deposit Insurance Corporation ("FDIC") assessments, the permitted payment of interest on demand deposits, and enhanced compliance requirements. Some of the rules and regulations promulgated or yet to be promulgated under Dodd-Frank will apply directly only to institutions much larger than ours, but could indirectly impact smaller banks, either due to competitive influences or because certain required practices for larger institutions may subsequently become expected "best practices" for smaller institutions. We expect that we may need to devote even more management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements under Dodd-Frank.

**Supervision and Regulation**

***Introduction***

Banking is a complex, highly regulated industry. Regulation and supervision by federal and state banking agencies are intended to maintain a safe and sound banking system, protect depositors and the FDIC's insurance fund, and to facilitate the conduct of sound monetary policy. In furtherance of these goals, Congress and the states have created several largely autonomous regulatory agencies and enacted numerous laws that govern banks, bank holding companies and the financial services industry. Consequently, the growth and earnings performance of the Company can be affected not only by management decisions and general economic conditions, but also by the requirements of applicable state and federal statutes, regulations and the policies of various governmental regulatory authorities, including the Federal Reserve, FDIC, and the DBO.

The system of supervision and regulation applicable to financial services businesses governs most aspects of the business of the Company, including: (i) the scope of permissible business; (ii) investments; (iii) reserves that must be maintained against deposits; (iv) capital levels that must be maintained; (v) the nature and amount of collateral that may be taken to secure loans; (vi) the establishment of new branches; (vii) mergers and consolidations with other financial institutions; and (viii) the payment of dividends.

Set forth below is a description of the significant elements of the laws and regulations applicable to HCC and HBC. The description is qualified in its entirety by reference to the full text of the statutes, regulations and policies that are described. Also, such statutes, regulations and policies are continually under review by the U.S. Congress and state legislatures and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to HCC or HBC could have a material effect on our business.

***Heritage Commerce Corp***

*General.* As a bank holding company, HCC is registered under the Bank Holding Company Act of 1956, as amended ("BHCA"), and is subject to regulation and periodic examination by the Federal Reserve. HCC is also required to file periodic reports of its operations and any additional information regarding its activities and those of its subsidiaries as may be required by the Federal Reserve.

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

### Table of Contents

HCC is also a bank holding company within the meaning of Section 1280 of the California Financial Code. Consequently, HCC is subject to examination by, and may be required to file reports with, the DBO. The DBO approval may be required for certain mergers and acquisitions.

*SEC and Nasdaq.* HCC's stock is traded on the NASDAQ Global Select Market (under the trading symbol "HTBK"), and HCC is subject to rules and regulations of The NASDAQ Stock Market, including those related to corporate governance. HCC is also subject to the periodic reporting requirements of Section 13 of the Securities Exchange Act of 1934 (the "Exchange Act") which requires HCC to file annual, quarterly and other current reports with the SEC. HCC is subject to additional regulations including, but not limited to, the proxy and tender offer rules promulgated by the SEC under Sections 13 and 14 of the Exchange Act, the reporting requirements of directors, executive officers and principal shareholders regarding transactions in the HCC's common stock and short swing profits rules promulgated by the SEC under Section 16 of the Exchange Act, and certain additional reporting requirements by principal shareholders of HCC promulgated by the SEC under Section 13 of the Exchange Act.

*The Sarbanes Oxley Act of 2002.* HCC is subject to the accounting oversight and corporate governance requirements of the Sarbanes-Oxley Act of 2002, including: (i) required executive certification of financial presentations; (ii) increased requirements for board audit committees and their members; (iii) enhanced disclosure of controls and procedures and internal control over financial reporting; (iv) enhanced controls over, and reporting of, insider trading; and (v) increased penalties for financial crimes and forfeiture of executive bonuses in certain circumstances.

*Permitted Activities.* In general, the BHCA limits the business of bank holding companies to banking, managing or controlling banks and other activities that the Federal Reserve has determined to be so closely related to banking as to be a proper incident thereto.

Bank holding companies that qualify and elect to be treated as "financial holding companies" may engage in a broad range of additional activities that are (i) financial in nature or incidental to such financial activities or (ii) complementary to a financial activity and do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. These activities include securities underwriting and dealing, insurance underwriting and making merchant banking investments. We have not elected to be treated as a financial holding company and currently have no plans to make a financial holding company election.

The BHCA does not place territorial restrictions on permissible non-banking activities of bank holding companies. The Federal Reserve has the power to order any bank holding company or its subsidiaries to terminate any activity or to terminate its ownership or control of any subsidiary when the Federal Reserve has reasonable grounds to believe that continuing such activity, ownership or control constitutes a serious risk to the financial soundness, safety or stability of any bank subsidiary of the bank holding company.

*Affiliate Transactions.* Transactions between affiliates are subject to Sections 23A and 23B of the Federal Reserve Act. Regulation W codifies interpretive guidance with respect to affiliate transactions. Generally, Sections 23A and 23B: (i) limit the extent to which a financial institution or its subsidiaries may engage in covered transactions (A) with an affiliate (as defined in such sections) to an amount equal to 10% of such institution's capital and surplus and (B) with all affiliates in the aggregate to an amount equal to 20% of such capital and surplus; and (ii) require all transactions with an affiliate, whether or not covered transactions, to be on terms substantially the same or at least as favorable to the institution or subsidiary, the terms provided or that would be provided to a nonaffiliate. Dodd-Frank enhances the requirements for certain transactions with affiliates, including an expansion of the definition of "covered transactions" and increasing the amount of time for which collateral requirements regarding covered transactions must be maintained. The term "covered transaction" includes the making of loans, purchase of assets, issuance of a guarantee and other similar types of transactions.

Table of Contents

*Source of Strength Doctrine.* Federal Reserve policy requires bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. Under this policy the holding company is expected to commit resources to support its bank subsidiary, including at times when the holding company may not be in a financial position to provide it. It is the Federal Reserve's position that bank holding companies should stand ready to use their available resources to provide adequate capital to their subsidiary banks during periods of financial stress or adversity. Bank holding companies must also maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting their subsidiary bank. A bank holding company's failure to meet its source-of-strength obligations may constitute an unsafe and unsound practice or a violation of the Federal Reserve's regulations or both. The source-of-strength doctrine most directly affects bank holding companies where a bank holding company's subsidiary bank fails to maintain adequate capital levels. In such a situation, the subsidiary bank will be required by the bank's federal regulator to take "prompt corrective action." Any capital loans by a bank holding company to its subsidiary bank are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary bank. The BHCA provides that in the event of a bank holding company's bankruptcy any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a bank subsidiary will be assumed by the bankruptcy trustee and entitled to priority of payment.

*Sound Banking Practices.* Bank holding companies and their non-banking subsidiaries are prohibited from engaging in activities that represent unsafe and unsound banking practices or that constitute violation of law or regulations. Under certain conditions the Federal Reserve may conclude that certain actions of a bank holding company such as a payment of a cash dividend, would constitute an unsafe and unsound banking practice. The Federal Reserve also has the authority to regulate the debt of bank holding companies, including the authority to impose interest rate ceilings and reserve requirements on such debt. Under certain circumstances the Federal Reserve may require a bank holding company to file written notice and obtain its approval prior to purchasing or redeeming its equity securities, unless certain conditions are met.

*Acquisitions.* The BHCA, the Bank Merger Act, the California Financial Code and other federal and state statutes regulate acquisitions of commercial banks and other FDIC-insured depository institutions. HCC must obtain the prior approval of the Federal Reserve before: (i) acquiring more than 5% of the voting stock of any FDIC-insured depository institution or other bank holding company (other than directly through our bank); (ii) acquiring all or substantially all of the assets of any bank or bank holding company; or (iii) merging or consolidating with any other bank holding company. Under the Bank Merger Act, the prior approval of the Federal Reserve is required for HCC to merge with another bank or purchase all or substantially all of the assets or assume any of the deposits of another FDIC-insured depository institution. In reviewing applications seeking approval of merger and acquisition transactions, bank regulators consider, among other things, the competitive effect and public benefits of the transactions, the capital position and managerial resources of the combined organization, the risks to the stability of the U.S. banking or financial system, the applicant's performance record under the Community Reinvestment Act of 1977 ("CRA"), the applicant's compliance with fair housing and other consumer protection laws and the effectiveness of all organizations involved in combating money laundering activities. In addition, failure to implement or maintain adequate compliance programs could cause bank regulators not to approve an acquisition where regulatory approval is required or to prohibit an acquisition even if approval is not required.

HCC is also subject to the Change in Bank Control Act of 1978 (the "Control Act") and related Federal Reserve regulations, which provide that any person who proposes to acquire at least 10% (but less than 25%) of any class of a bank holding company's voting securities is presumed to control the company (unless the company is not publicly held and some other shareholder owns a greater percentage of voting stock). Any person who would be presumed to acquire control or who proposes to acquire control of more than 25% of any class of a bank holding company's voting securities or who proposes to acquire actual



Table of Contents

control must provide the Federal Reserve with at least 60 days prior written notice of the acquisition. The Federal Reserve may disapprove a proposed acquisition if: (i) it would result in adverse competitive effects; (ii) the financial condition of the acquiring person might jeopardize the target institution's financial stability or prejudice the interests of depositors; (iii) the competence, experience or integrity of any acquiring person indicates that the proposed acquisition would not be in the best interests of the depositors or the public; or (iv) the acquiring person fails to provide all of the information required by the Federal Reserve Board. Any proposed acquisition of the voting securities of a bank holding company that is subject to approval under the BHCA is not subject to the Control Act notice requirements. Any company that proposes to acquire "control", as those terms are defined in the BHCA and Federal Reserve regulations, of a bank holding company or to acquire 25% or more of any class of voting securities of a bank holding company would be required to seek the Federal Reserve's prior approval under the BHCA to become a bank holding company.

*Tie-in Arrangements.* Federal law prohibits a bank holding company and any subsidiary banks from engaging in certain tie-in arrangements in connection with the extension of credit. Thus, for example, HBC may not extend credit, lease or sell property, or furnish any services, or fix or vary the consideration for any of the foregoing on the condition that: (i) the customer must obtain or provide some additional credit, property or services from or to HBC other than a loan, discount, deposit or trust services; (ii) the customer must obtain or provide some additional credit, property or service from or to HCC or HBC; or (iii) the customer must not obtain some other credit, property or services from competitors, except reasonable requirements to assure soundness of credit extended.

***Heritage Bank of Commerce***

*General.* As a California commercial bank whose deposits are insured by the FDIC, HBC is subject to regulation, supervision, and regular examination by the FDIC, the DBO and by the Federal Reserve as HBC's primary Federal regulator. The regulations of these agencies govern most aspects of a bank's business. California banks are also subject to federal statutes and regulations including Federal Reserve Regulation O and Federal Reserve Act Sections 23A and 23B and Regulation W.

Pursuant to the Federal Deposit Insurance Act ("FDIA") and the California Financial Code, California state chartered commercial banks may generally engage in any activity permissible for national banks. Therefore, HBC may form subsidiaries to engage in the many so-called "closely related to banking" or "nonbanking" activities commonly conducted by national banks in operating subsidiaries or subsidiaries of bank holding companies. Further, California banks may conduct certain "financial" activities in a subsidiary to the same extent as may a national bank, provided the bank is and remains "well-capitalized," "well-managed" and in satisfactory compliance with the CRA.

HBC is a member of the Federal Home Loan Bank ("FHLB") of San Francisco. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region and makes available loans or advances to its members. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. As an FHLB member HBC is required to own a certain amount of capital stock in the FHLB. At December 31, 2015, HBC was in compliance with the FHLB's stock ownership requirement. Federal Reserve stock is carried at cost and may be sold back to the Federal Reserve at its carrying value. Cash dividends received are reported as income.

*Depositor Preference.* In the event of the "liquidation or other resolution" of an insured depository institution, the claims of depositors of the institution, including the claims of the FDIC as subrogee of insured depositors, and certain claims for administrative expenses of the FDIC as a receiver, will have priority over other general unsecured claims against the institution. If an insured depository institution fails, insured and uninsured depositors along with the FDIC, will have priority in payment ahead of unsecured, non-deposit creditors including the parent bank holding company with respect to any extensions of credit they have made to such insured depository institution.

Table of Contents

*Brokered Deposit Restrictions.* Well-capitalized institutions are not subject to limitations on brokered deposits, while an adequately capitalized institution is able to accept, renew or roll over brokered deposits only with a waiver from the FDIC and subject to certain restrictions on the yield paid on such deposits. Undercapitalized institutions are generally not permitted to accept, renew, or roll over brokered deposits. HBC is eligible to accept brokered deposits without limitations.

*Loans to One Borrower.* With certain limited exceptions, the maximum amount that a California bank may lend to any borrower at any one time (including the obligations to the bank of certain related entities of the borrower) may not exceed 25 percent (and unsecured loans may not exceed 15 percent) of the bank's shareholders' equity, allowance for loan loss, and any capital notes and debentures of the bank.

*Loans to Directors, Executive Officers and Principal Shareholders.* The authority of HBC to extend credit to its directors, executive officers and principal shareholders, including their immediate family members and corporations and other entities that they control, is subject to substantial restrictions and requirements under Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O promulgated thereunder, as well as the Sarbanes-Oxley Act of 2002. These statutes and regulations impose specific limits on the amount of loans HBC may make to directors and other insiders, and specified approval procedures must be followed in making loans that exceed certain amounts. In addition, all loans HBC makes to directors and other insiders must satisfy the following requirements:

the loans must be made on substantially the same terms, including interest rates and collateral, as prevailing at the time for comparable transactions with persons not affiliated with HCC or HBC;

HBC must follow credit underwriting procedures at least as stringent as those applicable to comparable transactions with persons who are not affiliated with HCC or HBC; and

the loans must not involve a greater than normal risk of non-payment or include other features not favorable to HBC.

Furthermore, HBC must periodically report all loans made to directors and other insiders to the bank regulators, and these loans are closely scrutinized by the regulators for compliance with Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O. Each loan to directors or other insiders must be pre-approved by the HBC board of directors with the interested director abstaining from voting.

*Community Reinvestment Act.* The CRA is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. The CRA specifically directs the federal bank regulatory agencies, in examining insured depository institutions, to assess their record of helping to meet the credit needs of their entire community, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices. The CRA further requires the agencies to take a financial institution's record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, consummating mergers or acquisitions or holding company formations.

The federal banking agencies have adopted regulations which measure a bank's compliance with its CRA obligations on a performance based evaluation system. This system bases CRA ratings on an institution's actual lending service and investment performance rather than the extent to which the institution conducts needs assessments, documents community outreach or complies with other procedural requirements. The ratings range from "outstanding" to a low of "substantial noncompliance." HBC had a CRA rating of "satisfactory" as of its most recent regulatory examination.

*Environmental Regulation.* Federal, state and local laws and regulations regarding the discharge of harmful materials into the environment may have an impact on HBC. Since HBC is not involved in any business that manufactures, uses or transports chemicals, waste, pollutants or toxins that might have a material adverse effect on the environment, HBC's primary exposure to environmental laws is through its lending activities and through properties or businesses HBC may own, lease or acquire. Based on a general

Table of Contents

survey of HBC's loan portfolio, conversations with local appraisers and the type of lending currently and historically done by HBC, management is not aware of any potential liability for hazardous waste contamination that would be reasonably likely to have a material adverse effect on the Company as of December 31, 2015.

*Safeguarding of Customer Information and Privacy.* The Federal Reserve and other bank regulatory agencies have adopted guidelines for safeguarding confidential, personal customer information. These guidelines require financial institutions to create, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, protect against any anticipated threats or hazards to the security or integrity of such information and protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer. HBC has adopted a customer information security program to comply with such requirements.

Financial institutions are also required to implement policies and procedures regarding the disclosure of nonpublic personal information about consumers to non-affiliated third parties. In general, financial institutions must provide explanations to consumers on policies and procedures regarding the disclosure of such nonpublic personal information and, except as otherwise required by law, prohibits disclosing such information. HBC has implemented privacy policies addressing these restrictions which are distributed regularly to all existing and new customers of HBC.

*Anti-Money Laundering and the USA PATRIOT ACT.* A major focus of governmental policy on financial institutions in recent years has been aimed at combating money laundering and terrorist financing. The USA PATRIOT Act of 2001, or the USA Patriot Act, substantially broadened the scope of United States anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. Financial institutions are also prohibited from entering into specified financial transactions and account relationships and must use enhanced due diligence procedures in their dealings with certain types of high-risk customers and implement a written customer identification program. Financial institutions must take certain steps to assist government agencies in detecting and preventing money laundering and report certain types of suspicious transactions. Regulatory authorities routinely examine financial institutions for compliance with these obligations, and failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required. Regulatory authorities have imposed cease and desist orders and civil money penalties against institutions found to be violating these obligations.

*Office of Foreign Assets Control Regulation.* The U.S. Treasury Department's Office of Foreign Assets Control ("OFAC"), administers and enforces economic and trade sanctions against targeted foreign countries and regimes under authority of various laws, including designated foreign countries, nationals and others. OFAC publishes lists of specially designated targets and countries. HCC and HBC are responsible for, among other things, blocking accounts of and transactions with such targets and countries, prohibiting unlicensed trade and financial transactions with them and reporting blocked transactions after their occurrence. Failure to comply with these sanctions could have serious legal and reputational consequences, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required.

Table of Contents

***The Dodd-Frank Wall Street and Consumer Protection Regulation Act***

The implementation and impact of legislation and regulations enacted since 2008 in response to the U.S. economic downturn and financial industry instability continued through 2015 as modest recovery returned to many institutions in the banking sector. Certain provisions of Dodd-Frank, which was enacted in 2010, are now effective and have been fully implemented, including: (i) revisions in the deposit insurance assessment base for FDIC insurance and a permanent increase in coverage to \$250,000; (ii) the permissibility of paying interest on business checking accounts; (iii) the removal of barriers to interstate branching; (iv) required disclosure and shareholder advisory votes on executive compensation; (v) final new capital rules; (vi) a final rule to implement the so called Volcker rule restrictions on certain proprietary trading and investment activities; and (vii) final rules and increased enforcement action by the CFPB.

Many aspects of Dodd-Frank are still subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on the Company, its customers or the financial services industry more generally. However, certain provisions of Dodd-Frank will significantly impact or already are affecting our operations and expenses, including but not limited to changes in FDIC assessments, the permitted payment of interest on demand deposits, and enhanced compliance requirements. Some of the rules and regulations promulgated or yet to be promulgated under Dodd-Frank will apply directly only to institutions much larger than ours, but could indirectly impact smaller banks, either due to competitive influences or because certain required practices for larger institutions may subsequently become expected "best practices" for smaller institutions. We expect that we may need to devote even more management attention and resources to evaluate and make any changes necessary to comply with statutory and regulatory requirements under Dodd-Frank.

***The Volcker Rule***

In December 2013, the federal bank regulatory agencies adopted final rules that implement a part of Dodd-Frank commonly referred to as the "Volcker Rule." Under these rules and subject to certain exceptions, banking entities are restricted from engaging in activities that are considered proprietary trading and from sponsoring or investing in certain entities, including hedge or private equity funds that are considered "covered funds." These rules became effective April 1, 2014, although certain provisions are subject to delayed effectiveness under rules promulgated by the Federal Reserve. HCC and HBC held no investment positions at December 31, 2015 which were subject to the final rule. Therefore, while these new rules may require us to conduct certain internal analysis and reporting, we believe that they will not require any material changes in our operations or business.

***Deposit Insurance***

The FDIC is an independent federal agency that insures deposits up to prescribed statutory limits of federally insured banks and savings institutions and safeguards the safety and soundness of the banking and savings industries. The FDIC insures HBC's customer deposits through the Deposit Insurance Fund (the "DIF") up to prescribed limits for each depositor. Pursuant to Dodd-Frank, the maximum deposit insurance amount has been permanently increased to \$250,000. The amount of FDIC assessments paid by each DIF member institution is based on its relative risk of default as measured by regulatory capital ratios and other supervisory factors.

HBC is subject to deposit insurance assessments to maintain the DIF. In October 2010, the FDIC adopted a revised restoration plan to ensure that the DIF's designated reserve ratio ("DRR") reaches 1.35% of insured deposits by September 30, 2020, the deadline mandated by Dodd-Frank. However, financial institutions like HBC with assets of less than \$10 billion are exempted from the cost of this increase. The restoration plan proposed an increase in the DRR to 2% of estimated insured deposits as a

Table of Contents

long-term goal for the fund. The FDIC also proposed future assessment rate reductions in lieu of dividends when the DRR reaches 1.5% or greater.

The FDIC redefined its deposit insurance premium assessment base from an institution's total domestic deposits to its total assets less tangible equity, effective in the second quarter of 2011. The changes to the assessment base necessitated changes to assessment rates which also became effective April 1, 2011. The revised assessment rates are lower than prior rates, but the assessment base is larger and approximately the same amount of assessment revenue is being collected by the FDIC.

We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional bank or financial institution failures or if the FDIC otherwise determines, we may be required to pay even higher FDIC premiums than the recently increased levels. These announced increases and any future increases in FDIC insurance premiums may have a material and adverse effect on our earnings and could have a material adverse effect on the value of or market for our common stock.

In addition to DIF assessments, banks must pay quarterly assessments that are applied to the retirement of Financing Corporation ("FICO") bonds issued in the 1980's to assist in the recovery of the savings and loan industry. The FICO assessment amount fluctuates quarterly, but was 0.00145% of average total assets less average tangible equity for the third quarter of 2015. As of the date of this report, the Company had not received the FICO assessment for the fourth quarter of 2015. Those assessments will continue until the Financing Corporation bonds mature in 2019.

The FDIC may terminate a depository institution's deposit insurance upon a finding that the institution's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices that pose a risk to the DIF or that may prejudice the interest of the bank's depositors. The termination of deposit insurance for a bank would also result in the revocation of the bank's charter by the DBO.

***Capital Adequacy Requirements***

HCC and HBC are subject to the regulations of the Federal Reserve Board and the FDIC, respectively, governing capital adequacy. These agencies have adopted risk-based capital guidelines to provide a systematic analytical framework which makes regulatory capital requirements sensitive to differences in risk profiles among banking organizations, considers off-balance sheet exposures in evaluating capital adequacy, and minimizes disincentives to holding liquid, low-risk assets. Capital levels, as measured by these standards, are also used to categorize financial institutions for purposes of certain prompt corrective action regulatory provisions.

Prior to January 1, 2015, the guidelines included a minimum required ratio of qualifying Tier 1 capital plus Tier 2 capital to total risk weighted assets of 8% or total risk-based capital ratio, and a minimum required ratio of Tier 1 capital to total risk weighted assets of 4% or Tier 1 risk-based capital ratio. The guidelines also provided for a minimum ratio of Tier 1 capital to average assets, or "leverage ratio," of 3% for institutions having the highest regulatory rating, and 4% for all other institutions.

Tier 1 capital was generally defined as the sum of core capital elements, less goodwill and other intangible assets, accumulated other comprehensive income, disallowed deferred tax assets, and certain other deductions. The following items were defined as core capital elements: (i) common shareholders' equity; (ii) qualifying non-cumulative perpetual preferred stock and related surplus (and, in the case of holding companies, senior perpetual preferred stock issued to the U.S. Treasury Department pursuant to the Troubled Asset Relief Program); (iii) minority interests in the equity accounts of consolidated subsidiaries; and (iv) "restricted" core capital elements (which include qualifying trust preferred securities) up to 25% of all core capital elements. Tier 2 capital included the following supplemental capital elements: (i) allowance for loan and lease losses (but not more than 1.25% of an institution's risk-weighted assets);

Table of Contents

(ii) perpetual preferred stock and related surplus not qualifying as core capital; (iii) hybrid capital instruments, perpetual debt and mandatory convertible debt instruments; and (iv) term subordinated debt and intermediate-term preferred stock and related surplus. The maximum amount of Tier 2 capital was capped at 100% of Tier 1 capital.

As of December 31, 2014 and 2013, HBC's and the consolidated Company's regulatory capital ratios all exceeded regulatory requirements. See Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operation – Capital Resources.

In July 2013, the federal bank regulators approved final rules, or the capital rules, implementing the Basel Committee's December 2010 final capital framework for strengthening international capital standards, known as Basel III, and various provisions of Dodd-Frank. The capital rules substantially revise the risk-based capital requirements applicable to bank holding companies and banks, including HCC and HBC, compared to the previous risk-based capital rules. The capital rules revise the components of capital and address other issues affecting the numerator in regulatory capital ratio calculations. Subject to a phase-in period for various provisions, the capital rules became effective for HCC and HBC beginning on January 1, 2015.

The Basel III capital rules: (i) introduce a new capital measure called "common equity tier 1" and related regulatory capital ratio of common equity Tier 1 to risk-weighted assets; (ii) specify that Tier 1 capital consists of common equity Tier 1 and "Additional Tier 1 capital" instruments meeting certain revised requirements; (iii) mandate that most deductions/adjustments to regulatory capital measures be made to common equity Tier 1 and not to the other components of capital; and (iv) expand the scope of the deductions from and adjustments to capital as compared to existing regulations. Under the Basel III capital rules, for most banking organizations, the most common form of Additional Tier 1 capital is noncumulative perpetual preferred stock and the most common form of Tier 2 capital is subordinated debt and a portion of the allowance for loan and lease losses, which in each case, are subject to the Basel III capital rules' specific requirements. Under the Basel III capital rules, the following are the initial minimum capital ratios applicable to HCC and HBC as of January 1, 2015:

4.5% common equity Tier 1 to risk-weighted assets;

6.0% Tier 1 capital (common equity Tier 1 plus Additional Tier 1 capital) to risk-weighted assets;

8.0% total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets; and

4.0% Tier 1 leverage ratio.

The Basel III capital rules also introduce a new "capital conservation buffer," for banking organizations to maintain a common equity Tier 1 ratio more than 2.5% above these minimum risk-weighted asset ratios. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk-weighted assets above the minimum but below the capital conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The implementation of the capital conservation buffer was phased in beginning on January 1, 2016 at 0.625% and will be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). Thus, when fully phased-in on January 1, 2019, HCC and HBC will be required to maintain this additional capital conservation buffer of 2.5% of common equity Tier 1, resulting in the following minimum capital ratios:

4.5% common equity Tier 1 to risk-weighted assets, plus the capital conservation buffer, or a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7%;

6.0% Tier 1 capital to risk-weighted assets, plus the capital conservation buffer, or a minimum Tier 1 capital ratio of at least 8.5%;

Table of Contents

8.0% total capital to risk-weighted assets, plus the capital conservation buffer, or a minimum total capital ratio of at least 10.5%; and

4.0% Tier 1 leverage ratio.

The Basel III capital rules provide for a number of deductions from and adjustments to common equity Tier 1. These include, for example, the requirement that: (i) mortgage servicing rights; (ii) deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks, and (iii) significant investments in non-consolidated financial entities be deducted from common equity Tier 1 to the extent that any one such category exceeds 10% of common equity Tier 1 or all such items, in the aggregate, exceed 15% of common equity Tier 1. Implementation of the deductions and other adjustments to common equity Tier 1 began on January 1, 2015 and will be phased-in over a four-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter). In addition, HCC and HBC made a one-time election as permitted under the Basel III capital rules to continue the current capital standards under which the effects of accumulated other comprehensive income or loss ("AOCI") items included in shareholders' equity (for example, unrealized gains or losses on securities held in the available-for-sale portfolio) under U.S. GAAP are excluded for the purposes of determining regulatory capital ratios. HCC and HBC made this election in order to avoid significant variations in the level of capital depending upon the impact of interest rate fluctuations on the fair value of its available-for-sale securities portfolio.

With respect to HBC, the Basel III capital rules also revise the "prompt corrective action" regulations pursuant to Section 38 of the FDIA, as discussed below under "Prompt Corrective Action Provisions."

The capital rules also increase the required capital for certain categories of assets, including higher-risk construction real estate loans, certain past-due or nonaccrual loans, and certain exposures related to securitizations. The capital rules adopt the same risk weightings for residential mortgages that existed under previous risk-based capital rules.

Based on existing capital levels at December 31, 2015, HCC and HBC meet all capital adequacy requirements under the Basel III capital rules on a fully phased-in basis.

For more information on the Company's capital, see Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operation – Capital Resources.

The appropriate federal banking agency may under certain circumstances reclassify a well capitalized insured depository institution as adequately capitalized. An institution may be reclassified if the appropriate federal banking agency determines (after notice and opportunity for a hearing) that the institution is in an unsafe or unsound condition or deems the institution to be engaging in an unsafe or unsound practice. The appropriate agency is also permitted to require an adequately capitalized or undercapitalized institution to comply with the supervisory provisions as if the institution were in the next lower category (but not treat a significantly undercapitalized institution as critically undercapitalized) based on supervisory information other than the capital levels of the institution.

At each successively lower capital category, an insured bank is subject to increased restrictions on its operations. For example, a bank is generally prohibited from paying management fees to any controlling persons or from making capital distributions if to do so would make the bank "undercapitalized." Asset growth and branching restrictions apply to undercapitalized banks, which are required to submit written capital restoration plans meeting specified requirements (including a guarantee by the parent holding company, if any). "Significantly undercapitalized" banks are subject to broad regulatory authority, including among other things, capital directives, forced mergers, restrictions on the rates of interest they may pay on deposits, restrictions on asset growth and activities, and prohibitions on paying bonuses or increasing compensation to senior executive officers without FDIC approval. Even more severe restrictions apply to "critically undercapitalized" banks. Most importantly, except under limited circumstances, not

Table of Contents

later than 90 days after an insured bank becomes critically undercapitalized the appropriate federal banking agency is required to appoint a conservator or receiver for the bank.

***Consumer Financial Protection***

We are subject to a number of federal and state consumer protection laws that extensively govern our relationship with our customers. These laws include the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Truth in Savings Act, the Electronic Fund Transfer Act, the Expedited Funds Availability Act, the Home Mortgage Disclosure Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act, the Service Members Civil Relief Act and these laws' respective state-law counterparts, as well as state usury laws and laws regarding unfair and deceptive acts and practices. These and other federal laws, among other things, require disclosures of the cost of credit and terms of deposit accounts, provide substantive consumer rights, prohibit discrimination in credit transactions, regulate the use of credit report information, provide financial privacy protections, prohibit unfair, deceptive and abusive practices, restrict our ability to raise interest rates and subject us to substantial regulatory oversight. Violations of applicable consumer protection laws can result in significant potential liability from litigation brought by customers, including actual damages, restitution and attorneys' fees. Federal bank regulators, state attorneys general and state and local consumer protection agencies may also seek to enforce consumer protection requirements and obtain these and other remedies, including regulatory sanctions, customer rescission rights, action by the state and local attorneys general in each jurisdiction in which we operate and civil money penalties. Failure to comply with consumer protection requirements may also result in our failure to obtain any required bank regulatory approval for merger or acquisition transactions we may wish to pursue or our prohibition from engaging in such transactions even if approval is not required.

Dodd-Frank created a new, independent federal agency, the CFPB, which was granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws. The CFPB is also authorized to engage in consumer financial education, track consumer complaints, request data and promote the availability of financial services to underserved consumers and communities. Although all institutions are subject to rules adopted by the CFPB and examination by the CFPB in conjunction with examinations by the institution's primary federal regulator, the CFPB has primary examination and enforcement authority over institutions with assets of \$10 billion or more. The FDIC has primary responsibility for examination of HBC and enforcement with respect to federal consumer protection laws so long as HBC has total consolidated assets of less than \$10 billion, and state authorities are responsible for monitoring our compliance with all state consumer laws. The CFPB also has the authority to require reports from institutions with less than \$10 billion in assets, such as HBC, to support the CFPB in implementing federal consumer protection laws, supporting examination activities, and assessing and detecting risks to consumers and financial markets.

The consumer protection provisions of Dodd-Frank and the examination, supervision and enforcement of those laws and implementing regulations by the CFPB have created a more intense and complex environment for consumer finance regulation. The CFPB has significant authority to implement and enforce federal consumer finance laws, including the Truth in Lending Act, the Equal Credit Opportunity Act and new requirements for financial services products provided for in Dodd-Frank, as well as the authority to identify and prohibit unfair, deceptive or abusive acts and practices. The review of products and practices to prevent such acts and practices is a continuing focus of the CFPB, and of banking regulators more broadly. The ultimate impact of this heightened scrutiny is uncertain but could result in changes to pricing, practices, products and procedures. It could also result in increased costs related to regulatory oversight, supervision and examination, additional remediation efforts and possible penalties. In addition, Dodd-Frank provides the CFPB with broad supervisory, examination and enforcement authority over various consumer financial products and services, including the ability to require reimbursements and other payments to customers for alleged legal violations and to impose significant penalties, as well as



Table of Contents

injunctive relief that prohibits lenders from engaging in allegedly unlawful practices. The CFPB also has the authority to obtain cease and desist orders providing for affirmative relief or monetary penalties. Dodd-Frank does not prevent states from adopting stricter consumer protection standards. State regulation of financial products and potential enforcement actions could also adversely affect our business, financial condition or results of operations.

***Prompt Corrective Action Provisions***

Federal law requires each federal banking agency to take prompt corrective action to resolve the problems of insured financial institutions, including but not limited to those that fall below one or more prescribed minimum capital ratios. Prior to January 1, 2015, the federal banking agencies had by regulation defined the following five capital categories: (i) "well capitalized" (total risk-based capital ratio of 10%, Tier 1 risk-based capital ratio of 6%, and leverage ratio of 5%); (ii) "adequately capitalized" (total risk-based capital ratio of 8%, Tier 1 risk-based capital ratio of 4%, and leverage ratio of 4%, or 3% if the institution receives the highest rating from its primary regulator); (iii) "undercapitalized" (total risk-based capital ratio of less than 8%, Tier 1 risk-based capital ratio of less than 4%, or leverage ratio of less than 4%, or 3% if the institution receives the highest rating from its primary regulator); (iv) "significantly undercapitalized" (total risk-based capital ratio of less than 6%, Tier 1 risk-based capital ratio of less than 3%, or leverage ratio less than 3%); and (v) "critically undercapitalized" (tangible equity to total assets less than 2%). As of December 31, 2014 and 2013, both HCC and HBC were deemed to be well capitalized for regulatory capital purposes.

The Basel III capital rules, as promulgated by the Federal Reserve, revise the current prompt corrective action requirements effective January 1, 2015. Under the new rules, a financial institution will be: (i) "well capitalized" if the institution has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 8.0% or greater, common equity Tier 1 capital ratio of 6.5% or greater, and a leverage ratio of 5.0% or greater, and is not subject to any order or written directive by any such regulatory authority to meet and maintain a specific capital level for any capital measure; (ii) "adequately capitalized" if the institution has a total risk-based capital ratio of 8.0% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, common equity Tier 1 capital ratio of 4.5% or greater, and a leverage ratio of 4.0% or greater; (iii) "undercapitalized" if the institution has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio of less than 6.0%, common equity Tier 1 capital ratio of less than 4.5%, or a leverage ratio of less than 4.0%; (iv) "significantly undercapitalized" if the institution has a total risk-based capital ratio of less than 6.0%, a Tier 1 risk-based capital ratio of less than 4.0%, common equity Tier 1 capital ratio of less than 3.0%, or a leverage ratio of less than 3.0%; and (v) "critically undercapitalized" if the institution's tangible equity (defined as Tier 1 capital plus non-Tier 1 perpetual preferred stock) is equal to or less than 2.0% of average quarterly tangible assets. As of December 31, 2015, both HCC and HBC were deemed to be well capitalized for regulatory purposes.

***Enforcement Authority***

The federal and California regulatory structure gives the bank regulatory agencies extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. The regulatory agencies have adopted guidelines to assist in identifying and addressing potential safety and soundness concerns before an institution's capital becomes impaired. The guidelines establish operational and managerial standards generally relating to: (i) internal controls, information systems and internal audit systems; (ii) loan documentation; (iii) credit underwriting; (iv) interest rate exposure; (v) asset growth and asset quality; and (vi) compensation, fees, and benefits. Further, the regulatory agencies have adopted safety and soundness guidelines for asset quality and for evaluating and monitoring earnings to ensure that earnings are sufficient for the maintenance of adequate capital and reserves.

Table of Contents

If, as a result of an examination the DBO or the Federal Reserve should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of HBC's operations are unsatisfactory or that HBC or its management is violating or has violated any law or regulation, the DBO and the Federal Reserve, and separately the FDIC as insurer of the HBC's deposits, have residual authority to:

require affirmative action to correct any conditions resulting from any violation or practice;

direct an increase in capital and the maintenance of higher specific minimum capital ratios, which may preclude HBC from being deemed well capitalized and restrict its ability to accept certain brokered deposits;

restrict HBC's growth geographically by products and services or by mergers and acquisitions, including bidding in FDIC receiverships for failed banks;

enter into or issue informal or formal enforcement actions, including required board of directors' resolutions, memoranda of understanding, written agreements and consent or cease and desist orders or prompt corrective action orders to take corrective action and cease unsafe and unsound practices;

require prior approval of senior executive officer or director changes, remove officers and directors and assess civil monetary penalties; and

take possession of and close and liquidate HBC or appoint the FDIC as receiver.

***Dividends***

It is the Federal Reserve's policy that bank holding companies should generally pay dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. It is also the Federal Reserve's policy that bank holding companies should not maintain dividend levels that undermine their ability to be a source of strength to its banking subsidiaries. Additionally, in consideration of the current financial and economic environment, the Federal Reserve has indicated that bank holding companies should carefully review their dividend policy and has discouraged payment ratios that are at maximum allowable levels unless both asset quality and capital are very strong.

HBC is a legal entity that is separate and distinct from its holding company. HCC receives cash through dividends paid by HBC. Future cash dividends by HBC will depend upon management's assessment of future capital requirements, contractual restrictions, and other factors. The ability of the Board of Directors of HBC to declare a cash dividend to HCC is subject to California law, which restricts the amount available for cash dividends to the lesser of a bank's retained earnings or net income for its last three fiscal years (less any distributions to shareholders made during such period). Where this test is not met, cash dividends may still be paid, with the prior approval of the DBO in an amount not exceeding the greatest of: (i) retained earnings of the bank; (ii) the net income of the bank for its last fiscal year; or (iii) the net income of the bank for its current fiscal year. A California bank may also with the prior approval of the DBO and approval of the bank's shareholders distribute a dividend in connection with a reduction of capital of the bank. If the DBO determines that the shareholders' equity of the bank paying the dividend is not adequate or that the payment of the dividend would be unsafe or unsound for the bank, the DBO may order the bank not to pay the dividend. Since HBC is a FDIC insured institution, it is also possible, depending upon its financial condition and other factors that the FDIC could assert that the payment of dividends or other payments might, under some circumstances, constitute an unsafe or unsound practice and thereby prohibit such payments.

The California General Corporation Law prohibits HCC from making distributions, including dividends, to holders of its common stock or preferred stock unless either of the following tests are

Table of Contents

satisfied: (i) the amount of retained earnings immediately prior to the distribution equals or exceeds the sum of (A) the amount of the proposed distribution plus (B) any cumulative dividends in arrears on all shares having a preference with respect to the payment of dividends over the class or series to which the applicable distribution is being made; or (ii) immediately after the distribution, the value of HCC's consolidated assets would equal or exceed the sum of its total liabilities, plus the amounts that would be payable to satisfy the preferential rights of other shareholders upon a dissolution that are superior to the rights of the shareholders receiving the distribution.

***Stock Redemptions and Repurchases***

It is an essential principle of safety and soundness that a banking organization's redemption and repurchases of regulatory capital instruments, including common stock, from investors be consistent with the organization's current and prospective capital needs. In assessing such needs, the board of directors and management of a bank holding company should consider the factors discussed previously under "Dividends". The risk-based capital rule directs bank holding companies to consult with the Federal Reserve before redeeming any equity or other capital instrument included in Tier 1 or Tier 2 capital prior to stated maturity, if such redemption could have a material effect on the level or composition of the organization's capital base. Bank holding companies experiencing financial weaknesses, or that are at significant risk of developing financial weaknesses, must consult with the appropriate Federal Reserve supervisory staff before redeeming or repurchasing common stock or other regulatory capital instruments for cash or other valuable consideration. Similarly, any bank holding company considering expansion, either through acquisitions or through new activities, also generally must consult with the appropriate Federal Reserve supervisory staff before redeeming or repurchasing common stock or other regulatory capital instruments for cash or other valuable consideration. In evaluating the appropriateness of a bank holding company's proposed redemption or repurchase of capital instruments, the Federal Reserve will consider the potential losses that the holding company may suffer from the prospective need to increase reserves and write down assets from continued asset deterioration and the holding company's ability to raise additional common stock and other Tier 1 capital to replace capital instruments that are redeemed or repurchased. A bank holding company must inform the Federal Reserve of a redemption or repurchase of common stock or perpetual preferred stock for cash or other value resulting in a net reduction of the bank holding company's outstanding amount of common stock or perpetual preferred stock below the amount of such capital instrument outstanding at the beginning of the quarter in which the redemption or repurchase occurs. In addition, a bank holding company must advise the Federal Reserve sufficiently in advance of such redemptions and repurchases to provide reasonable opportunity for supervisory review and possible objection should the Federal Reserve determine a transaction raises safety and soundness concerns.

Regulation Y requires that a bank holding company that is not well capitalized or well managed, or that is subject to any unresolved supervisory issues, provide prior notice to the Federal Reserve for any repurchase or redemption of its equity securities for cash or other value that would reduce by 10% or more the holding company's consolidated net worth aggregated over the preceding 12-month period.

***Incentive Compensation***

Dodd-Frank requires the federal bank regulators and the SEC to establish joint regulations or guidelines prohibiting incentive-based payment arrangements at specified regulated entities, including HCC and HBC, having at least \$1 billion in total assets that encourage inappropriate risks by providing an executive officer, employee, director or principal stockholder with excessive compensation, fees, or benefits or that could lead to material financial loss to the entity. In addition, these regulators must establish regulations or guidelines requiring enhanced disclosure to regulators of incentive-based compensation arrangements. The agencies have proposed such regulations, but the regulations have not

Table of Contents

been finalized. If the regulations are adopted in the form initially proposed, they will impose limitations on the manner in which we may structure compensation for our executives.

The proposed regulations apply to incentive compensation paid to "covered persons" at covered financial institutions, including executive officers, employees, directors and principal shareholders (those who own 10% or more of the institution's shares). The proposed regulations prohibit a covered financial institution from creating or maintaining an incentive-based compensation arrangement that encourages inappropriate risks by providing a covered person either (i) with excessive compensation, or (ii) with incentive-based compensation that could lead to material financial loss to the financial institution. Under the proposed regulations incentive-based compensation is excessive if amounts paid are unreasonable or disproportionate to the services provided by the covered person taking into consideration factors listed in the regulations, including the financial condition of the covered financial institution and practices at comparable institutions. A compensation arrangement would be considered able to lead to material financial loss unless, it: (i) balances risk and financial reward (for example by using deferral of payment); (ii) is compatible with effective controls and risk management; and (iii) is supported by strong corporate governance. Under the proposed regulations covered financial institutions must also maintain policies and procedures governing the award of incentive-based compensation in line with the institution's size, complexity and business activities and the scope and nature of its use of incentive-based compensation.

The Federal Reserve and FDIC have also issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization's incentive compensation arrangements should: (i) provide incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk; (ii) be compatible with effective internal controls and risk management; and (iii) be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

The Federal Reserve will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as us, that are not "large, complex banking organizations." These reviews will be tailored to each organization based on the scope and complexity of the organization's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization's supervisory ratings, which can affect the organization's ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements or related risk management control or governance processes, pose a risk to the organization's safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

The scope, content and application of the U.S. banking regulators' policies on incentive compensation continue to evolve. It cannot be determined at this time whether compliance with such policies will adversely affect the ability of the Company to hire, retain and motivate key employees.

***Other Pending and Proposed Legislation***

Other legislative and regulatory initiatives which could affect HCC, HBC and the banking industry in general may be proposed or introduced before the United States Congress, the California legislature and other governmental bodies in the future. Such proposals, if enacted, may further alter the structure, regulation and competitive relationship among financial institutions, and may subject HCC or HBC to increased regulation, disclosure and reporting requirements. In addition, the various banking regulatory agencies often adopt new rules and regulations to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations may be enacted or the extent to which the business of HCC or HBC would be affected thereby.

Table of Contents

**ITEM 1A RISK FACTORS**

*Our business, financial condition and results of operations are subject to various risks, including those discussed below. The risks discussed below are those that we believe are the most significant risks, although additional risks not presently known to us or that we currently deem less significant may also adversely affect our business, financial condition and results of operations, perhaps materially.*

**Risks Relating to Our Industry**

*Our business may be adversely affected by business and economic conditions.*

Our business activities and earnings are affected by general business conditions in the United States and in our local market area. These conditions include short-term and long-term interest rates, inflation, unemployment levels, monetary supply, consumer confidence and spending, political issues, legislative and regulatory changes, broad trends in industry and finance, fluctuations in both debt and equity capital markets, and the strength of the economy in the United States generally and in our market area in particular, all of which are beyond the Company's control. While there are signs of economic conditions improving, the U.S. budget deficit and uncertainty in European economies underline that the economy remains uncertain. Business activity across a wide range of industries and regions is greatly affected. Local and state governments are in difficulty due to the reduction in sales taxes resulting from the lack of consumer spending and property taxes resulting from declining property values. Financial institutions continue to be affected by long-term unemployment and underemployment rates and a stricter regulatory environment. While our market areas have not experienced the same degree of challenge in unemployment as other areas, the effects of these issues have trickled down to households and businesses in our markets. There can be no assurance that the recent economic improvement is sustainable and credit worthiness of our borrowers will not deteriorate. Deterioration in economic conditions could result in an increase in loan delinquencies and non-performing assets, decreases in loan collateral values and a decrease in demand for the Company's products and services, among other things, any of which could have a material adverse impact on our financial condition and results of operations.

*Disruptions and volatility in the domestic interest rate environment and credit markets, including changes in interest spreads and the yield curve, could negatively impact business and the value of certain assets.*

Higher interest rates could negatively affect demand for new loans and reduce the ability of borrowers to repay their current loan obligations. The Company's loan portfolio consists of 54% of loans at variable rates and subject to higher interest costs as interest rates increase. The increase in interest rates could lead to increased delinquencies if highly-leveraged customers are unable to pay the higher interest costs and otherwise meet their obligations. These circumstances could not only result in increased loan defaults and charge-offs, but require increases to the allowance for loan losses which may materially and adversely affect our business, results of operations, and financial condition.

Furthermore, the Board of Governors of the Federal Reserve System in an attempt to help the overall economy has, among other things, kept interest rates low through its targeted Federal funds rate. In addition, deflationary pressures, while possibly lowering our operating costs, could have a significant negative effect on our borrowers, especially our business borrowers, and the values of underlying collateral securing loans, which could negatively affect our financial performance.

*The impact of new capital rules will impose enhanced capital adequacy requirements on us and may materially affect our operations.*

In 2013, the banking regulatory agencies and the Federal Reserve approved a new rule that substantially amend the regulatory risk-based capital rules applicable to us. The final rule implements the "Basel III" regulatory capital reforms and changes required by Dodd-Frank. The final rule includes new minimum risk-based capital and leverage ratios which became effective for us on January 1, 2015, and

Table of Contents

refines the definition of what constitutes "capital" for purposes of calculating these ratios. The new minimum capital requirements to be considered "adequately capitalized" are: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6.0% (which was increased from 4.0%); (iii) a total capital ratio of 8.0%, (which was unchanged from the previous rules); and (iv) a Tier 1 leverage ratio of 4.0%.

The final rule also established a "capital conservation buffer" of 2.5% above the new regulatory minimum capital ratios to be considered "adequately capitalized", and when fully effective in 2019, will result in the following minimum capital ratios: (i) a common equity Tier 1 capital ratio of 7.0%; (ii) a Tier 1 to risk-based assets capital ratio of 8.5%; and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement began to be phased in January 2016 at 0.625% of risk-weighted assets and will increase each year until fully implemented in January 2019. If an institution does not meet or exceed these minimum capital ratios it will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the "adequately capitalized" ratios plus the buffer amount. These limitations will establish a maximum percentage of eligible retained income that can be utilized for such activities.

The application of more stringent capital requirements for us could, among other things, result in lower returns on equity, require the raising of additional capital, and result in regulatory actions such as a prohibition on the payment of dividends or on the repurchase shares if we were unable to comply with such requirements. Furthermore, the imposition of liquidity requirements in connection with the implementation of Basel III could result in our having to restructure our business models or increase our holdings of liquid assets. Implementation of changes in asset risk weightings for risk-based capital calculations, items included or deducted in calculating regulatory capital or additional capital conservation buffers could result in management modifying our business strategy.

*The implementation of final rules under the many provisions of Dodd-Frank could adversely affect us.*

Regulation of the financial services industry is undergoing major changes from the enactment and ongoing implementation of Dodd-Frank. Certain provisions of Dodd-Frank are effective and have been fully implemented, including the revisions in the deposit insurance assessment base for FDIC insurance and the permanent increase in FDIC coverage to \$250,000; the permissibility of paying interest on business checking accounts; the removal of remaining barriers to interstate branching and required disclosure and shareholder advisory votes on executive compensation. Other recent actions to implement the final Dodd-Frank provisions included: (i) final new capital rules; (ii) a final rule to implement the "Volcker Rule" restrictions on certain proprietary trading and investment activities; and (iii) the promulgation of final rules and increased enforcement action by the CFPB. The full implementation of certain final rules is delayed or phased in over several years; therefore, as yet we cannot definitively assess what may be the short or longer term specific or aggregate effect of the full implementation of Dodd-Frank on us.

**Risks Related to Our Market and Business**

*We are subject to credit risk.*

There are inherent risks associated with our lending activities. These risks include, among other things, the impact of changes in interest rates and changes in the economic conditions in the markets where we operate as well as those across the United States and abroad. Increases in interest rates and/or weakening economic conditions could adversely impact the ability of borrowers to repay outstanding loans or the value of the collateral securing these loans. We are also subject to various laws and regulations that affect our lending activities. Failure to comply with applicable laws and regulations could subject us to regulatory enforcement action that could result in the assessment of significant civil money penalties against us.

Table of Contents

We seek to mitigate the risks inherent in our loan portfolio by adhering to specific underwriting practices. Although we believe that our underwriting criteria are appropriate for the various kinds of loans we make, we may incur losses on loans that meet our underwriting criteria, and these losses may exceed the amounts set aside as reserves in our allowance for loan losses. The value of real estate collateral supporting many construction and land development loans, land loans, commercial loans and multi-family loans may decline. Negative developments in the financial industry and credit markets may adversely impact our business, results of operations and financial condition.

*Our allowance for loan losses may not be adequate to cover actual loan losses which could adversely affect our earnings.*

We maintain an allowance for loan losses for probable incurred losses in the portfolio. The allowance is established through a provision for loan losses based on management's evaluation of the risks inherent in the loan portfolio and the general economy. The allowance is also appropriately increased for new loan growth. The allowance is based upon a number of factors, including the size of the loan portfolio, asset classifications, economic trends, industry experience and trends, industry and geographic concentrations, estimated collateral values, management's assessment of the credit risk inherent in the portfolio, historical loan loss experience and loan underwriting policies. The allowance is only an estimate of the probable incurred losses in the loan portfolio and may not represent actual losses realized over time, either of losses in excess of the allowance or of losses less than the allowance.

In addition, we evaluate all loans identified as impaired loans and allocate an allowance based upon our estimation of the potential loss associated with those problem loans. While we strive to carefully manage and monitor credit quality and to identify loans that may be deteriorating, at any time there are loans included in the portfolio that may result in losses, but that have not yet been identified as non-performing or potential problem loans. Through established credit practices, we attempt to identify deteriorating loans and adjust the allowance for loan losses accordingly. However, because future events are uncertain and because we may not successfully identify all deteriorating loans in a timely manner, there may be loans that deteriorate in an accelerated time frame. We cannot be sure that we will be able to identify deteriorating loans before they become nonperforming assets, or that we will be able to limit losses on those loans that have been so identified. Changes in economic, operating and other conditions which are beyond our control, including interest rate fluctuations, deteriorating values in underlying collateral (most of which consists of real estate), and changes in the financial condition of borrowers, may cause our estimate of probable losses or actual loan losses to exceed our current allowance. As a result, future additions to the allowance may be necessary. Further, because the loan portfolio contains a number of 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. Our regulators, as an integral part of their examination process, periodically review our allowance for loan losses and may require us to increase our allowance for loan losses by recognizing additional provisions for loan losses charged to expense, or to decrease our allowance for loan losses by recognizing loan charge-offs, net of recoveries. Any such additional provisions for loan losses or charge-offs, as required by these regulatory agencies, could have a material adverse effect on our business, results of operations and financial condition.

In December 2012, the Financial Accounting Standards Board ("FASB") issued a proposed Accounting Standards Update, Financial Instruments: Credit Losses, which establishes a new impairment framework also known as the "current expected credit loss model." In contrast to the incurred loss model currently used by financial entities like us, the current expected credit loss model requires an allowance be recognized based on the expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect from financial assets or commitments to extend credit). It requires the consideration of more forward-looking information than is permitted under current U.S. generally accepted accounting principles. In addition to relevant information about past events and current conditions, such as borrowers'

Table of Contents

current creditworthiness, quantitative and qualitative factors specific to borrowers, and the economic environment in which the entity operates, the new model requires consideration of reasonable and supportable forecasts that affect the expected collectability of the financial assets' remaining contractual cash flows, and evaluation of the forecasted direction of the economic cycle, as well as time value of money. This proposed impairment framework is expected to have wide reaching implications to financial institutions such as us. The allowance for loan losses could potentially increase due to a larger volume of financial assets that fall within the scope of the proposed model, resulting in an adverse impact on net income, volatility in earnings and higher capital requirements. The full effect of the implementation of this new model is unknown until the proposed guidance is finalized.

***Nonperforming assets take significant time to resolve and adversely affect our results of operations and financial condition.***

At December 31, 2015, nonperforming loans were 0.47% of the total loan portfolio and nonperforming assets were 0.29% of total assets. Nonperforming assets adversely affect our earnings in various ways. We do not record interest income on nonaccrual loans or foreclosed assets, thereby adversely affecting our income, and increasing our loan administration costs. Upon foreclosure or similar proceedings, we record the repossessed asset at the estimated fair value, less costs to sell, which may result in a write down or losses. A significant increase in the level of nonperforming assets from current levels would increase our risk profile and may impact the capital levels our regulators believe are appropriate in light of the increased risk profile. While we reduce problem assets through collection efforts, asset sales, workouts, restructurings and otherwise, decreases in the value of the underlying collateral, or in these borrowers' performance or financial condition, whether or not due to economic and market conditions beyond our control, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management and our directors, which can be detrimental to the performance of their other responsibilities.

***Our business is subject to interest rate risk and variations in interest rates may negatively affect our financial performance.***

Our earnings and cash flows are highly dependent upon net interest income. Net interest income is the difference between interest income earned on interest earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds.

Interest rates are sensitive to many factors outside our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve, which regulates the supply of money and credit in the United States. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and securities and interest we pay on deposits and borrowings, but could also affect our ability to originate loans and obtain deposits, and the fair value of our financial assets and liabilities. Our portfolio of securities is subject to interest rate risk and will generally decline in value if market interest rates increase, and generally increase in value if market interest rates decline.

In response to the recessionary state of the national economy, the housing market and the volatility of financial markets, the Federal Open Market Committee of the Federal Reserve ("FOMC") started a series of decreases in Federal funds target rate with seven decreases in 2008, bringing the target rate to a historically low range of 0% to 0.25% until December 2015. In December 2015, the FOMC increased the Federal funds rate to a range of 0.25% to 0.50%.

Changes in interest rates and monetary policy can impact the demand for new loans, the credit profile of our borrowers, the yields earned on loans and securities and rates paid on deposits and borrowings. Given our current volume and mix of interest bearing liabilities and interest earning assets, we would



Table of Contents

expect our interest rate spread (the difference in the rates paid on interest bearing liabilities and the yields earned on interest earning assets) as well as net interest income to increase if interest rates rise and, conversely, to decline if interest rates fall. Additionally, increasing levels of competition in the banking and financial services business may decrease our net interest spread as well as net interest margin by forcing us to offer lower lending interest rates and pay higher deposit interest rates. Although we believe our current level of interest rate sensitivity is reasonable, significant fluctuations in interest rates (such as a sudden and substantial increase in Prime and Overnight Fed Funds rates) as well as increasing competition may require us to increase rates on deposits at a faster pace than the yield we receive on interest earning assets increases. The impact of any sudden and substantial move in interest rates and/or increased competition may have an adverse effect on our business, results of operations and financial condition as our net interest income (including the net interest spread and margin) may be negatively impacted.

Additionally, a sustained decrease in market interest rates could adversely affect our earnings. When interest rates decline borrowers tend to refinance higher-rate, fixed-rate loans to lower rates, prepaying their existing loans. Under those circumstances we would not be able to reinvest those prepayments in assets earning interest rates as high as the rates on the prepaid loans. In addition, our commercial real estate and commercial loans, which carry interest rates that, in general, adjust in accordance with changes in the prime rate, will adjust to lower rates. We are also significantly affected by the level of loan demand available in our market. The inability to make sufficient loans directly affects the interest income we earn. Lower loan demand will generally result in lower interest income realized as we place funds in lower yielding investments.

***Increased deposit insurance costs and changes in deposit regulation may adversely affect our results of operations.***

As a result of recent economic conditions and the enactment of Dodd-Frank, the FDIC has increased the deposit insurance assessment rates in recent years and thus raised deposit premiums for insured depository institutions. If these increases are insufficient for the Deposit Insurance Fund to meet its funding requirements, further special assessments or increases in deposit insurance premiums may be required which we may be required to pay. We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional banks or financial institution failures, we may be required to pay even higher FDIC premiums than the recently increased levels. Any future additional assessments, increases or required prepayments in FDIC insurance premiums may materially adversely affect our results of operations.

***Liquidity risk could impair our ability to fund operations and jeopardize our financial condition.***

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the sale of loans and other sources could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities could be impaired by factors that affect us specifically or the financial services industry in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity due to a downturn in markets in which our loans are concentrated or adverse regulatory action against us. Our ability to acquire deposits or borrow could also be impaired by factors that are not specific to us, such as a severe disruption of the financial markets or negative views and expectations about the prospects for the financial services industry as a whole. Many if not all of these same factors could also significantly raise the cost of deposits to our Company and/or to the banking industry in general. This in turn could negatively affect the amount of interest we pay on our interest-bearing liabilities which could have an adverse impact on our interest rate spread and profitability.

***If we lost a significant portion of our low-cost deposits, our liquidity and profitability would be negatively impacted.***

Our profitability depends in part on our success in attracting and retaining a stable base of low-cost deposits. At December 31, 2015, 40% of our deposit base was comprised of noninterest bearing deposits.

Table of Contents

While we generally do not believe these core deposits are sensitive to interest rate fluctuations, the competition for these deposits in our markets is strong and customers are increasingly seeking investments that are safe, including the purchase of U.S. Treasury securities and other government guaranteed obligations as well as the establishment of accounts at the largest, most-well capitalized banks. If we were to lose a significant portion of our low-cost deposits, our liquidity and profitability would be negatively impacted.

***Our results of operations may be adversely affected by other-than-temporary impairment charges relating to our securities portfolio.***

We may be required to record future impairment charges on our securities if they suffer declines in value that we consider other-than-temporary. Numerous factors, including the lack of liquidity for re-sales of certain securities, the absence of reliable pricing information for securities, adverse changes in the business climate, adverse regulatory actions or unanticipated changes in the competitive environment, could have a negative effect on our securities portfolio and results of operations in future periods. Significant impairment accounting charges could also negatively impact our regulatory capital ratios.

***We depend on cash dividends from our subsidiary bank to pay cash dividends to our shareholders and to meet our cash obligations.***

As a holding company, dividends from our subsidiary bank provide a substantial portion of our cash flow used to pay cash dividends on our common and preferred stock and other obligations. Various statutory provisions restrict the amount of dividends HBC can pay to HCC without regulatory approval. See "Item 1 Business Supervision and Regulation Dividends."

***We may need to raise additional capital in the future and such capital may not be available when needed or at all.***

We may need to raise additional capital in the future to provide us with sufficient capital resources and liquidity to meet our commitments and business needs. Our ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital markets at that time which are outside of our control, and our financial performance. We cannot be assured that such capital will be available to us on acceptable terms or at all. Any occurrence that may limit our access to the capital markets may adversely affect our capital costs and our ability to raise capital. Moreover, if we need to raise capital in the future, we may have to do so when many other financial institutions are also seeking to raise capital and would have to compete with those institutions for investors. An inability to raise additional capital on acceptable terms when needed could have a material adverse effect on our business, results of operations and financial condition.

***Our profitability is dependent upon the economic conditions of the markets in which we operate.***

We operate primarily in Santa Clara County, Contra Costa County, Alameda County, and San Benito County and, as a result, our financial condition and results of operations are subject to changes in the economic conditions in those areas. Our success depends upon the business activity, population, income levels, deposits and real estate activity in these markets. Although our customers' business and financial interests may extend well beyond these market areas, adverse economic conditions that affect these market areas could reduce our growth rate, affect the ability of our customers to repay their loans to us and generally affect our financial condition and results of operations. Our lending operations are located in market areas dependent on technology and real estate industries and their supporting companies. Thus, our borrowers could be adversely impacted by a downturn in these sectors of the economy that could reduce the demand for loans and adversely impact the borrowers' ability to repay their loans, which would, in turn, increase our nonperforming assets. Because of our geographic concentration, we are less able than regional or national financial institutions to diversify our credit risks across multiple markets.

Table of Contents

***The small to medium-sized businesses to which we lend may have fewer financial resources to weather a downturn in the economy which could materially harm our operating results and financial condition.***

We serve the banking and financial services needs of small and medium-sized businesses. Small to medium-sized businesses frequently have smaller market shares than their competition, may be more vulnerable to economic downturns, often need substantial additional capital to expand and compete and may experience significant volatility in operating results. Any one or more of these factors may impair a borrower's ability to repay a loan. In addition, the success of a small to medium-sized business often depends on the management talents and efforts of one or two persons or a small group of persons, and the death, disability or resignation of one or more of these persons could have a material adverse impact on the business and its ability to repay a loan. Economic downturns and other events that negatively impact our market areas could cause us to incur substantial credit losses that could negatively affect our results of business, results of operations and financial condition.

***Our loan portfolio has a large concentration of real estate loans in California which involve risks specific to real estate values.***

A downturn in our real estate markets in California could adversely affect our business because many of our loans are secured by real estate. Real estate lending (including commercial, land development and construction) is a large portion of our loan portfolio. At December 31, 2015, approximately \$786.9 million, or 58% of our loan portfolio, was secured by various forms of real estate, including residential and commercial real estate. Included in the \$786.9 million of loans secured by real estate were \$349.7 million (or 44%) of owner-occupied loans. The real estate securing our loan portfolio is concentrated in California. The market value of real estate can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Real estate values and real estate markets are generally affected by changes in national, regional or local economic conditions, the rate of unemployment, fluctuations in interest rates and the availability of loans to potential purchasers, changes in tax laws and other governmental statutes, regulations and policies and acts of nature, such as earthquakes and natural disasters particular to California. Additionally, commercial real estate lending typically involves larger loan principal amounts and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. If real estate values including values of land held for development decline, the value of real estate collateral securing our loans could be significantly reduced. Our ability to recover on defaulted loans by foreclosing and selling the real estate collateral would then be diminished and we would be more likely to suffer losses on defaulted loans.

In addition, banking regulators now give commercial real estate loans extremely close scrutiny due to risks relating to the cyclical nature of the real estate market, and related risks for lenders with high concentrations of such loans. The regulators have required banks with relatively high levels of commercial real estate loans to implement enhanced underwriting standards, internal controls, risk management policies and portfolio stress testing, which has resulted in higher allowances for possible loan losses. Any increase in our allowance for loan losses would adversely affect our net income, and any requirement that we maintain higher capital levels could adversely impact our business, results of operations and financial condition.

***Our construction and land development loans are based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate and we may be exposed to more losses on these projects than on other loans.***

At December 31, 2015, land and construction loans, including land acquisition and development totaled \$84.4 million or 6% of our loan portfolio. This amount was comprised of 16% owner occupied and 84% non-owner occupied construction and land loans. Risk of loss on a construction loan depends largely upon whether our initial estimate of the property's value at completion of construction equals or exceeds

Table of Contents

the cost of the property construction (including interest) and the availability of permanent take-out financing. During the construction phase, a number of factors can result in delays and cost overruns. Because of the uncertainties inherent in estimating construction costs, as well as the market value of the completed project, it is relatively difficult to evaluate accurately the total funds required to complete a project and the related loan-to-value ratio. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent primarily on the completion of the project and the ability of the borrower to sell the property, rather than the ability of the borrower or guarantor to repay principal and interest. If estimates of value are inaccurate or if actual construction costs exceed estimates, the value of the property securing the loan may be insufficient to ensure full repayment. If our appraisal of the value of the completed project proves to be overstated, our collateral may be inadequate for the repayment of the loan upon completion of construction of the project. If we are forced to foreclose on a project prior to or at completion due to a default, there can be no assurance that we will be able to recover all of the unpaid balance of and accrued interest on the loan as well as related foreclosure and holding costs. In addition, we may be required to fund additional amounts to complete the project and may have to hold the property for an unspecified period of time.

***Our use of appraisals in deciding whether to make a loan on or secured by real property does not ensure the value of the real property collateral.***

In considering whether to make a loan secured by real property we generally require an appraisal of the property. However, an appraisal is only an estimate of the value of the property at the time the appraisal is conducted, and an error in fact or judgment could adversely affect the reliability of an appraisal. In addition, events occurring after the initial appraisal may cause the value of the real estate to decrease. As a result of any of these factors the value of collateral backing a loan may be less than estimated, and if a default occurs we may not recover the outstanding balance of the loan.

***Repayment of our commercial loans is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value.***

At December 31, 2015, commercial loans totaled \$556.5 million or 41% of our loan portfolio, (including SBA guaranteed loans and factored receivables). Commercial lending involves risks that are different from those associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial loans are primarily made based on the cash flows of the borrowers and secondarily on any underlying collateral provided by the borrowers. A borrower's cash flows may be unpredictable, and collateral securing those loans may fluctuate in value. Although commercial loans are often collateralized by equipment, inventory, accounts receivable, or other business assets, the liquidation of collateral in the event of default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories may be obsolete or of limited use, among other things.

***We must effectively manage our growth strategy.***

We seek to expand our franchise safely and consistently. A successful growth strategy requires us to manage multiple aspects of the business simultaneously, such as following adequate loan underwriting standards, balancing loan and deposit growth without increasing interest rate risk or compressing our net interest margin, maintaining sufficient capital, and recruiting, training and retaining qualified professionals.

As part of our general growth strategy we may expand into additional communities or attempt to strengthen our position in our current markets by opening new offices, subject to any regulatory constraints on our ability to open new offices. To the extent that we are able to open additional offices, we are likely to

Table of Contents

experience the effects of higher operating expenses relative to operating income from the new operations for a period of time which may have an adverse effect on our levels of reported net income, return on average equity and return on average assets.

***New lines of business or new products and services may subject us to additional risks.***

From time to time, we may implement or may acquire new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and new products and services we may invest significant time and resources. We may not achieve target timetables for the introduction and development of new lines of business and new products or services and price and profitability targets may not prove feasible. External factors, such as regulatory compliance obligations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of our system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on our business, results of operations and financial condition.

***If we are unable to identify and acquire other financial institutions and successfully integrate our acquired businesses, our business and earnings may be negatively affected.***

We plan to continue to grow our business organically. However, from time to time, we may consider potential acquisition opportunities that we believe support our business strategy and may enhance our profitability. We face significant competition from numerous other financial services institutions, many of which will have greater financial resources than we do, when considering acquisition opportunities. Accordingly, attractive acquisition opportunities may not be available to us. There can be no assurance that we will be successful in identifying or completing any future acquisitions.

Acquisitions of financial institutions involve operational risks and uncertainties and acquired companies may have unforeseen liabilities, exposure to asset quality problems, key employee and customer retention problems and other problems that could negatively affect our organization. We may not be able to complete future acquisitions and, if we do complete such acquisitions, we may not be able to successfully integrate the operations, management, products and services of the entities that we acquire and eliminate redundancies. The integration process could result in the loss of key employees or disruption of the combined entity's ongoing business or inconsistencies in standards, controls, procedures, and policies that adversely affect our ability to maintain relationships with customers and employees or achieve the anticipated benefits of the transaction. The integration process may also require significant time and attention from our management that they would otherwise direct at servicing existing business and developing new business. We may not be able to realize any projected cost savings, synergies or other benefits associated with any such acquisition we complete. Acquisitions typically involve the payment of a premium over book and market values and, therefore, some dilution of our tangible book value and net income per common share may occur in connection with any future transaction. Our inability to find suitable acquisition candidates and failure to successfully integrate the entities we acquire into our existing operations may increase our operating costs significantly and adversely affect our business and earnings.

In addition, we must generally satisfy a number of meaningful conditions prior to completing any acquisition, including, in certain cases, federal and state bank-regulatory approval. Bank regulators consider a number of factors when determining whether to approve a proposed transaction, including the effect of the transaction on financial stability and the ratings and compliance history of all institutions involved, including the CRA, examination results and anti-money laundering and Bank Secrecy Act compliance records of all institutions involved. The process for obtaining required regulatory approvals has become substantially more difficult as a result of the financial crisis, which could affect our future business.

Table of Contents

We may fail to pursue, evaluate or complete strategic and competitively significant business opportunities as a result of our inability, or our perceived inability, to obtain any required regulatory approvals in a timely manner or at all.

***We may experience goodwill impairment.***

If our estimates of segment fair value change due to changes in our businesses or other factors, we may determine that impairment charges on goodwill recorded as a result of acquisitions are necessary. Estimates of fair value are determined based on a complex model using cash flows, the fair value of our Company as determined by our stock price, and company comparisons. If management's estimates of future cash flows are inaccurate, fair value determined could be inaccurate and impairment may not be recognized in a timely manner. If the fair value of the Company declines, we may need to recognize goodwill impairment in the future which would have a material adverse effect on our results of operations and capital levels.

***Our decisions regarding the fair value of assets acquired could be different than initially estimated, which could materially and adversely affect our business, financial condition, results of operations, and future prospects.***

In business combinations, we acquire significant portfolios of loans that are marked to their estimated fair value. There is no assurance that the acquired loans will not suffer deterioration in value. The fluctuations in national, regional and local economic conditions, including those related to local residential, commercial real estate and construction markets, may increase the level of charge-offs in the loan portfolio that we acquire and correspondingly reduce our net income. These fluctuations are not predictable, cannot be controlled and may have a material adverse impact on our operations and financial condition, even if other favorable events occur.

***We have a significant deferred tax asset and cannot assure that it will be fully realized.***

Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between the carrying amounts and tax basis of assets and liabilities computed using enacted tax rates. We regularly assess available positive and negative evidence to determine whether it is more likely than not that our net deferred tax asset will be realized. Realization of a deferred tax asset requires us to apply significant judgment and is inherently speculative because it requires estimates that cannot be made with certainty. At December 31, 2015, we had a net deferred tax asset of \$22.2 million. If we were to determine at some point in the future that we will not achieve sufficient future taxable income to realize our net deferred tax asset, we would be required, under generally accepted accounting principles, to establish a full or partial valuation allowance which would require us to incur a charge to operations for the period in which the determination was made.

***We may be adversely affected by the soundness of other financial institutions.***

Our ability to engage in routine funding transactions could be adversely affected by the actions and liquidity of other financial institutions. Financial institutions are often interconnected as a result of trading, clearing, counterparty, or other business relationships. We have exposure to many different industries and counterparties, and routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Defaults by financial services institutions, even rumors or questions about one or more financial institutions or the financial services industry in general, could lead to market wide liquidity problems and further, could lead to losses or defaults by the Company or other institutions. Many of these transactions expose us to credit risk in the event of default of the applicable counterparty or client. In addition our credit risk may increase when the collateral held by us cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the loan or derivative exposure due to us. Any such losses could materially and adversely affect our financial condition.

Table of Contents

***We face strong competition from financial service companies and other companies that offer banking services.***

We face substantial competition in all phases of our operations from a variety of different competitors. Our competitors, including larger commercial banks, community banks, savings and loan associations, mutual savings banks, credit unions, consumer finance companies, insurance companies, securities dealers, brokers, mortgage bankers, investment advisors, money market mutual funds and other financial institutions, compete with lending and deposit gathering services offered by us. Many of these competing institutions have much greater financial and marketing resources than we have. Due to their size, many competitors can achieve larger economies of scale and may offer a broader range of products and services than we can. If we are unable to offer competitive products and services, our business may be negatively affected. Some of the financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on bank holding companies and federally insured financial institutions or are not subject to increased supervisory oversight arising from regulatory examinations. As a result, these non-bank competitors have certain advantages over us in accessing funding and in providing various services.

We anticipate intense competition will be continued for the coming year due to the recent consolidation of many financial institutions and more changes in legislature, regulation and technology. Further, we expect loan demand to continue to be challenging due to the uncertain economic climate and the intensifying competition for creditworthy borrowers, both of which could lead to loan rate concession pressure and could impact our ability to generate profitable loans. We expect we may see tighter competition in the industry as banks seek to take market share in the most profitable customer segments, particularly the small business segment and the mass-affluent segment, which offers a rich source of deposits as well as more profitable and less risky customer relationships. Further, with the rebound of the equity markets our deposit customers may perceive alternative investment opportunities as providing superior expected returns. Technology and other changes have made it more convenient for bank customers to transfer funds into alternative investments or other deposit accounts such as online virtual banks and non-bank service providers. The current low interest rate environment could increase such transfers of deposits to higher yielding deposits or other investments. Efforts and initiatives we undertake to retain and increase deposits, including deposit pricing, can increase our costs. When our customers move money into higher yielding deposits or in favor of alternative investments, we can lose a relatively inexpensive source of funds, thus increasing our funding costs.

New technology and other changes are allowing parties to effectuate financial transactions that previously required the involvement of banks. For example, consumers can maintain funds in brokerage accounts or mutual funds that would have historically been held as bank deposits. Consumers can also complete transactions such as paying bills and transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as "disintermediation," could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and access to lower cost deposits as a source of funds could have a material adverse effect on our business, results of operations and financial condition.

***We are subject to extensive government regulation that could limit or restrict our activities which in turn may adversely impact our ability to increase our assets and earnings.***

We operate in a highly regulated environment and are subject to supervision and regulation by a number of governmental regulatory agencies, including the Federal Reserve, the DBO and the FDIC. Regulations adopted by these agencies, which are generally intended to provide protection for depositors and customers rather than for the benefit of shareholders, govern a comprehensive range of matters relating to ownership and control of our common stock, our acquisition of other companies and businesses, permissible activities for us to engage in, maintenance of adequate capital levels, and other aspects of our operations. These bank regulators possess broad authority to prevent or remedy unsafe or unsound practices or violations of law. The laws and regulations applicable to the banking industry could change at

Table of Contents

any time and we cannot predict the effects of these changes on our business and profitability. Increased regulation could increase our cost of compliance and adversely affect profitability. Moreover, certain of these regulations contain significant punitive sanctions for violations, including monetary penalties and limitations on a bank's ability to implement components of its business plan, such as expansion through mergers and acquisitions or the opening of new branch offices. In addition, changes in regulatory requirements may add costs associated with compliance efforts. Furthermore, government policy and regulation, particularly as implemented through the Federal Reserve System, significantly affect credit conditions. As a result of the negative financial market and general economic trends, there is a potential for new federal or state laws and regulation regarding lending and funding practices and liquidity standards. Bank regulatory agencies have been and are expected to be aggressive in responding to concerns and trends identified in examinations, including the expected issuance of formal enforcement orders. Negative developments in the financial industry and the impact of new legislation and regulation in response to those developments could negatively impact our business, business, results of operations and financial condition.

***We face a risk of noncompliance and enforcement action with the Bank Secrecy Act and other anti-money laundering statutes and regulations.***

The Bank Secrecy Act, the USA Patriot Act of 2001, and other laws and regulations require financial institutions, among other duties, to institute and maintain an effective anti-money laundering program and file suspicious activity and currency transaction reports as appropriate. The federal Financial Crimes Enforcement Network is authorized to impose significant civil money penalties for violations of those requirements and has recently engaged in coordinated enforcement efforts with the individual federal banking regulators as well as the U.S. Department of Justice, Drug Enforcement Administration, and Internal Revenue Service. We are also subject to increased scrutiny of compliance with the rules enforced by the Office of Foreign Assets Control and compliance with the Foreign Corrupt Practices Act. If our policies, procedures and systems are deemed deficient, we would be subject to liability, including fines and regulatory actions, which may include restrictions on our ability to pay dividends and the necessity to obtain regulatory approvals to proceed with certain aspects of our business plan. Failure to maintain and implement adequate programs to combat money laundering and terrorist financing could also have serious reputational consequences for us. Any of these results could materially and adversely affect our business, results of operations and financial condition.

***Loans that we make through certain federal programs are dependent on the federal government's continuation and support of these programs and on our compliance with their requirements.***

We participate in various U.S. government agency guarantee programs, including programs operated by the Small Business Administration. We are responsible for following all applicable U.S. government agency regulations, guidelines and policies whenever we originate loans as part of these guarantee programs. If we fail to follow any applicable regulations, guidelines or policies associated with a particular guarantee program, any loans we originate as part of that program may lose the associated guarantee exposing us to credit risk we would not otherwise be exposed to or underwritten as part of our origination process for U.S. government agency guaranteed loans, or result in our inability to continue originating loans under such programs. The loss of any guarantees for loans we have extended under U.S. government agency guarantee programs or the loss of our ability to participate in such programs could have a material adverse effect on our business, results of operations and financial condition.

***Technology is continually changing and we must effectively implement new technologies.***

The financial services industry is undergoing technological changes with frequent introductions of new technology driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables us to reduce costs. Our future success will depend in part upon



Table of Contents

our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in our operations as we continue to grow and expand our market areas. In order to anticipate and develop new technology, we employ a qualified staff of internal information system specialists and consider this area a core part of our business. We do not develop our own software products, but have been able to respond to technological changes in a timely manner through association with leading technology vendors. Some of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers. If we are unable to make such investments, or we are unable to respond to technological changes in a timely manner, our operating costs may increase which could adversely affect our business, results of operations and financial condition.

*If our information systems were to experience a system failure, our business and reputation could suffer.*

We rely heavily on communications and information systems to conduct our business. The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to minimize service disruptions by protecting our computer equipment, systems, and network infrastructure from physical damage due to fire, power loss, telecommunications failure or a similar catastrophic event. We have protective measures in place to prevent or limit the effect of the failure or interruption of our information systems, and will continue to upgrade our security technology and update procedures to help prevent such events. However, if such failures or interruptions were to occur, they could result in damage to our reputation, a loss of customers, increased regulatory scrutiny, or possible exposure to financial liability, any of which could have a material adverse effect on our business, financial condition and results of operations.

*The occurrence of fraudulent activity, breaches or failures of our information security controls or cybersecurity-related incidents could have a material adverse effect on our business, financial condition and results of operations.*

As a financial institution we are susceptible to fraudulent activity, information security breaches and cybersecurity-related incidents that may be committed against us or our customers which may result in financial losses or increased costs to us or our customers, disclosure or misuse of our information or our customer information, misappropriation of assets, privacy breaches against our customers, litigation, or damage to our reputation. Such fraudulent activity may take many forms, including check fraud, electronic fraud, wire fraud, on-line banking, phishing, social engineering and other dishonest acts. Information security breaches and cybersecurity-related incidents may include fraudulent or unauthorized access to systems used by us or our customers, denial or degradation of service attacks, and malware or other cyber-attacks. In recent periods, there continues to be a rise in electronic fraudulent activity, security breaches and cyber-attacks within the financial services industry, especially in the commercial banking sector due to cyber criminals targeting commercial bank accounts. Consistent with industry trends we have also experienced an increase in attempted electronic fraudulent activity, security breaches and cybersecurity-related incidents in recent periods. Moreover, in recent periods, several large corporations, including financial institutions and retail companies, have suffered major data breaches, in some cases exposing not only confidential and proprietary corporate information, but also sensitive financial and other personal information of their customers and employees and subjecting them to potential fraudulent activity. Some of our customers may have been affected by these breaches which increase their risks of identity theft, credit card fraud and other fraudulent activity that could involve their accounts with us.

Information pertaining to us and our customers is maintained and transactions are executed on the networks and systems of ours, our customers and certain of our third party partners, such as our online banking or core systems. The secure maintenance and transmission of confidential information as well as execution of transactions over these systems are essential to protect us and our customers against fraud and security breaches and to maintain our customers' confidence. Breaches of information security also

Table of Contents

may occur, and in infrequent, incidental, cases have occurred, through intentional or unintentional acts by those having access to our systems or our customers' or counterparties' confidential information, including employees. In addition, increases in criminal activity levels and sophistication, advances in computer capabilities, new discoveries, vulnerabilities in third-party technologies (including browsers and operating systems) or other developments could result in a compromise or breach of the technology, processes and controls that we use to prevent fraudulent transactions and to protect data about us, our customers and underlying transactions as well as the technology used by our customers to access our systems. Although we have developed and continue to invest in systems and processes that are designed to detect and prevent security breaches and cyber-attacks and periodically test our security, our inability to anticipate, or failure to adequately mitigate, breaches of security could result in: losses to us or our customers; our loss of business and/or customers; damage to our reputation; the incurrence of additional expenses; disruption to our business; our inability to grow our online services or other businesses; additional regulatory scrutiny or penalties; or our exposure to civil litigation and possible financial liability any of which could have a material adverse effect on our business, financial condition and results of operations.

More generally, publicized information concerning security and cyber-related problems could inhibit the use or growth of electronic or web-based applications or solutions as a means of conducting commercial transactions. Such publicity may also cause damage to our reputation as a financial institution. As a result, our business, financial condition and results of operations could be adversely affected.

***We rely on third party service providers.***

We rely on external vendors to provide certain products and services necessary to maintain our day-to-day operations. Accordingly, our operations are exposed to risk that these vendors will not perform in accordance with the contracted arrangements under service agreements. The failure of external vendors to perform in accordance with the contractual terms of a service agreement because of changes in a vendor's organization structure, financial condition, support for existing products and services or strategic focus or for any other reason could be disruptive to our operations, which could have a material adverse impact on our business, financial condition and results of operations.

Additionally, we outsource our data processing to an external vendor. If this vendor encounters difficulties or if we have difficulty in communicating with the vendor, it will significantly affect our ability to adequately process and account for customer transactions, which would in turn significantly affect our ability to conduct our business operations. Furthermore, a breach of the vendor's technology may also cause reimbursable loss to our consumer and business customers through no fault of our own. Fraud attacks targeting customer-controlled devices, plastic payment card terminals and merchant data collection points provide another source of potential loss, again through no fault of our own. Liability arising from such a security breach or fraud attack could have a material adverse impact on our business, financial condition and results of operations.

***We depend on the accuracy and completeness of information about customers and counterparties.***

In deciding whether to extend credit or enter into other transactions with customers and counterparties, we may rely on information furnished to us by or on behalf of customers and counterparties, including financial statements and other financial information. We also may rely on representations of customers and counterparties as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. For example, under our accounts receivable financing arrangements, we rely on information, such as invoices, contracts and other supporting documentation, provided by our customers and their account debtors to determine the amount of credit to extend. Similarly, in deciding whether to extend credit, we may rely upon our customers' representations that their financial statements conform to U.S. GAAP (or other applicable accounting standards in foreign markets) and present fairly, in all material respects, the financial condition, results of operations and cash flows of the customer. Our financial condition, results of operations, financial

Table of Contents

reporting or reputation could be negatively affected if we rely on materially misleading, false, inaccurate or fraudulent information.

***Our controls and procedures may fail or be circumvented.***

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

***Our accounting estimates and risk management processes rely on analytical and forecasting models.***

Processes that management uses to estimate our probable credit losses and to measure the fair value of financial instruments, as well as the processes used to estimate the effects of changing interest rates and other market measures on our financial condition and results of operations, depend upon the use of analytical and forecasting models. These models reflect assumptions that may not be accurate, particularly in times of market stress or other unforeseen circumstances. Even if these assumptions are accurate, the models may prove to be inadequate or inaccurate because of other flaws in their design or their implementation.

If the models that management uses for interest rate risk and asset-liability management are inadequate, we may incur increased or unexpected losses upon changes in market interest rates or other market measures. If the models that management uses for determining our probable credit losses are inadequate, the allowance for loan losses may not be sufficient to support future charge-offs. If the models that management uses to measure the fair value of financial instruments are inadequate, the fair value of such financial instruments may fluctuate unexpectedly or may not accurately reflect what we could realize upon sale or settlement of such financial instruments. Any such failure in management's analytical or forecasting models could have a material adverse effect on our business, financial condition and results of operations.

***Changes in accounting standards could materially impact our financial statements.***

From time to time, the Financial Accounting Standards Board or the SEC may change the financial accounting and reporting standards that govern the preparation of our financial statements. In addition, the bodies that interpret the accounting standards (such as banking regulators or outside auditors) may change their interpretations or positions on how these standards should be applied. These changes may be beyond our control, can be difficult to predict and can materially impact how we record and report our financial condition or results of operations. In some cases, we could be required to apply a new or revised standard retrospectively, or apply an existing standard differently, also retrospectively, in each case resulting in our revising or restating prior period financial statements.

***Adverse results from litigation or governmental investigations can impact our business practices and operating results.***

We are currently involved in certain legal proceedings and may from time to time be involved in governmental investigations and inquiries relating to matters that arise in connection with the conduct of our business. While we have not recognized a material accrual liability for lawsuits and claims filed or pending against us to date, the outcome of litigation and other legal and regulatory matters is inherently uncertain and it is possible that the actual results of one or more of such matters currently pending or threatened may be substantially higher than the amounts reserved, or judgments may be rendered, or fines or penalties assessed in matters for which we have no reserves. Adverse outcomes in lawsuits or

Table of Contents

investigations may result in significant monetary damages or injunctive relief that may adversely affect our operating results or financial condition as well as our ability to conduct our businesses as they are presently being conducted.

***Our risk management framework may not be effective which could have a material adverse effect on our strategic planning and our mitigation of risks and/or losses as well as have adverse regulatory consequences.***

Our risk management framework seeks to mitigate risk and loss to us. We have established processes and procedures intended to identify, measure, monitor, report and analyze the types of risk to which we are subject, including liquidity risk, credit risk, market risk, interest rate risk, operational risk, legal and compliance risk, and reputational risk, among others. However, as with any risk management framework, there are inherent limitations to our risk management strategies as there may exist or develop in the future risks that we have not appropriately anticipated or identified. If our risk management framework is not effective, we could suffer unexpected losses and our business, results of operations and financial condition could be materially adversely affected. We may also be subject to potentially adverse regulatory consequences.

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

In the course of our business, when a borrower defaults on a loan secured by real property, we generally purchase the property in foreclosure or accept a deed to the property surrendered by the borrower. We may also take over the management of properties when owners have defaulted on loans. While we have guidelines intended to exclude properties with an unreasonable risk of contamination, hazardous substances may exist on some of the properties that we own, manage or occupy and unknown hazardous risks could impact the value of real estate collateral. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial and exceed the value of the property. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we become subject to significant environmental liabilities, business, results of operations and financial condition could be adversely affected.

***We are subject to a variety of operational risks, the manifestation of any one of which may adversely affect our business and results of operations.***

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

Because the nature of the financial services business involves a high volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully rectified. Our necessary dependence upon automated systems to record and process transactions and our large transaction volume may further increase the risk that technical flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. We also may be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control (for example, computer viruses or electrical or telecommunications outages, natural disasters, disease pandemics or other damage to property or physical assets), which may give rise to disruption of service to customers and to financial loss or liability. The occurrence of any of these risks could diminish our ability to operate our business (for example, by requiring us to expend significant resources to correct the defect),

Table of Contents

as well as potential liability to customers, reputational damage and regulatory intervention, which in turn could materially and adversely affect our business, financial condition and results of operations.

***Reputational risk can adversely affect our business.***

Threats to our reputation can come from many sources, including adverse sentiment about financial institutions generally, unethical practices, employee misconduct, failure to deliver minimum standards of service or quality, compliance deficiencies, and questionable or fraudulent activities of our customers. We have policies and procedures in place to protect our reputation and promote ethical conduct, but these policies and procedures may not be fully effective. Negative publicity regarding our business, employees, or customers, with or without merit, may result in the loss of customers, investors and employees, costly litigation, a decline in revenues and increased governmental regulation.

***We are dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect our prospects.***

Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the California community banking industry. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a significant degree upon our ability to attract and retain qualified management, loan origination, finance, administrative, marketing and technical personnel and upon the continued contributions of our management and personnel. In particular, our success has been and continues to be highly dependent upon the abilities of key executives, including our Chief Executive Officer and certain other key employees.

***Severe weather, natural disasters, acts of war or terrorism and other external events could significantly impact our business.***

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. For example, our primary market areas in California are subject to earthquakes and fires. Operations in our market could be disrupted by both the evacuation of large portions of the population as well as damage and or lack of access to our banking and operation facilities. While we have not experienced such event to date, other severe weather or natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on our business financial condition and results of operations.

**Risks Related to Our Securities**

***Our securities are not an insured deposit.***

Our securities are not bank deposits and, therefore, are not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in our securities is inherently risky for the reasons described in this section and elsewhere in this report and is subject to the same market forces that affect the price of securities in any company.

***Our outstanding Series C Preferred Stock impacts net income available to our common shareholders and earnings per common share, and conversion of our Series C Preferred Stock will be dilutive to holders of our common stock.***

The dividends declared and the accretion on our outstanding Series C Preferred Stock reduce the net income available to common shareholders and our earnings per common share. Our Series C Preferred

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

### Table of Contents

Stock will also receive preferential treatment in the event of our liquidation, dissolution or winding up. The ownership interest of our existing holders of common stock will be diluted to the extent our Series C Preferred Stock is automatically converted into common stock. The Series C Preferred Stock is convertible into an aggregate of 5,601,000 shares of our common stock upon a transfer of the Series C Preferred Stock to a transferee not affiliated with the holder in a widely dispersed offering. The shares of common stock underlying the Series C Preferred Stock represent approximately 17% of the shares of our common stock outstanding on December 31, 2015.

***The price of our common stock may fluctuate significantly, and this may make it difficult for you to resell shares of common stock owned by you at times or at prices you find attractive.***

The stock market and, in particular, the market for financial institution stocks, has experienced significant volatility. In some cases, the markets have produced downward pressure on stock prices for certain issuers without regard to those issuers' underlying financial strength. As a result, the trading volume in our common stock may fluctuate more than usual and cause significant price variations to occur.

The trading price of the shares of our common stock will depend on many factors, which may change from time to time and which may be beyond our control, including, without limitation, our financial condition, performance, creditworthiness and prospects, future sales or offerings of our equity or equity related securities, and other factors identified above under "Cautionary Note Regarding Forward Looking Statements," "Risk Factors" and below. These broad market fluctuations have adversely affected and may continue to adversely affect the market price of our common stock. Among the factors that could affect our stock price are:

actual or anticipated quarterly fluctuations in our operating results and financial condition;

changes in financial estimates or publication of research reports and recommendations by financial analysts or actions taken by rating agencies with respect to our common stock or those of other financial institutions;

failure to meet analysts' revenue or earnings estimates;

speculation in the press or investment community generally or relating to our reputation, our operations, our market area, our competitors or the financial services industry in general;

strategic actions by us or our competitors, such as acquisitions, restructurings, dispositions or financings;

actions by our current shareholders, including institutional investors;

fluctuations in the stock price and operating results of our competitors;

future sales of our equity, equity related or debt securities;

proposed or adopted regulatory changes or developments;

anticipated or pending investigations, proceedings, or litigation that involve or affect us;

trading activities in our common stock, including short selling;

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

domestic and international economic factors unrelated to our performance; and

general market conditions and, in particular, developments related to market conditions for the financial services industry.

*The trading volume in our common stock is less than that of other larger financial services companies.*

Although our common stock is listed for trading on the Nasdaq, its trading volume is generally less than that of other, larger financial services companies, and investors are not assured that a liquid market

Table of Contents

will exist at any given time for our voting common stock. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace at any given time of willing buyers and sellers of our voting common stock. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the lower trading volume of our voting common stock, significant sales of our voting common stock, or the expectation of these sales, could cause our stock price to fall.

***Federal and state law may limit the ability of another party to acquire us, which could cause the price of our securities to decline.***

Federal law prohibits a person or group of persons "acting in concert" from acquiring "control" of a bank holding company unless the Federal Reserve has been given 60 days prior written notice of such proposed acquisition and within that time period the Federal Reserve has not issued a notice disapproving the proposed acquisition or extending for up to another 30 days the period during which such a disapproval may be issued. An acquisition may be made prior to the expiration of the disapproval period if the Federal Reserve issues written notice of its intent not to disapprove the action. Under a rebuttable presumption established by the Federal Reserve, the acquisition of 10% or more of a class of voting stock of a bank or bank holding company with a class of securities registered under Section 12 of the Exchange Act would, under the circumstances set forth in the presumption, constitute the acquisition of control. In addition, any "company" would be required to obtain the approval of the Federal Reserve under the BHCA, before acquiring 25% (5% in the case of an acquirer that is, or is deemed to be, a bank holding company) or more of any class of voting stock, or such lesser number of shares as may constitute control.

Under the California Financial Code, no person may, directly or indirectly, acquire control of a California state bank or its holding company unless the DBO has approved such acquisition of control. A person would be deemed to have acquired control of HBC if such person, directly or indirectly, has the power: (i) to vote 25% or more of the voting power of HBC; or (ii) to direct or cause the direction of the management and policies of HBC. For purposes of this law, a person who directly or indirectly owns or controls 10% or more of our outstanding common stock would be presumed to control HBC.

These provisions of federal and state law may prevent a merger or acquisition that would be attractive to shareholders and could limit the price investors would be willing to pay in the future for our securities.

***We may raise additional capital, which could have a dilutive effect on the existing holders of our securities and adversely affect the market price of our securities.***

We are not restricted from issuing additional shares of common stock or securities that are convertible into or exchangeable for, or represent the right to receive shares of common stock. We frequently evaluate opportunities to access the capital markets taking into account our regulatory capital ratios, financial condition and other relevant considerations and, subject to market conditions, we may take further capital actions. Such actions could include, among other things, the issuance of additional shares of common stock or other securities in public or private transactions in order to further increase our capital levels above the requirements for a "well capitalized" institution established by the federal bank regulatory agencies as well as other regulatory targets. These issuances could dilute ownership interests of investors and could dilute the per share book value of our common stock.

***The issuance of additional shares of preferred stock could adversely affect holders of common stock, which may negatively impact an investment in our securities.***

Our board of directors is authorized to issue additional classes or series of preferred stock without any action on the part of the shareholders, except in certain circumstances. Our board of directors also has the power, without shareholder approval except in certain circumstances, to set the terms of any such classes or series of preferred stock that may be issued, including voting rights, dividend rights and preferences over



Table of Contents

the common stock with respect to dividends or upon the liquidation, dissolution or winding up of our business and other terms. If we issue preferred stock in the future that has a preference over the common stock with respect to the payment of dividends or upon liquidation, dissolution or winding up, or if we issue preferred stock with voting rights that dilute the voting power of the common stock, then the rights of holders of the common stock or the market price of the common stock could be adversely affected.

**ITEM 1B UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2 PROPERTIES**

The main and executive offices of HCC and HBC are located at 150 Almaden Boulevard in San Jose, California 95113, with branch offices located at 15575 Los Gatos Boulevard in Los Gatos, California 95032, at 387 Diablo Road in Danville, California 94526, at 3137 Stevenson Boulevard in Fremont, California 94538, at 300 Main Street in Pleasanton, California 94566, at 101 Ygnacio Valley Road in Walnut Creek, California 94596, at 18625 Sutter Boulevard in Morgan Hill, California 95037, at 7598 Monterey Street in Gilroy, California 95020, at 419 S. San Antonio Road in Los Altos, California 94022, at 333 W. El Camino Real in Sunnyvale, California 94087, and at 351 Tres Pinos Road in Hollister, California 95023. BVF's administrative offices are located at 2933 Bunker Hill Lane, Santa Clara, CA 95054.

**Main Offices**

The main offices of HBC are located at 150 Almaden Boulevard in San Jose, California on the first three floors in a fifteen-story Class-A type office building. All three floors, consisting of approximately 35,547 square feet, are subject to a direct lease dated April 13, 2000, as amended, which expires on May 31, 2020. The current monthly rent payment is \$104,864 with annual increases of 3% until the lease expires. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In January of 1997, the Company leased approximately 1,255 square feet (referred to as the "Kiosk") located next to the primary operating area at 150 Almaden Boulevard in San Jose, California to be used for meetings, staff training and marketing events. The current monthly rent payment is \$3,702 with annual increases of 3% until the lease expires on May 31, 2020. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In June of 2015, the Company amended its primary lease at 150 Almaden Boulevard in San Jose, California to include 4,484 square feet of expansion space in a five-story Class-B type office building located at 100 W. San Fernando Street, San Jose, California, adjacent to the main offices. The current monthly rent payment is \$10,762 with 3% annual increases until the lease expires on May 31, 2020. The Company has reserved the right to extend the term of the lease for one additional period of five years.

**Branch Offices**

In May of 2006, the Company leased approximately 2,505 square feet on the first floor in a three-story multi-tenant multi-use building located at 7598 Monterey Street in Gilroy, California. The current monthly rent payment is \$5,389 until the lease expires on September 30, 2016. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In June of 2007, as part of the acquisition of Diablo Valley Bank, the Company took ownership of an 8,285 square foot one-story commercial office building, including the land, located at 387 Diablo Road in Danville, California.

In June of 2008, the Company leased approximately 5,213 square feet on the first floor in a two-story multi-tenant office building located at 419 S. San Antonio Road in Los Altos, California. The current

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

### Table of Contents

monthly rent payment is \$26,773 and is subject to annual increases of 3% until the lease expires on April 30, 2018. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In September of 2010, the Company extended its lease for approximately 4,096 square feet in an one-story stand-alone office building located at 300 Main Street in Pleasanton, California. The current monthly rent payment is \$16,619 and is subject to annual increases of 3% until the lease expires on October 31, 2017.

In September of 2012, the Company leased, effective March 1, 2013, approximately 3,172 square feet in an one-story multi-tenant multi-use building located at 3137 Stevenson Boulevard in Fremont, California. The monthly rent payment is \$7,452 and is subject to annual increases of 3% until the lease expires on February 29, 2020. The Company has reserved the right to extend the term of the lease for one additional period of four years and another additional period of three years.

In June of 2013, the Company leased approximately 3,022 square feet on the first floor of a three-story multi-tenant office building located at 333 West El Camino Real in Sunnyvale, California. The current monthly rent payment is \$12,025 and is subject to annual increases of 3% until the lease expires on May 31, 2018. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In October of 2013, the Company extended its lease for approximately 1,920 square feet in a one story stand-alone building located in an office complex at 15575 Los Gatos Boulevard in Los Gatos, California. The current monthly rent payment is \$6,009 and is subject to annual increases of 3% until the lease expires on November 30, 2018. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In April of 2014, the Company leased approximately 3,391 square feet in a multi-tenant commercial center located at 351 Tres Pinos in Hollister, CA. The current monthly rent payment is \$4,336 and is subject to annual increases of 3% until the lease expires on June 30, 2019. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In May of 2014, the Company extended its lease for approximately 3,850 square feet on the first floor in a four story multi-tenant office building located at 101 Ygnacio Valley Road in Walnut Creek, California. The current monthly rent payment is \$13,879 and is subject to 3% annual increases until the lease expires on August 15, 2021. In addition, the Company modified its lease to include 1,461 square feet of expansion space, which Company may take possession of a portion or portions at any time throughout the extended lease period. The current monthly rent for the expansion space is \$1,632 and is subject to annual increases of 3% until the lease expires. The Company has reserved the right to extend the term of the lease for one additional period of five years.

In August of 2014, the Company amended and extended its lease at 18625 Sutter Boulevard in Morgan Hill, California to include approximately 4,716 square feet in a one story multi-tenant office building located. The current monthly rent payment is \$6,013 with annual increases of 2% until the lease expires on October 31, 2021. The Company has reserved the right to extend the term of the lease for one additional period of five years.

### **Bay View Funding Office**

In April 2013, Bay View Funding leased approximately 7,440 square feet of a two-story multi-tenant office building located at 2933 Bunker Hill Lane, Santa Clara, CA 95054. The current monthly rent payment is \$17,479 until the lease expires on February 28, 2017. The Company has reserved the right to extend the term of the lease for one additional period of two years.

Table of Contents

For additional information on operating leases and rent expense, refer to Note 7 to the Consolidated Financial Statements following "Item 15 *Exhibits and Financial Statement Schedules.*"

**ITEM 3 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 4 MINE SAFETY DISCLOSURES**

Not Applicable.

Table of Contents**PART II****ITEM 5 MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****Market Information**

The Company's common stock is listed on the NASDAQ Global Select Market under the symbol "HTBK."

The information in the following table for 2015 and 2014 indicates the high and low closing prices for the common stock, based upon information provided by the NASDAQ Global Select Market and cash dividend payment for each quarter presented.

Quarter	Stock Price		Dividend Per Share
	High	Low	
<b>Year ended December 31, 2015:</b>			
Fourth quarter	\$ 12.25	\$ 10.28	\$ 0.08
Third quarter	\$ 11.83	\$ 9.45	\$ 0.08
Second quarter	\$ 9.75	\$ 8.75	\$ 0.08
First quarter	\$ 9.14	\$ 8.21	\$ 0.08
<b>Year ended December 31, 2014:</b>			
Fourth quarter	\$ 8.98	\$ 8.24	\$ 0.05
Third quarter	\$ 8.46	\$ 7.94	\$ 0.05
Second quarter	\$ 8.31	\$ 7.77	\$ 0.04
First quarter	\$ 8.38	\$ 7.81	\$ 0.04

The closing price of our common stock on February 29, 2016 was \$9.33 per share as reported by the NASDAQ Global Select Market.

As of February 29, 2016, there were approximately 630 holders of record of common stock. There are no other classes of common equity outstanding.

**Dividend Policy**

The amount of future dividends will depend upon our earnings, financial condition, capital requirements and other factors, and will be determined by our board of directors on a quarterly basis. It is Federal Reserve policy that bank holding companies generally pay dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. It is also Federal Reserve policy that bank holding companies not maintain dividend levels that undermine the holding company's ability to be a source of strength to its banking subsidiaries. Additionally, in consideration of the current financial and economic environment, the Federal Reserve has indicated that bank holding companies should carefully review their dividend policy and has discouraged payment ratios that are at maximum allowable levels unless both asset quality and capital are very strong. Under the federal Prompt Corrective Action regulations, the Federal Reserve or the FDIC may prohibit a bank holding company from paying any dividends if the holding company's bank subsidiary is classified as undercapitalized.

As a holding company, our ability to pay cash dividends is affected by the ability of our bank subsidiary, HBC, to pay cash dividends. The ability of HBC (and our ability) to pay cash dividends in the future and the amount of any such cash dividends is and could be in the future further influenced by bank regulatory requirements and approvals and capital guidelines.

The decision whether to pay dividends will be made by our board of directors in light of conditions then existing, including factors such as our results of operations, financial condition, business conditions,

Table of Contents

regulatory capital requirements and covenants under any applicable contractual arrangements, including agreements with regulatory authorities.

For information on the statutory and regulatory limitations on the ability of the Company to pay dividends and on HBC to pay dividends to HCC see "Item 1 Business Supervision and Regulation Dividends."

**Securities Authorized for Issuance Under Equity Compensation Plans**

The following table provides information as of December 31, 2015 regarding equity compensation plans under which equity securities of the Company were authorized for issuance:

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	1,775,027(1)	\$10.62	940,985(2)
Equity compensation plans not approved by security holders	N/A	N/A	N/A

(1) Consists of 1,163,745 options to acquire shares under the Company's Amended and Restated 2004 Equity Plan and 611,282 options to acquire shares under the Company's 2013 Equity Incentive Plan

(2) Available under the Company's 2013 Equity Incentive Plan.

Table of Contents

**Performance Graph**

The following graph compares the stock performance of the Company from December 31, 2010 to February 29, 2016, to the performance of several specific industry indices. The performance of the S&P 500 Index, NASDAQ Stock Index and NASDAQ Bank Stocks were used as comparisons to the Company's stock performance. Management believes that a performance comparison to these indices provides meaningful information and has therefore included those comparisons in the following graph.

The following chart compares the stock performance of the Company from December 31, 2010 to February 29, 2016, to the performance of several specific industry indices. The performance of the S&P 500 Index, NASDAQ Stock Index and NASDAQ Bank Stocks were used as comparisons to the Company's stock performance.

Index	Period Ending						
	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	02/29/16
Heritage Commerce Corp*	100	105	155	184	196	266	207
S&P 500*	100	100	113	147	164	163	154
NASDAQ Total US*	100	98	114	157	179	189	172
NASDAQ Bank Index*	100	88	101	141	145	154	136

\*

Source: SNL Financial Bank Information Group (434) 977-1600

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

Table of Contents

**ITEM 6 SELECTED FINANCIAL DATA**

The following table presents a summary of selected financial information that should be read in conjunction with the Company's Consolidated Financial Statements and notes thereto following "Item 15 "Exhibits and Financial Statement Schedules."

**SELECTED FINANCIAL DATA**

	AT OR FOR YEAR ENDED DECEMBER 31,				
	2015	2014	2013	2012	2011
	(Dollars in thousands, except per share data)				
<b>INCOME STATEMENT DATA:</b>					
Interest income	\$ 78,743	\$ 59,256	\$ 52,786	\$ 52,565	\$ 52,031
Interest expense	2,422	2,153	2,600	4,187	5,875
Net interest income before provision for loan losses	76,321	57,103	50,186	48,378	46,156
Provision (credit) for loan losses	32	(338)	(816)	2,784	4,469
Net interest income after provision for loan losses	76,289	57,441	51,002	45,594	41,687
Noninterest income	8,985	7,746	7,214	8,865	8,422
Noninterest expense	58,673	44,222	40,470	39,061	38,537
Income before income taxes	26,601	20,965	17,746	15,398	11,572
Income tax expense	10,104	7,538	6,206	5,489	201
Net income	16,497	13,427	11,540	9,909	11,371
Dividends and discount accretion on preferred stock	(1,792)	(1,008)	(336)	(1,206)	(2,333)
Net income available to common shareholders	14,705	12,419	11,204	8,703	9,038
Less: undistributed earnings allocated to Series C Preferred Stock	(912)	(1,342)	(1,687)	(1,527)	(1,589)
Distributed and undistributed earnings allocated to common shareholders	\$ 13,793	\$ 11,077	\$ 9,517	\$ 7,176	\$ 7,449
<b>PER COMMON SHARE DATA:</b>					
Basic net income(1)	\$ 0.48	\$ 0.42	\$ 0.36	\$ 0.27	\$ 0.28
Diluted net income(2)	\$ 0.48	\$ 0.42	\$ 0.36	\$ 0.27	\$ 0.28
Book value per common share(3)	\$ 7.03	\$ 6.22	\$ 5.84	\$ 5.71	\$ 5.30
Tangible book value per common share(4)	\$ 5.35	\$ 5.60	\$ 5.78	\$ 5.63	\$ 5.20
Pro forma book value per common share assuming Series C Preferred Stock was converted into common stock(5)	\$ 6.51	\$ 5.74	\$ 5.43	\$ 5.32	\$ 4.98
Pro forma tangible book value per share, assuming Series C Preferred Stock was converted into common stock(6)	\$ 5.07	\$ 5.23	\$ 5.38	\$ 5.25	\$ 4.90
Dividend payout ratio(7)	65.09%	42.88%	16.60%	N/A	N/A
Weighted average number of shares outstanding basic	28,567,213	26,390,615	26,338,161	26,303,245	26,266,584
Weighted average number of shares outstanding diluted	28,786,078	26,526,282	26,386,452	26,329,336	26,270,394
Common shares outstanding at period end	32,113,479	26,503,505	26,350,938	26,322,147	26,295,001
Pro forma common shares outstanding at period end, assuming Series C Preferred Stock was converted into common stock(8)	37,714,479	32,104,505	31,951,938	31,923,147	31,896,001
<b>BALANCE SHEET DATA:</b>					
Securities (available-for sale and held-to-maturity)	\$ 494,390	\$ 301,697	\$ 376,021	\$ 419,384	\$ 380,455
Net loans	\$ 1,339,790	\$ 1,070,264	\$ 895,749	\$ 793,286	\$ 743,891
Allowance for loan losses	\$ 18,926	\$ 18,379	\$ 19,164	\$ 19,027	\$ 20,700
Goodwill and other intangible assets	\$ 54,182	\$ 16,320	\$ 1,527	\$ 2,000	\$ 2,491
Total assets	\$ 2,361,579	\$ 1,617,103	\$ 1,491,632	\$ 1,693,312	\$ 1,306,194
Total deposits	\$ 2,062,775	\$ 1,388,386	\$ 1,286,221	\$ 1,479,368	\$ 1,049,428
Subordinated debt	\$	\$	\$	\$ 9,279	\$ 23,702
Short-term borrowings	\$ 3,000	\$	\$	\$	\$
Total shareholders' equity	\$ 245,436	\$ 184,358	\$ 173,396	\$ 169,741	\$ 197,831

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

**SELECTED PERFORMANCE RATIOS:(9)**

Return on average assets	0.86%	0.88%	0.81%	0.73%	0.89%
Return on average tangible assets	0.88%	0.88%	0.81%	0.73%	0.89%
Return on average equity	8.04%	7.44%	6.77%	5.75%	6.02%
Return on average tangible equity	9.41%	7.60%	6.84%	5.83%	6.11%
Net interest margin (fully tax equivalent)	4.41%	4.10%	3.84%	3.88%	3.94%
Efficiency ratio, excluding impairment of goodwill	68.78%	68.19%	70.51%	68.24%	70.61%
Average net loans (excludes loans held-for-sale) as a percentage of average deposits	70.82%	74.54%	67.26%	67.98%	75.91%
Average total shareholders' equity as a percentage of average total assets	10.73%	11.85%	11.90%	12.72%	14.82%

**SELECTED ASSET QUALITY DATA:(10)**

Net (recoveries) charge-offs to average loans	0.04%	0.05%	0.11%	0.57%	1.12%
Allowance for loan losses to total loans	1.39%	1.69%	2.09%	2.34%	2.71%
Nonperforming loans to total loans plus nonaccrual loans held-for-sale	0.47%	0.54%	1.29%	2.24%	2.20%
Nonperforming assets	\$ 6,742	\$ 6,551	\$ 12,393	\$ 19,464	\$ 19,142

**HERITAGE COMMERCE CORP CAPITAL RATIOS:**

Total risk-based	12.5%	13.9%	15.3%	16.2%	21.9%
Tier 1 risk-based	11.4%	12.6%	14.0%	15.0%	20.6%
Common equity Tier 1 risk-based capital	10.4%	N/A	N/A	N/A	N/A
Leverage	8.6%	10.6%	11.2%	11.5%	15.3%

Notes:

- (1) Represents distributed and undistributed earnings allocated to common shareholders, divided by the average number of shares of common stock outstanding for the respective period. See Note 17 to the consolidated financial statements.



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

### Table of Contents

- (2) Represents distributed and undistributed earnings allocated to common shareholders, divided by the average number of shares of common stock and common stock-equivalents outstanding for the respective period. See Note 17 to the consolidated financial statements.
- (3) Represents shareholders' equity minus preferred stock divided by the number of shares of common stock outstanding at the end of the period indicated. See Item 7 *Management's Discussion and Analysis of Financial Condition and Results of Operations* *Series C Preferred Stock*.
- (4) Represents shareholders' equity minus preferred stock, minus goodwill and other intangible assets divided by the number of shares of common stock outstanding at the end of period indicated. See Item 7 *Management's Discussion and Analysis of Financial Condition and Results of Operations* *Series C Preferred Stock*.
- (5) Represents shareholders' equity minus preferred stock divided by the number of shares of common stock outstanding at the end of the period indicated, assuming 21,004 shares of Series C Preferred Stock were converted into 5,601,000 shares of common stock. See Item 7 *Management's Discussion and Analysis of Financial Condition and Results of Operations* *Series C Preferred Stock*.
- (6) Represents shareholders' equity minus preferred stock, minus goodwill and other intangible assets divided by the number of shares of common stock outstanding at the end of period indicated, assuming 21,004 shares of Series C Preferred Stock were converted into 5,601,000 shares of common stock. See Item 7 *Management's Discussion and Analysis of Financial Condition and Results of Operations* *Series C Preferred Stock*.
- (7) Percentage is calculated based on dividends paid on common stock and Series C Preferred Stock (on an as converted basis) divided by net income.
- (8) Assumes 21,004 shares of Series C Preferred Stock were converted into 5,601,000 shares of common stock at December 31, 2015, 2014, 2013, 2012, and 2011.
- (9) Average balances used in this table and throughout this Annual Report are based on daily averages.
- (10) Average loans and total loans exclude loans held for sale.

### **ITEM 7 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"), its wholly-owned subsidiary, Heritage Bank of Commerce (the "Bank" or "HBC"), and HBC's wholly-owned subsidiary, BVF/CSNK Acquisition Corp., a Delaware corporation ("BVF") and its subsidiary CSNK Working Capital Finance Corp, a California Corporation, dba Bay View Funding ("CSNK"). BVF and CSNK are collectively referred to as "Bay View Funding." 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-K refer to Heritage Commerce Corp and its subsidiaries.

On August 20, 2015, the Company completed the acquisition of Focus Business Bank ("Focus"), which is discussed in more detail below, and in Notes 1, 8, and 9 to the consolidated financial statements.

#### **Critical Accounting Policies and Estimates**

The preparation of financial statements in accordance with the accounting principles generally accepted in the United States ("U.S. GAAP") requires management to make a number of judgments, estimates and assumptions that affect the reported amount of assets, liabilities, income and expense in the financial statements. Various elements of our accounting policies, by their nature, involve the application of highly sensitive and judgmental estimates and assumptions. Some of these policies and estimates relate to matters that are highly complex and contain inherent uncertainties. It is possible that, in some instances, different estimates and assumptions could reasonably have been made and used by management, instead of those we applied, which might have produced different results that could have had a material effect on the financial statements.

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

We have identified the following accounting policies and estimates that, due to the inherent judgments and assumptions and the potential sensitivity of the financial statements to those judgments and assumptions, are critical to an understanding of our financial statements. We believe that the judgments, estimates and assumptions used in the preparation of the Company's financial statements are appropriate. For a further description of our accounting policies, see Note 1 *Summary of Significant Accounting Policies* in the financial statements included in this Form 10-K.

Table of Contents

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Allowance for Loan Losses*

The allowance for loan losses is an estimate of the losses in our loan portfolio. The allowance is only an estimate of the inherent loss in the loan portfolio and may not represent actual losses realized over time, either of losses in excess of the allowance or of losses less than the allowance. Our accounting for estimated loan losses is discussed under the heading "Allowance for Loan Losses" and disclosed primarily in Notes 1 and 4 to the consolidated financial statements.

*Loan Sales and Servicing*

The amounts of gains recorded on sales of loans and the initial recording of servicing assets and Interest-only ("I/O") strips are based on the estimated fair values of the respective components. In recording the initial value of the servicing assets and the fair value of the I/O strips receivable, the Company uses estimates which are made on management's expectations of future prepayment and discount rates as discussed in Notes 1 and 5 to the consolidated financial statements.

*Stock Based Compensation*

We grant stock options to purchase our common stock and restricted stock to our employees and directors under the 2013 Equity Incentive Plan. Additionally, we have outstanding options that were granted under option plans from which we no longer make grants. The benefits provided under all of these plans are subject to the provisions of accounting guidance related to share-based payments. Our results of operations for fiscal years 2015, 2014, and 2013 were impacted by the recognition of non-cash expense related to the fair value of our share-based compensation awards.

The determination of fair value of stock-based payment awards on the date of grant using the Black-Scholes model is affected by our stock price, as well as the input of other subjective assumptions. These assumptions include, but are not limited to, the expected term of stock options and our stock price volatility. Our stock options have characteristics significantly different from those of traded options, and changes in the assumptions can materially affect the fair value estimates.

Accounting guidance requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. If actual forfeitures vary from our estimates, we will recognize the difference in compensation expense in the period the actual forfeitures occur.

*Business Combinations*

The Company accounts for acquisitions of businesses using the acquisition method of accounting. Under the acquisition method, assets acquired and liabilities assumed are recorded at their estimated fair values at the date of acquisition. This fair value may differ from the cost basis recorded on the acquired institution's financial statements. Management performs an initial assessment to determine which assets and liabilities must be designated for fair value analysis. Management typically engages experts in the field of valuation to perform the valuation of significant assets and liabilities and, after assessing the resulting fair value computation, will utilize such value in computing the initial purchase accounting adjustments for the acquired assets. It is possible that these values could be viewed differently through either alternative

Table of Contents

valuation approaches or if performed by different experts. Management is responsible for determining that the values determined by experts are reasonable. Any excess of the purchase price over amounts allocated to the acquired assets, including identifiable intangible assets, and liabilities assumed is recorded as goodwill. The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate a more accurate or appropriate value for an asset or liability. See Note 1 *Summary of Significant Accounting Policies*, Note 8 *Business Combinations* and Note 9 *Goodwill and Other Intangible Assets* in the financial statements in this Form 10-K.

***Goodwill and Other Intangible Assets***

Goodwill and intangible assets are evaluated at least annually for impairment or more frequently if events or circumstances, such as changes in economic or market conditions, indicate that impairment may exist. Goodwill is tested for impairment at the reporting unit level. A reporting unit is an operating segment or one level below an operating segment for which discrete financial information is available and regularly reviewed by management. If the fair value of the reporting unit including goodwill is determined to be less than the carrying amount of the reporting unit, a further test is required to measure the amount of impairment. If an impairment loss exists, the carrying amount of the goodwill is adjusted to a new cost basis. For purposes of the goodwill impairment test, the valuation of the Company is based on a weighted blend of the income approach and market approach. The income approach estimates the fair value of the Company based on the present value of discounted cash flows from operations. The market approach considers key pricing multiples of similar companies. Management believes the assumptions used in these calculations are consistent with current industry practice for valuing similar types of companies. On November 1, 2014, estimated goodwill of \$13.0 million resulted from the acquisition of Bay View Funding. On August 20, 2015, estimated goodwill of \$32.6 million resulted from the merger of Focus. At December 31, 2015, goodwill from the Bay View Funding acquisition was \$13.0 million, and goodwill from the Focus acquisition was \$32.6 million.

Intangible assets consist of core deposit and customer relationship intangible assets arising from the acquisition of Diablo Valley Bank in June 2007, a core deposit intangible asset arising from the Focus acquisition in August 2015, and a below market lease, customer relationship and brokered relationship, and a non-compete agreement intangible assets arising from the acquisition of Bay View Funding in November 2014. These assets are amortized over their estimated useful lives. Impairment testing of these assets is performed at the individual asset level. Impairment exists if the carrying amount of the asset is not recoverable and exceeds its fair value at the date of the impairment test. For intangible assets, estimates of expected future cash flows (cash inflows less cash outflows) that are directly associated with an intangible asset are used to determine the fair value of that asset. Management makes certain estimates and assumptions in determining the expected future cash flows from core deposit and customer relationship intangibles including account attrition, expected lives, discount rates, interest rates, servicing costs and other factors. Significant changes in these estimates and assumptions could adversely impact the valuation of these intangible assets. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset.

Our accounting policy for goodwill and other intangible assets is disclosed primarily in Notes 1 and 9 to the consolidated financial statements.

***Deferred Tax Assets***

Our net deferred income tax asset arises from temporary differences between the carrying amount of assets and liabilities reported in the financial statements and the amounts used for income tax return purposes. Our accounting for deferred tax assets is discussed under the heading "*Income Tax Expense*" and disclosed primarily in Notes 1 and 12 to the consolidated financial statements.

Table of Contents

**Segment Reporting**

HBC is a commercial bank serving customers located in Santa Clara, Alameda, Contra Costa, and San Benito counties of California. Bay View Funding provides business-essential working capital factoring financing to various industries throughout the United States. No customer accounts for more than 10 percent of revenue for HBC or the Company. The Company's management uses segments results in its operating and strategic planning. The operating segments are Banking and Factoring.

**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 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. Bay View Funding, a subsidiary of HBC, is based in Santa Clara and provides business essential working capital factoring financing to various industries throughout the United States.

**Performance Overview**

For the year ended December 31, 2015, net income was \$16.5 million, or \$0.48 per average diluted common share, compared to \$13.4 million, or \$0.42 per average diluted common share, for the year ended December 31, 2014, and \$11.5 million, or \$0.36 per average diluted common share, for the year ended December 31, 2013. The Company's annualized return on average tangible assets was 0.88% and annualized return on average tangible equity was 9.41% for the year ended December 31, 2015, compared to 0.88% and 7.60%, respectively, for the year ended December 31, 2014, and 0.81% and 6.84% for the year ended December 31, 2013.

**Bay View Funding Acquisition**

On November 1, 2014, the Company acquired Bay View Funding by purchasing all of the outstanding common stock from the stockholders of Bay View Funding for an aggregate purchase price of \$22.52 million. Bay View Funding became a wholly owned subsidiary of HBC. Based in Santa Clara, California, Bay View Funding, provides business essential working capital factoring financing to various industries throughout the United States. Bay View Funding's results of operations have been included in the Company's results beginning November 1, 2014. The following table reflects selected financial information for Bay View Funding at December 31, 2015:

	2015	2014
	(Dollars in thousands)	
Total factored receivables at December 31,	\$ 40,059	\$ 40,012
Average factored receivables for the year ended December 31,	\$ 42,091	\$ 7,104
Total full time equivalent employees at December 31,	36	36

**Focus Business Bank Merger**

On August 20, 2015, the Company completed the merger of HBC with Focus for an aggregate transaction value of \$66.6 million. Shareholders of Focus received a fixed exchange ratio at closing of

Table of Contents

1.8235 shares of the Company's common stock for each share of Focus common stock. The Company issued 5,456,713 shares of the Company's common stock to Focus shareholders for a total value of \$58.3 million based on the Company's closing stock price of \$10.68 on August 20, 2015. In addition, the Company paid cash to the Focus holders of in-the-money stock options totaling \$8.3 million.

The Focus acquisition added total assets, at fair value, of approximately \$438.8 million, \$174.8 million in loans (including loans held-for-sale), at fair value, and \$405.1 million in deposits, at fair value, at August 20, 2015. Focus's results of operations have been included in the Company's results of operations beginning August 21, 2015. The one-time pre-tax severance, retention, acquisition and integration costs totaled \$6.4 million for the year ended December 31, 2015.

**2015 Highlights**

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

The fully tax equivalent ("FTE") net interest margin increased 31 basis points to 4.41% for the year ended December 31, 2015, compared to 4.10% for the year ended December 31, 2014. The improvement in the net interest margin for the full year of 2015 was primarily due to revenue realized from the higher yielding Bay View Funding factored receivables portfolio, the accretion of the loan purchase discount from the Focus acquisition in loan interest income, and a special dividend paid by the FHLB in the second quarter of 2015, partially offset by the temporary investment of excess liquidity from the Focus acquisition.

Net interest income increased 34% to \$76.3 million for the year ended December 31, 2015, compared to \$57.1 million for the year ended December 31, 2014, primarily due to loans acquired in the Focus acquisition, organic growth in the loan portfolio, contributions to revenue from Bay View Funding, the accretion of the loan purchase discount in loan interest income from the Focus transaction, and increases in core deposits.

There was a \$32,000 provision for loan losses for the year ended December 31, 2015, compared to a \$338,000 credit provision for loan losses for the year ended December 31, 2014.

Noninterest income increased to \$9.0 million for the year ended December 31, 2015, compared to \$7.7 million for the year ended December 31, 2014, primarily due to a \$642,000 gain on the sale of securities in the fourth quarter of 2015, and the full year impact of fee income from Bay View Funding.

Noninterest expense for the year ended December 31, 2015 was \$58.7 million, compared to \$44.2 million for the year ended December 31, 2014. The increase in noninterest expense for the year ended December 31, 2015, was primarily due to costs related to the integration of Focus, and the additional operating costs of Focus and Bay View Funding. Noninterest expense included total Focus pre tax acquisition and integration costs of \$6.4 million for the year ended December 31, 2015. Of the total acquisition and integration costs, salaries and employee benefits (including severance and retention expenses) were \$2.9 million, and other expenses related to the Focus acquisition and integration were \$3.5 million for the year ended December 31, 2015.

The efficiency ratio for the year ended December 31, 2015 was 68.78%, compared to 68.19% for the year ended December 31, 2014.

Income tax expense for the year ended December 31, 2015 was \$10.1 million, compared to \$7.5 million for the year ended December 31, 2014. The effective tax rate for the year ended December 31, 2015 was 38.0%, compared to 36.0% for the year ended December 31, 2014. The increase in the effective tax rate for the year ended December 31, 2015, was primarily due to an increase in taxable income with a limited amount of tax deductions.

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

### Table of Contents

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

Primarily due to the Focus acquisition and internal growth, cash, Federal funds sold, interest-bearing deposits in other financial institutions and securities available-for-sale increased 122% to \$729.2 million at December 31, 2015, compared to \$328.7 million at December 31, 2014.

Securities held-to-maturity, at amortized cost, were \$109.3 million at December 31, 2015, compared to \$95.4 million at December 31, 2014.

Loans, excluding loans held-for-sale, increased 25% to \$1.36 billion at December 31, 2015, from \$1.09 billion at December 31, 2014, which included an increase of \$113.4 million, or 10%, in the Company's legacy loan portfolio, and \$156.7 million from the Focus loan portfolio.

Classified assets (net of SBA guarantees) were \$20.5 million at December 31, 2015, compared to \$16.0 million at December 31, 2014. The increase in classified assets at December 31, 2015 from December 31, 2014 was primarily due to the Focus acquisition. At December 31, 2015, \$10.6 million of the classified assets were from the Company's legacy loan portfolio, and \$9.9 million of the classified assets were from the Focus loan portfolio.

The allowance for loan losses at December 31, 2015 was \$18.9 million, or 1.39% of total loans, representing 296.74% of nonperforming loans. The allowance for loan losses at December 31, 2014 was \$18.4 million, or 1.69% of total loans, representing 313.90% of nonperforming loans.

Nonperforming assets were \$6.7 million, or 0.29% of total assets at December 31, 2015, compared to \$6.6 million, or 0.41% of total assets at December 31, 2014. At December 31, 2015, \$6.0 million of the NPAs were from the Company's legacy loan portfolio, and \$734,000 of the NPAs were from the Focus loan portfolio.

Net loan recoveries were \$515,000 for the year ended December 31, 2015, compared to net loan charge-offs of \$447,000 for the year ended December 31, 2014.

Total deposits increased \$674.4 million, or 49%, to \$2.06 billion at December 31, 2015, compared to \$1.39 billion at December 31, 2014, which included an increase of \$297.5 million, or 21%, in the Company's legacy deposit portfolio, and \$376.9 million from the Focus deposit portfolio.

The ratio of noncore funding (which consists of time deposits \$250,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase and short-term borrowings) to total assets was 7.93% at December 31, 2015, compared to 12.54% at December 31, 2014.

The loan to deposit ratio was 65.87% at December 31, 2015, compared to 78.41% at December 31, 2014.

As of January 1, 2015, along with other community banking organizations, the Company and the Bank became subject to new capital requirements, and certain provisions of the new rules are being phased in through 2019 under the Dodd-Frank Act and Basel III. The Company's consolidated capital ratios exceeded regulatory guidelines and the Bank's capital ratios exceeded the regulatory

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

### Table of Contents

guidelines for a well-capitalized financial institution under the Basel III regulatory requirements at December 31, 2015.

	At December 31, 2015		Transitional Minimum Regulatory Requirement Effective January 1, 2015	Minimum Regulatory Requirement(1) Effective January 1, 2019	Well-capitalized by Regulatory Definition Under FDICIA(2) Effective January 1, 2015
	Heritage Commerce Corp	Heritage Bank of Commerce			
<b>Capital Ratios</b>					
Total Risk-Based	12.5%	12.6%	8.0%	10.5%	10.0%
Tier 1 Risk-Based	11.4%	11.4%	6.0%	8.5%	8.0%
Common Equity Tier 1					
Risk-based	10.4%	11.4%	4.5%	7.0%	6.5%
Leverage	8.6%	8.6%	4.0%	4.0%	5.0%

(1) Includes 2.5% capital conservation buffer

(2) Only applies to HBC

### **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 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. 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. 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.

Total deposits were \$2.06 billion at December 31, 2015, compared to \$1.39 billion at December 31, 2014, which included an increase of \$297.5 million, or 21%, in the Company's legacy deposit portfolio, and \$376.9 million from the Focus deposit portfolio. Deposits (excluding all time deposits and CDARS deposits) increased \$686.4 million, or 61%, to \$1.81 billion at December 31, 2015, from \$1.13 billion at December 31, 2014.

The Company had \$17.8 million in brokered deposits at December 31, 2015, compared to \$28.1 million at December 31, 2014. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators increased to \$49.1 million at December 31, 2015, compared to \$41.5 million at December 31, 2014. Certificates of deposit from the State of California totaled \$78.0 million at December 31, 2015, compared to \$98.0 million at December 31, 2014. CDARS money market and time deposits increased to \$7.6 million at December 31, 2015, compared to \$11.2 million at December 31, 2014.

### **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 December 31, 2015, we had \$344.1 million in cash and cash equivalents and approximately \$445.1 million in available borrowing capacity from various sources including the FHLB, the FRB, and Federal funds facilities with several financial institutions. The Company also had \$358.3 million (at fair value) in unpledged securities available at December 31, 2015. Our loan to deposit ratio increased to 65.87% at December 31, 2015, compared to 78.41% at December 31, 2014.



Table of Contents

***Lending***

Our lending business originates primarily through our branch offices located in our primary markets. In addition, Bay View Funding provides factoring financing throughout the United States. Total loans, excluding loans held-for-sale, increased \$270.2 million, or 25%, to \$1.36 billion at December 31, 2015, compared to \$1.09 billion at December 31, 2014, which included an increase of \$113.4 million, or 10%, in the Company's legacy loan portfolio, and \$156.7 million from the Focus loan portfolio. The total loan portfolio remains well diversified with commercial and industrial ("C&I") loans accounting for 41% of the portfolio at December 31, 2015, which included \$40.1 million of factored receivables at Bay View Funding. Commercial and residential real estate loans accounted for 46% of the total loan portfolio at December 31, 2015, of which 42% were owner-occupied by businesses. Consumer and home equity loans accounted for 7% of the total loan portfolio, and land and construction loans accounted for the remaining 6% of our total loan portfolio at December 31, 2015. C&I line usage was 39% at December 31, 2015, compared to 42% at December 31, 2014.

***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). Net interest income increased 34% to \$76.3 million for the year ended December 31, 2015, compared to \$57.1 million for the year ended December 31, 2014, primarily due to loans acquired in the Focus acquisition, organic growth in the loan portfolio, contributions to interest income from Bay View Funding, the accretion of the loan purchase discount in loan interest income from the Focus transaction, and increases in core deposits.

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

Table of Contents

in the financial condition of borrowers, such as have resulted due to the current, and potentially worsening, economic conditions. Additionally, Federal and state banking regulators, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to recognize further loan loss provisions or charge-offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses would have an adverse effect, which may be material, on our financial condition and results of operation.

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

***Noninterest Income***

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

***Noninterest Expense***

Management considers the control of operating expenses to be a critical element of the Company's performance. Noninterest expense for the year ended December 31, 2015 was \$58.7 million, compared to \$44.2 million a year ago. The increase in noninterest expense for the year ended December 31, 2015 was primarily due to costs related to the integration of Focus, and the additional operating costs of Focus and Bay View Funding. Noninterest expense included total Focus pre-tax acquisition and integration costs of \$6.4 million for year ended December 31, 2015. Of the total acquisition and integration costs, salaries and employee benefits (including severance and retention expenses) were \$2.9 million, and other expenses related to the Focus acquisition and integration were \$3.5 million for the year ended December 31, 2015.

***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 strategic activities that it may choose to pursue.

**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 growth in earning assets, 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 that comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income can also be impacted by the reversal of interest on loans placed on nonaccrual status, and recovery of interest on loans that have been on nonaccrual and are either sold or returned to accrual status. To maintain its net interest margin, the Company must manage the relationship between interest earned and paid.

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

### Table of Contents

The following Distribution, Rate and Yield table presents for each of the past three years, 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.

	Year Ended December 31,								
	2015			2014			2013		
	Average Balance	Interest Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate
(Dollars in thousands)									
<b>Assets:</b>									
Loans, gross(1)	\$ 1,186,096	\$ 68,259	5.75%	\$ 992,376	\$ 49,207	4.96%	\$ 845,303	\$ 41,570	4.92%
Securities taxable	246,084	6,707	2.73%	251,077	7,117	2.83%	329,012	8,937	2.72%
Securities exempt from Federal tax(2)	86,589	3,358	3.88%	79,939	3,115	3.90%	61,636	2,355	3.82%
Federal funds sold and interest-bearing deposits in other financial institutions	239,123	1,594	0.67%	96,534	907	0.94%	93,985	749	0.80%
Total interest earning assets(2)	1,757,892	79,918	4.55%	1,419,926	60,346	4.25%	1,329,936	53,611	4.03%
Cash and due from banks	34,196			25,829			23,510		
Premises and equipment, net	7,463			7,343			7,500		
Goodwill and other intangible assets	29,780			3,746			1,774		
Other assets	83,090			66,428			68,678		
Total assets	\$ 1,912,421			\$ 1,523,272			\$ 1,431,398		
<b>Liabilities and shareholders' equity:</b>									
<b>Deposits:</b>									
Demand, noninterest-bearing	\$ 630,198			\$ 463,134			\$ 427,299		
Demand, interest-bearing	317,219	585	0.18%	207,359	341	0.16%	172,615	246	0.14%
Savings and money market	433,123	894	0.21%	363,903	671	0.18%	308,510	544	0.18%
Time deposits under \$100	20,631	61	0.30%	20,448	63	0.31%	23,069	80	0.35%
Time deposits \$100 and Over	204,982	658	0.32%	196,118	629	0.32%	194,587	747	0.38%
Time deposits brokered	25,154	199	0.79%	36,440	319	0.88%	75,968	745	0.98%
CDARS money market and time deposits	12,078	6	0.05%	15,380	9	0.06%	17,996	7	0.04%
Total interest-bearing deposits	1,013,187	2,403	0.24%	839,648	2,032	0.24%	792,745	2,369	0.30%
Total deposits	1,643,385	2,403	0.15%	1,302,782	2,032	0.16%	1,220,044	2,369	0.19%
Subordinated debt							5,816	229	3.94%
Short-term borrowings	629	19	3.02%	4,003	121	3.02%	129	2	1.55%
Total interest-bearing liabilities	1,013,816	2,422	0.24%	843,651	2,153	0.26%	798,690	2,600	0.33%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,644,014	2,422	0.15%	1,306,785	2,153	0.16%	1,225,989	2,600	0.21%
Other liabilities	63,253			35,973			35,018		
Total liabilities	1,707,267			1,342,758			1,261,007		
Shareholders' equity	205,154			180,514			170,391		
Total liabilities and shareholders' equity	1,912,421			1,523,272			1,431,398		
Net interest income(2) / margin		77,496	4.41%		58,193	4.10%		51,011	3.84%
Less tax equivalent adjustment(2)		(1,175)			(1,090)			(825)	

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

Net interest income	\$ 76,321	\$ 57,103	\$ 50,186
---------------------	-----------	-----------	-----------

- 
- (1) Includes loans held-for-sale. Yields and 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% federal tax rate.
- 

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 multiplied by prior period rates and rate variances are equal to the increase or decrease in the average rate multiplied by

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

Table of Contents

the prior period average balance. Variances attributable to both rate and volume changes are equal to the change in rate multiplied by the change in average balance and are included below in the average volume column.

	2015 vs. 2014 Increase (Decrease) Due to Change in:			2014 vs. 2013 Increase (Decrease) Due to Change in:		
	Average Volume	Average Rate	Net Change	Average Volume	Average Rate	Net Change
<b>(Dollars in thousands)</b>						
<b>Income from the interest earning assets:</b>						
Loans, gross	\$ 11,197	\$ 7,855	\$ 19,052	\$ 7,280	\$ 357	\$ 7,637
Securities taxable	(147)	(263)	(410)	(2,194)	374	(1,820)
Securities exempt from Federal tax(1)	256	(13)	243	711	49	760
Federal funds sold and interest-bearing deposits in other financial institutions	947	(260)	687	24	134	158
Total interest income on interest earning assets(1)	12,253	7,319	19,572	5,821	914	6,735
<b>Expense from the interest-bearing liabilities:</b>						
Demand, interest-bearing	212	32	244	65	30	95
Savings and money market	130	93	223	116	11	127
Time deposits under \$100		(2)	(2)	(9)	(8)	(17)
Time deposits \$100 and over	30	(1)	29	6	(124)	(118)
Time deposits brokered	(89)	(31)	(120)	(350)	(76)	(426)
CDARS money market and time deposits	(2)	(1)	(3)	(2)	4	2
Subordinated debt				(229)		(229)
Short-term borrowings	(102)		(102)	117	2	119
Total interest expense on interest-bearing liabilities	179	90	269	(286)	(161)	(447)
Net interest income(1)	\$ 12,074	\$ 7,229	19,303	\$ 6,107	\$ 1,075	7,182
Less tax equivalent adjustment(1)			(85)			(265)
Net interest income			\$ 19,218			\$ 6,917

(1) Reflects tax equivalent adjustment for tax exempt income based on a 35% federal tax rate.

Net interest income for the year ended December 31, 2015 increased 34% to \$76.3 million, compared to \$57.1 million a year ago, primarily due to loans acquired in the Focus acquisition, organic growth in the loan portfolio, contributions to interest income from Bay View Funding, and the accretion of the loan purchase discount in loan interest income from the Focus transaction. Net interest income for the year ended December 31, 2014 increased 14% to \$57.1 million, compared to \$50.2 million for the year ended December 31, 2013, primarily as a result of growth in the loan portfolio, and two months of interest income from Bay View Funding.

The Company's net interest margin (FTE), expressed as a percentage of average earning assets was 4.41% for 2015, an increase of 31 basis points compared to 4.10% for 2014. The increase year to year is primarily due to revenue from the higher yielding Bay View Funding factored receivables portfolio, the accretion of the loan purchase discount in loan interest income, and a special dividend of \$203,000 paid by the FHLB in the second quarter of 2015, partially offset by the temporary investment of excess liquidity from the Focus acquisition. The Company's net interest margin for 2014 increased 26 basis points from 3.84% for 2013, primarily the result of loan growth, two months of revenue from Bay

View Funding, higher yields on securities, and a lower cost of funds.

Table of Contents

The yield on the loan portfolio was 5.75% for the year ended December 31, 2015, compared to 4.96% for the year ended December 31, 2014. The increase in the yield on the loan portfolio for the year ended December 31, 2015 reflects the accretion of the loan purchase discount of \$1.4 million in loan interest income from the Focus transaction, and the full year impact of the higher yielding Bay View Funding factored receivables portfolio. Excluding the accretion of the loan purchase discount, the yield on the loan portfolio was 5.62% for the year ended December 31, 2015. The remaining balance of the purchase discount on the Focus loan portfolio was \$3.9 million at December 31, 2015.

At December 31, 2015, Federal funds sold and interest-bearing deposits in other financial institutions totaled \$320.0 million. Average Federal funds sold and interest-bearing deposits in other financial institutions were \$228.3 million for the year ended December 31, 2015, compared to \$86.1 million for the year ended December 31, 2014, and \$83.2 million for the year ended December 31, 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, in contrast to a large base of core deposits that are generally slower to re-price. This causes the Company's balance sheet to be asset-sensitive which means that, all else being equal, the Company's net interest margin will be lower during periods when short-term interest rates are falling and higher when rates are rising.

***Provision for Loan Losses***

Credit risk is inherent in the business of making loans. The Company establishes an allowance for loan losses through charges to earnings, which are shown in the statements of operations 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 operations. 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 provision for loan losses for the year ended December 31, 2015 was \$32,000, compared to a \$338,000 credit to the provision for loan losses for the year ended December 31, 2014. The allowance for loan losses related to the commercial portfolio decreased \$439,000 at December 31, 2015 from December 31, 2014, as a result of a credit to the provision for loan losses of \$789,000 related to the commercial loan portfolio, and net recoveries of \$350,000. The decrease in the allowance for loan losses was primarily due to a decline in the Company's legacy problem loans. The allowance for loan losses related to the real estate portfolio increased \$1.0 million at December 31, 2015 from December 31, 2014, as a result of a provision for loan losses of \$862,000 and net recoveries of \$144,000. The increase in the allowance for loan losses was primarily due to an increase in the balance of real estate loans outstanding.

The allowance for loan losses totaled \$18.9 million, or 1.39% of total loans at December 31, 2015, compared to \$18.4 million, or 1.69% of total loans at December 31, 2014, and \$19.2 million, or 2.09% of total loans at December 31, 2013. The allowance for loan losses to total loans decreased at December 31, 2015, compared to December 31, 2014, primarily due to the impact of the Focus loan portfolio, which was marked to fair value on the acquisition date. Excluding the \$141.6 million (at fair value) Focus loan portfolio at December 31, 2015, the allowance for loan losses was 1.55% of total loans. The allowance for loan losses decreased at December 31, 2014, compared to December 31, 2013, primarily due to increasing loan balances with no default histories, coupled with the decrease in nonperforming assets, improving the quality of the loan portfolio overall. Net recoveries totaled \$515,000 for the year ended December 31, 2015, compared to net charge-offs of \$447,000 for the year ended December 31, 2014, and net recoveries of \$953,000 for the year ended December 31, 2013. Provisions for loan losses are charged to operations to

Table of Contents

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:

	Year Ended December 31,			Increase (decrease) 2015 versus 2014		Increase (decrease) 2014 versus 2013	
	2015	2014	2013	Amount	Percent	Amount	Percent
(Dollars in thousands)							
Service charges and fees on deposit accounts	\$ 2,803	\$ 2,519	\$ 2,457	\$ 284	11%	\$ 62	3%
Increase in cash surrender value of life insurance	1,697	1,600	1,654	97	6%	(54)	3%
Servicing income	1,143	1,296	1,446	(153)	12%	(150)	10%
Gain on sales of SBA loans	843	971	449	(128)	13%	522	116%
Gain on sales of securities	642	97	38	545	562%	59	155%
Other	1,857	1,263	1,170	594	47%	93	8%
<b>Total</b>	<b>\$ 8,985</b>	<b>\$ 7,746</b>	<b>\$ 7,214</b>	<b>\$ 1,239</b>	<b>16%</b>	<b>\$ 532</b>	<b>7%</b>

The increase in noninterest income for the year ended December 31, 2015, compared to the year ended December 31, 2014, was primarily due to a \$642,000 gain on the sale of securities in the fourth quarter of 2015, and the full year impact of fee income from Bay View Funding. The increase in noninterest income for the year ended December 31, 2014, compared to the year ended December 31, 2013, was primarily due to a higher gain on sales of SBA loans.

The Company received gross proceeds of \$71.8 million on investment securities available-for-sale it sold during the fourth quarter of 2015 with a book value totaling \$71.2 million, resulting in a gain on sale of securities of \$637,000. There was also a \$5,000 gain on a bond that was called in the fourth quarter of 2015 included in gain on sale of securities. The Company sold \$108.6 million of investment securities available-for-sale for a net gain of \$97,000 during the year ended December 31, 2014, compared to a \$38,000 gain during the year ended December 31, 2013.

A portion of the Company's noninterest income is associated with its SBA lending activity, as gain on sales of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. During 2015, SBA loan sales resulted in a \$843,000 gain, compared to a \$971,000 gain on sales of SBA loans in 2014, and a \$449,000 gain on sales of SBA loans in 2013. The servicing assets that result from the sales of SBA loans with servicing retained are amortized over the expected term of the loans using a method approximating the interest method. Servicing income generally declines as the respective loans are repaid.

The increase in cash surrender value of life insurance approximates a 3.11% after tax yield on the policies. To realize this tax advantaged yield the policies must be held until death of the insured individuals, who are current and former officers and directors of the Company.



Table of Contents**Noninterest Expense**

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

	Year Ended December 31,			Increase (decrease) 2015 versus 2014		Increase (decrease) 2014 versus 2013	
	2015	2014	2013	Amount	Percent	Amount	Percent
(Dollars in thousands)							
Salaries and employee benefits	\$ 35,146	\$ 26,250	\$ 23,450	\$ 8,896	34%	\$ 2,800	12%
Occupancy and equipment	4,300	4,053	4,043	247	6%	10	0%
Acquisition and integration related costs(1)	3,546	895		2,651	296%	895	N/A
Professional fees	1,828	1,891	2,588	(63)	3%	(697)	27%
Data processing	1,371	969	1,078	402	41%	(109)	10%
Software subscriptions	1,214	999	1,289	215	22%	(290)	22%
Insurance expense	1,127	1,126	1,032	1	0%	94	9%
FDIC deposit insurance premiums	1,092	892	894	200	22%	(2)	0%
Correspondent bank charges	1,021	760	684	261	34%	76	11%
Amortization on intangible assets	1,043	510	473	533	105%	37	8%
Foreclosed assets	(94)	53	(251)	(147)	277%	304	121%
Other	7,079	5,824	5,190	1,255	22%	634	12%
<b>Total</b>	<b>\$ 58,673</b>	<b>\$ 44,222</b>	<b>\$ 40,470</b>	<b>\$ 14,451</b>	<b>33%</b>	<b>\$ 3,752</b>	<b>9%</b>

(1)

Does not include one-time pre-tax severance and retention cost of \$2.9 million, which is included in salaries and employee benefits for the year ended December 31, 2015.

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

	2015		2014		2013	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
(Dollars in thousands)						
Salaries and employee benefits	\$ 35,146	61%	\$ 26,250	59%	\$ 23,450	58%
Occupancy and equipment	4,300	7%	4,053	9%	4,043	10%
Acquisition and integration related costs(1)	3,546	6%	895	2%		0%
Professional fees	1,828	3%	1,891	4%	2,588	6%
Data processing	1,371	2%	969	2%	1,078	3%
Software subscriptions	1,214	2%	999	2%	1,289	3%
Insurance expense	1,127	2%	1,126	3%	1,032	3%
FDIC deposit insurance premiums	1,092	2%	892	2%	894	2%
Correspondent bank charges	1,021	2%	760	2%	684	2%
Amortization on intangible assets	1,043	1%	510	1%	473	1%
Foreclosed assets	(94)	0%	53	0%	(251)	1%
Other	7,079	12%	5,824	14%	5,190	13%
<b>Total</b>	<b>\$ 58,673</b>	<b>100%</b>	<b>\$ 44,222</b>	<b>100%</b>	<b>\$ 40,470</b>	<b>100%</b>

---

(1)

Does not include one-time pre-tax severance and retention cost of \$2.9 million, which is included in salaries and employee benefits for the year ended December 31, 2015.

---

Noninterest expense for the year ended December 31, 2015 increased 33% to \$58.7 million, compared to \$44.2 million for the year ended December 31, 2014. The increase from year to year was primarily due to costs related to the integration of Focus, and the additional operating costs of Focus and Bay View

Table of Contents

Funding. Noninterest expense included total Focus pre tax acquisition and integration costs of \$6.4 million for the year ended December 31, 2015. Of the total acquisition and integration costs, salaries and employee benefits (including severance and retention expenses) were \$2.9 million, and other expenses related to the Focus acquisition and integration were \$3.5 million for the year ended December 31, 2015. Full-time equivalent employees were 260, 242, and 193 at December 31, 2015, 2014, and 2013, respectively.

Noninterest expense for the year ended December 31, 2014 increased 9% to \$44.2 million, compared to \$40.5 million for the year ended December 31, 2013. The increase from year to year was primarily due to increased salaries and employee benefits expense. The increase in noninterest expense for the year ended December 31, 2014 was primarily due to two months of operating expenses incurred by Bay View Funding, one-time costs related to the Bay View Funding acquisition, and higher salaries and employee benefits costs, which were partially offset by lower professional fees, software subscriptions, and data processing expense.

***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, interest on tax-exempt securities, certain expenses that are not allowed as tax deductions, and tax credits.

The Company's Federal and state income tax expense in 2015 was \$10.1 million, compared to \$7.5 million in 2014, and \$6.2 million in 2013. The following table shows the effective income tax rates for the dates indicated:

	<b>For the Year Ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>2013</b>
Effective income tax rate	38.0%	36.0%	35.0%

The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of tax exempt securities, 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 Enterprise Zone hiring credits.

The Company adopted the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014. The Company quantified the impact of adopting the proportional amortization method compared to the equity method to its current year and prior period financial statements. The Company determined that the adoption of the proportional amortization method did not have a material impact to its financial statements. The low income housing investment losses, net of the tax benefits received, are included in income tax expense for all periods reflected on the consolidated income statements.

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.

Table of Contents

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 the deferred tax assets 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 the net deferred tax assets of \$22.2 million and \$18.5 million at December 31, 2015, and December 31, 2014, 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 assets at December 31, 2015 and December 31, 2014 will be fully realized in future years.

**Business Segment Information**

The following presents the Company's operating segments. Transactions between segments consist primarily of borrowed funds. Intersegment interest expense is allocated to the Factoring segment based on the Company's prime rate and funding costs. The provision for loan loss is allocated based on the segment's allowance for loan loss determination which considers the effects of charge-offs. Noninterest income and expense directly attributable to a segment are assigned to it. Taxes are paid on a consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring originated by Bay View Funding, which has been included in the results of operations since the acquisition on November 1, 2014.

	<b>For the Twelve Months Ended December 31, 2015</b>		
	<b>Banking(1)</b>	<b>Factoring</b>	<b>Consolidated</b>
	<b>(Dollars in thousands)</b>		
Interest income	\$ 66,306	\$ 12,437	\$ 78,743
Intersegment interest allocations	1,087	(1,087)	
Total interest expense	2,422		2,422
Net interest income	64,971	11,350	76,321
Provision (credit) for loan losses	(156)	188	32
Net interest income after provision	65,127	11,162	76,289
Noninterest income	8,234	751	8,985
Noninterest expense	51,438	7,235	58,673
Intersegment expense allocations	386	(386)	
Income before income taxes	22,309	4,292	26,601
Income tax expense	8,301	1,803	10,104
Net income	\$ 14,008	\$ 2,489	\$ 16,497
Total assets	\$ 2,306,543	\$ 55,036	\$ 2,361,579
Loans, net of deferred fees	\$ 1,318,657	\$ 40,059	\$ 1,358,716
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

(1) Includes the holding company's results of operations.

Table of Contents

	<b>For the Twelve Months Ended December 31, 2014</b>		
	<b>Banking(1)</b>	<b>Factoring(2)</b>	<b>Consolidated</b>
	<b>(Dollars in thousands)</b>		
Interest income	\$ 57,178	\$ 2,078	\$ 59,256
Intersegment interest allocations	31	(31)	
Total interest expense	2,033	120	2,153
Net interest income	55,176	1,927	57,103
Provision (credit) for loan losses	(338)		(338)
Net interest income after provision	55,514	1,927	57,441
Noninterest income	7,662	84	7,746
Noninterest expense	43,132	1,090	44,222
Income before income taxes	20,044	921	20,965
Income tax expense	7,151	387	7,538
Net income	\$ 12,893	\$ 534	\$ 13,427
Total assets	\$ 1,561,911	\$ 55,192	\$ 1,617,103
Loans, net of deferred fees	\$ 1,048,631	\$ 40,012	\$ 1,088,643
Goodwill	\$	\$ 13,044	\$ 13,044

(1) Includes the holding company's results of operations.

(2) Includes two months of Bay View Funding's results of operations.

**Banking.** For the twelve months ended December 31, 2015, our banking segment's net income increased to \$14.0 million, compared with \$12.9 million for the twelve months ended December 31, 2014. Net interest income increased to \$65.0 million for the twelve months ended December 31, 2015, compared to \$55.2 million for the twelve months ended December 31, 2014. The increase in net interest income for the twelve months ended December 31, 2015, compared to the comparable periods in 2014, was primarily as a result of the Focus acquisition and organic growth in the loan portfolio and core deposits. For the twelve months ended December 31, 2015, noninterest expense was \$51.4 million, compared to \$43.1 million for the twelve months ended December 31, 2014. The increase in noninterest expense for the twelve months ended December 31, 2015, was primarily due to one-time costs related to the Focus transaction, and the additional operating costs of Focus. For the twelve months ended December 31, 2015, the credit provision for loan losses was \$156,000, compared with a credit for loan losses of \$338,000, for the twelve months ended December 31, 2014.

**Factoring.** Bay View Funding's primary business operation is purchasing and collecting factored receivables. Factored receivables are receivables that have been transferred by the originating organization and typically have not been subject to previous collection efforts. In a factoring transaction, Bay View Funding directly purchases the receivables generated by its clients at a discount to their face value. The transactions are structured to provide the clients with immediate working capital when there is a mismatch between payments to the client for a good or service and the incurrence of operating costs required to provide for such good or service. The average life of the factored receivables is 33 days. The balance of the purchased receivables as of December 31, 2015 and 2014 was \$40.1 million and \$40.0 million, respectively. Bay View Funding's results of operations have been included in the Company's results beginning November 1, 2014. For the twelve months ended December 31, 2015, Bay View Funding provided net interest income of \$11.3 million, noninterest income of \$751,000, and \$2.5 million of the Company's net income. For the twelve months ended December 31, 2014, two months of Bay View Funding's results of operations provided net interest income of \$1.9 million, noninterest income of \$84,000, and \$534,000 of the Company's net income.

Table of Contents**Financial Condition**

As of December 31, 2015, total assets were \$2.36 billion, an increase of 46% compared to \$1.62 billion at December 31, 2014. The investment securities available-for-sale portfolio totaled \$385.1 million at December 31, 2015, an increase of 87% from \$206.3 million at December 31, 2014. In addition, securities held-to-maturity totaled \$109.3 million at December 31, 2015, compared to \$95.4 million at December 31, 2014. The total loan portfolio, excluding loans held-for-sale, was \$1.36 billion, an increase of 25% from \$1.09 billion at year-end 2014, which included an increase of \$113.4 million, or 10%, in the Company's legacy loan portfolio, and \$141.6 million from the Focus loan portfolio.

Total deposits increased \$674.4 million, or 49%, to \$2.06 billion at December 31, 2015, compared to \$1.39 billion at December 31, 2014, which included an increase of \$297.5 million, or 21%, in the Company's legacy deposit portfolio, and \$376.9 million from the Focus deposit portfolio. Deposits (excluding all time deposits and CDARS deposits) increased \$686.4 million, or 61%, to \$1.81 billion at December 31, 2015, from \$1.13 billion at December 31, 2014.

**Securities Portfolio**

The following table reflects the balances for each category of securities at year-end:

	December 31,		
	2015	2014	2013
	(Dollars in thousands)		
<b>Securities available-for-sale (at fair value):</b>			
Agency mortgage-backed securities	\$ 324,230	\$ 154,172	\$ 207,644
U.S. Treasury	30,003		
Trust preferred securities	15,132	15,300	20,410
U.S. Government sponsored entities	9,041		
Corporate bonds	6,673	36,863	52,046
<b>Total</b>	<b>\$ 385,079</b>	<b>\$ 206,335</b>	<b>\$ 280,100</b>
<b>Securities held-to-maturity (at amortized cost):</b>			
Municipals Tax Exempt	\$ 93,518	\$ 79,882	\$ 79,989
Agency mortgage-backed securities	15,793	15,480	15,932
	<b>\$ 109,311</b>	<b>\$ 95,362</b>	<b>\$ 95,921</b>

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

### Table of Contents

The table below summarizes the weighted average life and weighted average yields of securities as of December 31, 2015:

	Within One Year or Less		After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total		
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	
<b>Weighted Average Life</b>											
<b>(Dollars in thousands)</b>											
Securities available-for-sale (at fair value):											
Agency mortgage-backed securities	\$		\$ 129,882	2.47%	\$ 190,326	2.33%	\$ 4,022	2.65%	\$ 324,230	2.39%	
U.S. Treasury			30,003	1.15%					30,003	1.15%	
Trust preferred securities							15,132	5.95%	15,132	5.95%	
U.S. Government sponsored entities	1,996	0.66%	2,984	0.99%	4,061	2.04%			9,041	1.39%	
Corporate bonds			6,673	2.87%					6,673	2.87%	
<b>Total</b>	<b>\$</b>	<b>1,996</b>	<b>0.66%</b>	<b>\$ 169,542</b>	<b>2.23%</b>	<b>\$ 194,387</b>	<b>2.32%</b>	<b>\$ 19,154</b>	<b>5.26%</b>	<b>\$ 385,079</b>	<b>2.42%</b>
Securities held-to-maturity (at amortized cost):											
Municipals Tax Exempt(1)	\$	2,733	3.69%	\$ 20,816	3.65%	\$ 42,703	4.00%	\$ 27,266	3.80%	\$ 93,518	3.85%
Agency mortgage-backed securities				5,579	2.47%			10,214	3.27%	15,793	2.99%
<b>Total</b>	<b>\$</b>	<b>2,733</b>	<b>3.69%</b>	<b>\$ 26,395</b>	<b>3.40%</b>	<b>\$ 42,703</b>	<b>4.00%</b>	<b>\$ 37,480</b>	<b>3.65%</b>	<b>\$ 109,311</b>	<b>3.73%</b>

(1) Reflects tax equivalent yield based on a 35% Federal tax rate.

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; and (iv) 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. 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 \$385.1 million at December 31, 2015, compared to \$206.3 million at December 31, 2014. At December 31, 2015, the Company's securities available-for-sale portfolio was comprised of \$324.3 million agency mortgage-backed securities (all issued by U.S. Government sponsored entities), \$30.0 million U.S. Treasuries, \$15.1 million of single entity issue trust preferred securities, \$9.0 million of U.S. Government agency securities, and \$6.7 million of corporate bonds. The pre-tax unrealized

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

gain on securities available-for-sale at December 31, 2015 was \$501,000, compared to a pre-tax unrealized gain on securities available-for-sale of \$4.8 million at December 31, 2014, and a pre-tax unrealized loss on securities available-for-sale of (\$2.4) million at December 31, 2013.



Table of Contents

During the fourth quarter of 2015, the Company repositioned a portion of its securities portfolio. The Company received gross proceeds of \$71.8 million on investment securities available-for-sale it sold during the fourth quarter of 2015 with a book value totaling \$71.2 million, resulting in a gain on sale of securities of \$637,000. There was also a \$5,000 gain on a bond that was called in the fourth quarter of 2015 included in gain on sale of securities. The investment securities sold during the fourth quarter of 2015 consisted of \$29.4 million of corporate bonds, \$8.3 million of tax-exempt municipal bonds, \$11.3 million of collateralized mortgage obligations, \$18.2 million of mortgage-backed securities, and \$4.0 million of U.S. Treasuries.

During the year ended December 31, 2015, the Company purchased \$232.6 million of investment securities available-for-sale, with a weighted average book yield of 1.95%. The investment securities purchased during 2015 consisted of \$202.6 million of mortgage-backed securities with a weighted average book yield of 1.99%, and \$30.0 million of U.S. Treasuries with a weighted average book yield of 1.15%. The mortgage-backed securities purchased during the year ended December 31, 2015 consisted of \$82.9 million of Federal National Mortgage Association ("FNMA") securities, \$69.9 million of Government National Mortgage Association ("GNMA") securities, and \$49.8 million of Federal Home Loan Mortgage Corporation ("FHLMC") securities, with an average book yield of 1.99%, 1.90%, and 1.99%, respectively.

At December 31, 2015, investment securities held-to-maturity totaled \$109.3 million, compared to \$95.4 million at December 31, 2014. At December 31, 2015, the Company's securities held-to-maturity portfolio, at amortized cost, was comprised of \$93.5 million tax-exempt municipal bonds, and \$15.8 million agency mortgage-backed securities.

During the year ended December 31, 2015, the Company purchased \$9.5 million of investment securities held-to-maturity, with a weighted average book yield of 3.64%. The investment securities purchased during 2015 consisted of \$3.2 million of mortgage-backed securities with a weighted average book yield of 2.60%, and \$6.3 million of U.S. Treasuries with a weighted average book yield of 4.18%.

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 earning 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 December 31, 2015, as compared to 67% of total assets at December 31, 2014. The ratio of loans to deposits decreased to 65.87% at December 31, 2015 from 78.41% December 31, 2014.

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

Table of Contents**Loan Distribution**

	December 31,									
	2015	% to Total	2014	% to Total	2013	% to Total	2012	% to Total	2011	% to Total
	(Dollars in thousands)									
Commercial	\$ 556,522	41%	\$ 462,403	43%	\$ 393,074	43%	\$ 375,469	46%	\$ 366,590	48%
Real estate:										
Commercial and residential	625,665	46%	478,335	44%	423,288	46%	354,934	44%	311,479	41%
Land and construction	84,428	6%	67,980	6%	31,443	3%	22,352	3%	23,016	3%
Home equity	76,833	6%	61,644	6%	51,815	6%	43,865	5%	52,017	7%
Consumer	16,010	1%	18,867	1%	15,677	2%	15,714	2%	11,166	1%
Loans	1,359,458	100%	1,089,229	100%	915,297	100%	812,334	100%	764,268	100%
Deferred loan (fees) costs, net	(742)		(586)		(384)		(21)		323	
Loans, including deferred fees and costs	1,358,716	100%	1,088,643	100%	914,913	100%	812,313	100%	764,591	100%
Allowance for loan losses	(18,926)		(18,379)		(19,164)		(19,027)		(20,700)	
Loans, net	\$ 1,339,790		\$ 1,070,264		\$ 895,749		\$ 793,286		\$ 743,891	

The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and services oriented entities) and commercial real estate, with the remaining 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, 58% of its gross loans were secured by real property as of December 31, 2015, compared to 56% as of December 31, 2014. 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 uses underwriting guidelines to assess the borrowers' historical cash flow to determine debt service, and we further stress test 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 loans conditionally guaranteed by the SBA (collectively referred to as "SBA loans"). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold the Company retains the servicing rights for the sold portion. During 2015, loans were sold resulting in a gain on sales of SBA loans of \$843,000, compared to a gain on sales of SBA loans of \$971,000 for 2014, and \$449,000 for 2013.

The Company's factoring receivables are from the operations of Bay View Funding whose primary business is purchasing and collecting factored receivables. Factored receivables are receivables that have been transferred by the originating organization and typically have not been

subject to previous collection efforts. These receivables are acquired from a variety of companies, including but not limited to service providers, transportation companies, manufacturers, distributors, wholesalers, apparel companies, advertisers, and temporary staffing companies. The portfolio of factored receivables is included in the Company's commercial loan portfolio.

Table of Contents

As of December 31, 2015, commercial and residential real estate loans of \$625.7 million consist primarily of adjustable and fixed-rate loans secured by deeds of trust on commercial and residential property. The commercial and residential real estate loans at December 31, 2015 consist of \$264.9 million, or 42% of commercial owner occupied properties, \$360.8 million, or 58%, of commercial investment properties. Properties securing the commercial and residential real estate loans are primarily 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. Construction loans are provided primarily in our market area, and we have extensive controls for the disbursement process. Land and construction loans increased \$16.4 million to \$84.4 million at December 31, 2015, from \$68.0 million at December 31, 2014, primarily as a result of strong housing demand within the Company's lending area.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 75% loan to value ratio. Home equity lines are reviewed semi-annually, with specific emphasis on loans with a loan to value ratio greater than 70%. The Company takes measures to work with customers to reduce line commitments and minimize potential losses.

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 \$39.8 million and \$66.3 million at December 31, 2015, respectively.

***Loan Maturities***

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale), as of December 31, 2015. 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 Street

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

### Table of Contents

Journal. As of December 31, 2015, approximately 54% of the Company's loan portfolio consisted of floating interest rate loans.

	Due in One Year or Less	Over One Year But Less than Five Years	Over Five Years	Total
	(Dollars in thousands)			
Commercial	\$ 465,595	\$ 78,339	\$ 12,588	\$ 556,522
Real estate:				
Commercial and residential	71,334	268,876	285,455	625,665
Land and construction	84,180	248		84,428
Home equity	72,273	1,361	3,199	76,833
Consumer	14,793	1,124	93	16,010
<b>Loans</b>	<b>\$ 708,175</b>	<b>\$ 349,948</b>	<b>\$ 301,335</b>	<b>\$ 1,359,458</b>
Loans with variable interest rates	\$ 646,457	\$ 80,616	\$ 6,251	\$ 733,324
Loans with fixed interest rates	61,718	269,332	295,084	626,134
<b>Loans</b>	<b>\$ 708,175</b>	<b>\$ 349,948</b>	<b>\$ 301,335</b>	<b>\$ 1,359,458</b>

### *Loan Servicing*

As of December 31, 2015, 2014, and 2013 there were \$175.5 million, \$130.6million, and \$135.5 million, respectively, of SBA loans that were serviced by the Company for others. Activity for loan servicing rights was as follows:

	2015	2014	2013
	(Dollars in thousands)		
Beginning of year balance	\$ 565	\$ 525	\$ 709
Additions	2,126	319	106
Amortization	(482)	(279)	(290)
End of year balance	\$ 2,209	\$ 565	\$ 525

Loan servicing rights are included in Accrued Interest Receivable and Other Assets on the consolidated balance sheets and reported net of amortization. The increase in loan servicing rights for the year ended December 31, 2015, compared to the prior year, was primarily due to the Focus acquisition of \$1.9 million in serviced SBA loans at fair value. There was no valuation allowance as of December 31, 2015 and 2014, as the fair market value of the assets was greater than the carrying value.

I/O strip receivables relate to the excess servicing assets on loans sold prior to 2009. Activity for the I/O strip receivable was as follows:

	2015	2014	2013
	(Dollars in thousands)		
Beginning of year balance	\$ 1,481	\$ 1,647	\$ 1,786
Unrealized holding loss	(114)	(166)	(139)
End of year balance	\$ 1,367	\$ 1,481	\$ 1,647

Management reviews the key economic assumptions used to estimate the fair value of I/O strip receivables on a quarterly basis. The fair value of the I/O strip can be adversely impacted by a significant increase in either the prepayment speed of the portfolio or the discount rate. At December 31, 2015, key economic assumptions and the sensitivity of the fair value of the I/O strip receivables to immediate changes

Table of Contents

to the CPR assumption of 10% and 20%, and changes to the discount rate assumption of 1% and 2%, are as follows:

	(Dollars in thousands)	
Carrying amount/fair value of Interest-Only (I/O) strip	\$	1,367
Prepayment speed assumption (annual rate)		7.4%
Impact on fair value of 10% adverse change in prepayment speed (CPR 8.2%)	\$	(29)
Impact on fair value of 20% adverse change in prepayment speed (CPR 8.9%)	\$	(58)
Residual cash flow discount rate assumption (annual)		12.5%
Impact on fair value of 1% adverse change in discount rate (13.8% discount rate)	\$	(44)
Impact on fair value of 2% adverse change in discount rate (15.0% discount rate)	\$	(86)

**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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

Table of Contents

repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. Foreclosed assets consist of properties and other assets acquired by foreclosure or similar means that management is offering or will offer for sale.

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

	December 31,				
	2015	2014	2013	2012	2011
	(Dollars in thousands)				
Nonaccrual loans held-for-sale	\$	\$	\$	\$	\$ 186
Nonaccrual loans held-for-investment	4,716	5,855	11,326	17,335	14,353
Restructured and loans 90 days past due and still accruing	1,662		492	859	2,291
<b>Total nonperforming loans</b>	<b>6,378</b>	<b>5,855</b>	<b>11,818</b>	<b>18,194</b>	<b>16,830</b>
Foreclosed assets	364	696	575	1,270	2,312
<b>Total nonperforming assets</b>	<b>\$ 6,742</b>	<b>\$ 6,551</b>	<b>\$ 12,393</b>	<b>\$ 19,464</b>	<b>\$ 19,142</b>

Nonperforming assets as a percentage of loans plus nonaccrual loans held-for-sale plus foreclosed assets	0.50%	0.60%	1.35%	2.39%	2.50%
Nonperforming assets as a percentage of total assets	0.29%	0.41%	0.83%	1.15%	1.47%

The following table presents nonperforming loans by class at year end:

	2015			2014		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	\$ 724	\$ 1,378	\$ 2,102	\$ 2,534		\$ 2,534
Real estate:						
Commercial and residential	2,992		2,992	1,651		1,651
Land and construction	219		219	1,320		1,320
Home equity	777	284	1,061	344		344
Consumer	4		4	6		6
<b>Total</b>	<b>\$ 4,716</b>	<b>\$ 1,662</b>	<b>\$ 6,378</b>	<b>\$ 5,855</b>		<b>\$ 5,855</b>

Nonperforming assets were \$6.7 million, or 0.29% of total assets, at December 31, 2015, compared to \$6.6 million, or 0.41% of total assets, at December 31, 2014. At December 31, 2015, \$6.0 million of the NPAs were in the Company's legacy loan portfolio, and \$734,000 of the NPAs were in the Focus loan portfolio. Included in total nonperforming assets were foreclosed assets of \$364,000 at December 31, 2015, compared to \$696,000 at December 31, 2014.



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

### Table of Contents

The following table provides a summary of the loan portfolio by loan type and credit quality classification at the dates indicated:

	December 31, 2015			December 31, 2014		
	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total
	(Dollars in thousands)					
Commercial	\$ 547,536	\$ 8,986	\$ 556,522	\$ 455,767	\$ 6,636	\$ 462,403
Real estate:						
Commercial and residential	617,865	7,800	625,665	472,061	6,274	478,335
Land and construction	84,209	219	84,428	66,660	1,320	67,980
Home equity	75,511	1,322	76,833	60,736	908	61,644
Consumer	15,705	305	16,010	18,518	349	18,867
<b>Total</b>	<b>\$ 1,340,826</b>	<b>\$ 18,632</b>	<b>\$ 1,359,458</b>	<b>\$ 1,073,742</b>	<b>\$ 15,487</b>	<b>\$ 1,089,229</b>

\*

Classified loans in the table above include SBA guarantees.

The following provides a rollforward of troubled debt restructurings ("TDRs"):

	For the Year Ended December 31, 2015		
	Performing TDRs	Nonperforming TDRs	Total
	(Dollars in thousands)		
Balance at January 1, 2015	\$ 167	\$ 916	\$ 1,083
Principal repayments	(18)	(912)	(930)
Balance at December 31, 2015	\$ 149	\$ 4	\$ 153

	For the Year Ended December 31, 2014		
	Performing TDRs	Nonperforming TDRs	Total
	(Dollars in thousands)		
Balance at January 1, 2014	\$ 492	\$ 3,230	\$ 3,722
Principal repayments	(462)	(2,147)	(2,609)
Net charge-offs	(30)		(30)
Change in TDR classification	167	(167)	
Balance at December 31, 2014	\$ 167	\$ 916	\$ 1,083

### *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

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

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

Table of Contents

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 loss analysis.

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 with a well-defined weakness, which are characterized by the distinct possibility that the Company will sustain a loss if the deficiencies are 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 \$20.5 million at December 31, 2015 and \$16.0 million at December 31, 2014. There were no loans held-for-sale included in classified assets at December 31, 2015 and December 31, 2014. Loans held-for-sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses.

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 Board and the California Department of Business Oversight 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 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.

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

### Table of Contents

The following table summarizes 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:

	2015	2014	2013	2012	2011
	(Dollars in thousands)				
Balance, beginning of year	\$ 18,379	\$ 19,164	\$ 19,027	\$ 20,700	\$ 25,204
Charge-offs:					
Commercial	(527)	(815)	(1,676)	(3,935)	(7,559)
Real estate:					
Commercial and residential	(2)		(173)	(1,362)	(1,599)
Land and construction			(1)	(133)	(1,757)
Home equity		(87)	(102)	(33)	
Consumer	(9)	(25)			(8)
<b>Total charge-offs</b>	<b>(538)</b>	<b>(927)</b>	<b>(1,952)</b>	<b>(5,463)</b>	<b>(10,923)</b>
Recoveries:					
Commercial	877	418	2,621	776	678
Real estate:					
Commercial and residential	9	35	274	230	381
Land and construction	127	26			879
Home equity	10	1	9		9
Consumer	30		1		3
<b>Total recoveries</b>	<b>1,053</b>	<b>480</b>	<b>2,905</b>	<b>1,006</b>	<b>1,950</b>
Net recoveries (charge-offs)	515	(447)	953	(4,457)	(8,973)
Provision (credit) for loan losses	32	(338)	(816)	2,784	4,469
<b>Balance, end of year</b>	<b>\$ 18,926</b>	<b>\$ 18,379</b>	<b>\$ 19,164</b>	<b>\$ 19,027</b>	<b>\$ 20,700</b>
<b>RATIOS:</b>					
Net charge-offs (recoveries) to average loans*	0.04%	0.05%	0.11%	0.57%	1.12%
Allowance for loan losses to total loans*	1.39%	1.69%	2.09%	2.34%	2.71%
Allowance for loan losses to nonperforming loans, excluding nonaccrual loans held-for-sale	296.74%	313.90%	162.16%	104.58%	124.37%

\*  
Excludes loans held-for-sale

The following table provides a summary of the allocation of the allowance for loan losses for specific categories 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

Table of Contents

portion of the allowance allocated to each category represents the total amount available for charge-offs that may occur within these categories.

	December 31,									
	2015		2014		2013		2012		2011	
	Percent of Loans in each category to total Allowance	Percent of Loans in each category to total loans	Percent of Loans in each category to total Allowance	Percent of Loans in each category to total loans	Percent of Loans in each category to total Allowance	Percent of Loans in each category to total loans	Percent of Loans in each category to total Allowance	Percent of Loans in each category to total loans	Percent of Loans in each category to total Allowance	Percent of Loans in each category to total loans
	(Dollars in thousands)									
Commercial	\$ 10,748	41%	\$ 11,187	43%	\$ 12,533	43%	\$ 12,866	46%	\$ 13,215	48%
Real estate:										
Commercial and residential	4,980	46%	4,707	44%	4,922	46%	4,609	44%	6,203	41%
Land and construction	1,504	6%	1,048	6%	356	3%	399	3%	594	3%
Home equity	1,592	6%	1,315	6%	1,270	6%	1,026	5%	541	7%
Consumer	102	1%	122	1%	83	2%	127	2%	147	1%
Total	\$ 18,926	100%	\$ 18,379	100%	\$ 19,164	100%	\$ 19,027	100%	\$ 20,700	100%

The allowance for loan losses totaled \$18.9 million, or 1.39% of total loans at December 31, 2015, compared to \$18.4 million, or 1.69% of total loans at December 31, 2014. The allowance for loan losses to total loans decreased at December 31, 2015, compared to December 31, 2014, primarily due to the Focus loan portfolio, which was marked to fair market value on the acquisition date, and an increase in the Company's legacy loan balances with no default histories, coupled with the decrease in the Company's legacy nonperforming assets, improving the quality of the loan portfolio overall. The allowance for loan losses to total nonperforming loans decreased to 296.74% at December 31, 2015, compared to 313.90% at December 31, 2014. 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 \$515,000, or 0.04% of average loans, for the year ended December 31, 2015, compared to net charge-offs of \$447,000, or 0.05% of average loans, for the year ended December 31, 2014.

The allowance for loan losses related to the commercial portfolio decreased \$439,000 at December 31, 2015 from December 31, 2014, as a result of a credit to the provision for loan losses of \$789,000 related to the commercial loan portfolio, and net recoveries of \$350,000. The decrease in the allowance for loan losses was primarily due to a decline in the Company's legacy problem loans. The allowance for loan losses related to the real estate portfolio increased \$1.0 million at December 31, 2015 from December 31, 2014, as a result of a provision for loan losses of \$862,000 and net recoveries of \$144,000. The increase in the allowance for loan losses was primarily due to an increase in the balance of real estate loans outstanding.

**Goodwill and Other Intangible Assets**

On November 1, 2014, estimated goodwill of \$13.0 million resulted from the acquisition Bay View Funding. On August 20, 2015, estimated goodwill of \$32.6 million resulted from the merger of Focus. Goodwill represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate a more accurate or appropriate value for an asset or liability. Total goodwill at December 31, 2015 was \$45.6 million, which consisted of \$13.0 million related to the Bay View Funding acquisition, and \$32.6 million related to the Focus acquisition.

Goodwill impairment exists when a reporting unit's carrying value exceeds its fair value, which is determined through a qualitative assessment whether it is more likely than not that the fair value of equity of the reporting unit exceeds the carrying value ("Step Zero"). If the qualitative assessment indicates it is more likely than not that the fair value of equity of a reporting unit is less than book value, than a quantitative two-step impairment test is required. Step 1 includes the determination of the carrying value

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

### Table of Contents

of the Company's single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess.

The Company completed its annual impairment analysis on the goodwill from the Bay View Funding acquisition as of November 30, 2015 with the assistance of an independent valuation firm. Based on the Step Zero qualitative analysis performed, the Company determined that it is more likely than not that the fair value of the Company's equity exceeded its reported book value of equity at November 30, 2015. As such, no impairment was indicated and no further testing was required.

Other intangible assets were \$8.5 million at December 31, 2015, compared to \$3.3 million at December 31, 2014. Core deposit and customer relationship intangible assets arising from the acquisition of Diablo Valley Bank in June 2007 were \$621,000 at December 31, 2015 and \$1.1 million at December 31, 2014, net of accumulated amortization. The core deposit intangible asset arising from the acquisition of Focus was \$6.0 million at December 31, 2015, net of accumulated amortization. A below market lease, customer relationship and brokered relationship, and a non-compete agreement intangible assets arising from the acquisition of Bay View Funding in November 2014 were \$1.9 million at December 31, 2015 and \$2.2 million at December 31, 2014, net of accumulated amortization.

### **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 in this report. The Company's liquidity is impacted by the volatility of deposits from 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, weaken. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed \$250,000, 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:

	Year Ended December 31,					
	2015		2014		2013	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
(Dollars in thousands)						
Demand, noninterest-bearing	\$ 821,405	40%	\$ 517,662	37%	\$ 431,085	34%
Demand, interest-bearing	496,278	24%	225,821	16%	195,451	15%
Savings and money market	496,843	24%	384,644	28%	347,052	27%
Time deposits under \$250	62,026	3%	57,443	4%	58,655	5%
Time deposits \$250 and over	160,815	8%	163,452	12%	157,996	12%
Time deposits brokered	17,825	1%	28,116	2%	55,524	4%
CDARS money market and time deposits	7,583	0%	11,248	1%	40,458	3%
Total deposits	\$ 2,062,775	100%	\$ 1,388,386	100%	\$ 1,286,221	100%

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

### Table of Contents

The Company obtains deposits from a cross-section of the communities it serves. The Company is not dependent upon funds from sources outside the United States of America. Public funds were 4% of deposits at December 31, 2015 and 7% at December 31, 2014.

Deposits totaled \$2.06 billion at December 31, 2015, compared to \$1.39 billion at December 31, 2014, which included an increase of \$297.5 million, or 21%, in the Company's legacy deposit portfolio, and \$376.9 million from the Focus deposit portfolio. Noninterest-bearing deposits increased 59% to \$821.4 million at December 31, 2015, from \$517.7 million, at December 31, 2014. Interest-bearing demand deposits increased 120% to \$496.3 million at December 31, 2015, from \$225.8 million at December 31, 2014. Savings and money market deposits increased 29% to \$496.8 million at December 31, 2015, from \$384.6 million at December 31, 2014. At December 31, 2015, brokered deposits decreased 37% to \$17.8 million, from \$28.1 million at December 31, 2014. CDARS money market and time deposits decreased to \$7.6 million at December 31, 2015, from \$11.2 million at December 31, 2014. Deposits (excluding all time deposits and CDARS deposits), increased \$686.4 million, or 61%, to \$1.81 billion at December 31, 2015, from \$1.13 billion at December 31, 2014.

At December 31, 2015, the Company had \$93.0 million (at fair value) of securities pledged for \$78.0 million in certificates of deposits from the State of California. At December 31, 2014, the Company had \$109.8 million (at fair value) of securities pledged for \$98.0 million in certificates of deposits from the State of California.

CDARS deposits were comprised of \$3.4 million of money market accounts and \$4.2 million of time deposits at December 31, 2015. CDARS deposits were comprised of \$4.0 million of money market accounts and \$7.2 million of time deposits at December 31, 2014.

The following table indicates the contractual maturity schedule of the Company's time deposits of \$250,000 and over, and all CDARS time deposits and brokered deposits as of December 31, 2015:

	Balance	% of Total
	(Dollars in thousands)	
Three months or less	\$ 104,256	57%
Over three months through six months	39,751	22%
Over six months through twelve months	32,168	18%
Over twelve months	6,660	4%
<b>Total</b>	<b>\$ 182,835</b>	<b>100%</b>

The Company focuses primarily on providing and servicing business deposit accounts that are frequently over \$250,000 in average balance per account. As a result, certain types of business clients that the Company serves typically carry average deposits in excess of \$250,000. The account activity for some account types and client types necessitates appropriate liquidity management practices by the Company to 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:

	2015	2014	2013
Return on average assets	0.86%	0.88%	0.81%
Return on average tangible assets	0.88%	0.88%	0.81%
Return on average equity	8.04%	7.44%	6.77%
Return on average tangible equity	9.41%	7.60%	6.84%
Average equity to average assets ratio	10.73%	11.85%	11.90%

Table of Contents

**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 contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, yet are not reflected in any form within the Company's consolidated balance sheets. Total unused commitments to extend credit were \$573.7 million at December 31, 2015, as compared to \$439.3 million at December 31, 2014. Unused commitments represented 42% and 40% of outstanding gross loans at December 31, 2015 and 2014, 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 the lines of credit will ever be fully utilized. For more information regarding the Company's off-balance sheet arrangements, see Note 15 to the consolidated financial statements located elsewhere herein.

The following table presents the Company's commitments to extend credit for the periods indicated:

	December 31, 2015		December 31, 2014	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)			
Unused lines of credit and commitments to make loans	\$ 16,917	\$ 539,897	\$ 8,164	\$ 415,146
Standby letters of credit	3,402	13,458	3,235	12,783
	\$ 20,319	\$ 553,355	\$ 11,399	\$ 427,929

**Contractual Obligations**

The contractual obligations of the Company, summarized by type of obligation and contractual maturity, at December 31, 2015, are as follows:

	Less Than One Year	One to Three Years	Three to Five Years	After Five Years	Total
	(Dollars in thousands)				
Deposits(1)	\$ 2,051,677	\$ 10,873	\$ 225	\$	\$ 2,062,775
Operating leases	3,434	4,855	2,954	232	11,475
Other short-term borrowings	3,000				3,000
Other long-term liabilities(2)	919	2,962	3,220	38,196	45,297
Total contractual obligations	\$ 2,059,030	\$ 18,690	\$ 6,399	\$ 38,428	\$ 2,122,547

(1) Deposits with indeterminate maturities, such as demand, savings and money market accounts, are reflected as obligations due in less than one year.

(2) Includes maximum payments related to employee benefit plans, assuming all future vesting conditions are met. Additional information is provided in Note 14 to the consolidated financial statements.

In addition to those obligations listed above, in the normal course of business, the Company will make cash distributions for the payment of interest on interest-bearing deposit accounts and debt obligations, payments for quarterly income tax estimates and contributions to certain employee benefit plans.



*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

Table of Contents

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 may utilize overnight Federal funds purchase arrangements and other borrowing arrangements with correspondent banks, solicit brokered deposits if cost effective deposits are not available from local sources and maintain collateralized lines of credit with the FHLB and Federal Reserve. 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 of liquidity is our loan to deposit ratio. Our loan to deposit ratio was 65.87% at December 31, 2015, compared to 78.41% at December 31, 2014.

***FHLB and Federal Reserve 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 Federal Reserve. 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 December 31, 2015, and December 31, 2014. The Company had \$245.6 million of loans pledged to the FHLB as collateral on an available line of credit of \$141.9 million at December 31, 2015. The Company had \$246.6 million of loans pledged to the FHLB as collateral on an available line of credit of \$140.0 million at December 31, 2014.

The Company can also borrow from Federal Reserve's discount window. The Company had \$395.0 million of loans pledged to the Federal Reserve as collateral on an available line of credit of \$243.2 million at December 31, 2015, none of which was outstanding. The Company had \$388.0 million of loans pledged to the Federal Reserve as collateral on an available line of credit of \$260.4 million at December 31, 2014, none of which was outstanding.

At December 31, 2015 and 2014, the Company had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at December 31, 2015 or 2014.

The Company has a \$5.0 million line of credit with a correspondent bank, of which \$3.0 million was outstanding at December 31, 2015.

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 December 31, 2015 and December 31, 2014.

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

	December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Average balance during the year	\$ 578	\$ 3,953	\$ 58
Average interest rate during the year	3.14%	3.06%	0.20%
Maximum month-end balance during the year	\$ 3,000	\$ 29,796	\$
Average rate at December 31,	3.00%	2.87%	N/A

Table of Contents**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 and the FDIC, establish a risk-adjusted ratio relating capital to different categories of assets and off-balance sheet exposures. See Business Supervision and Regulation Prompt Corrective Action Provisions.

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of the consolidated Company under the Basel III requirements as of December 31, 2015, and under the Basel I requirements as of December 31, 2014, December 31, 2013:

	December 31,			
	2015	2014		2013
	(Dollars in thousands)			
	Under Basel III		Under Basel I	
<b>Capital components:</b>				
Common equity Tier 1 capital	\$	181,222	N/A	N/A
Additional Tier 1 capital		18,077	N/A	N/A
Tier 1 Capital		199,299	\$ 169,278	\$ 165,162
Tier 2 Capital		19,616	16,790	14,754
Total risk-based capital	\$	218,915	\$ 186,068	\$ 179,916
Risk-weighted assets	\$	1,750,515	\$ 1,341,094	\$ 1,175,813
Average assets for capital purposes	\$	2,322,940	\$ 1,598,724	\$ 1,477,082
<b>Capital ratios:</b>				
Total risk-based capital		12.5%	13.9%	15.3%
Tier 1 risk-based capital		11.4%	12.6%	14.0%
Common equity Tier 1 risk-based capital		10.4%	N/A	N/A
Leverage(1)		8.6%	10.6%	11.2%

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

Table of Contents

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of HBC under the Basel III requirements as of December 31, 2015, and under the Basel I requirements as of December 31, 2014, December 31, 2013:

	December 31,			
	2015	2014		2013
	(Dollars in thousands)			
	Under Basel III		Under Basel I	
<b>Capital components:</b>				
Common equity Tier 1 capital	\$	200,327	N/A	N/A
Additional Tier 1 capital			N/A	N/A
Tier 1 Capital		200,327	\$ 158,976	\$ 149,037
Tier 2 Capital		19,616	16,789	14,790
Total risk-based capital	\$	219,943	\$ 175,765	\$ 163,827
Risk-weighted assets	\$	1,750,222	\$ 1,340,949	\$ 1,178,719
Average assets for capital purposes	\$	2,322,232	\$ 1,599,173	\$ 1,477,168
<b>Capital ratios:</b>				
Total risk-based capital		12.6%	13.1%	13.9%
Tier 1 risk-based capital		11.4%	11.9%	12.6%
Common equity Tier 1 risk-based capital		11.4%	N/A	N/A
Leverage(1)		8.6%	9.9%	10.1%

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

The following table presents the applicable well-capitalized regulatory guidelines and the standards for minimum capital adequacy requirements under the Basel III as of December 31, 2015, and under Basel I as of December 31, 2014 and December 31, 2013:

	Under Basel III			Under Basel I	
	Transitional	Minimum	Well-capitalized	Minimum	Well-Capitalized
	Minimum	Regulatory	Regulatory		
Regulatory	Regulatory	Definition	Regulatory	Regulatory	
Requirement	Requirement(1)	Under	Requirement	Requirement	
Effective	Effective	FDICIA(2)	Effective	Requirements	
January 1,	January 1,	January 1,	January 1,	Requirements	
2015	2019	2015	2015	Requirements	
<b>Capital ratios:</b>					
Total risk-based capital	8.00%	10.50%	10.00%	8.00%	10.00%
Tier 1 risk-based capital	6.00%	8.50%	8.00%	4.00%	6.00%
Common equity Tier 1 risk-based capital	4.50%	7.00%	6.50%	N/A	N/A
Leverage	4.00%	4.00%	5.00%	4.00%	5.00%

(1) Includes 2.5% capital conservation buffer.

(2) Applies to HBC only

---

At December 31, 2015, the Company's and HBC's regulatory capital increased concurrent with average assets for capital purposes and risk-weighted assets due to the common stock issued in the Focus

Table of Contents

transaction, net of normal fluctuations to regulatory capital from dividends, share based compensation, and net income.

At December 31, 2015, the Company's consolidated capital ratio exceeded regulatory guidelines and HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under Basel III prompt corrective action provisions. Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios of total risk-based capital, Tier 1 capital, and common equity Tier 1 (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of December 31, 2015, December 31, 2014, and December 31, 2013, the Company and HBC met all capital adequacy guidelines to which they were subject. There are no conditions or events since December 31, 2015, that management believes have changed the categorization of the Company or HBC as well-capitalized.

At December 31, 2015, the Company had total shareholders' equity of \$245.4 million, compared to \$184.4 million at December 31, 2014. The increase in total shareholders' equity at December 31, 2015 from December 31, 2014 was primarily due to the Focus acquisition and an increase in retained earnings. The Company issued 5,456,713 shares of the Company's common stock to Focus shareholders for a total value of \$58.3 million based on the Company's closing stock price of \$10.68 on August 20, 2015. At December 31, 2015, total shareholders' equity included \$19.5 million in preferred stock, \$193.3 million in common stock, \$38.8 million in retained earnings, and (\$6.2) million of accumulated other comprehensive loss.

The accumulated other comprehensive loss was (\$6.2) million at December 31, 2015, compared to accumulated other comprehensive loss of (\$1.9) million at December 31, 2014. The unrealized gain on securities available-for-sale was \$296,000, net of taxes, at December 31, 2015, compared to an unrealized gain on securities available-for-sale of \$2.8 million, net of taxes, at December 31, 2014. The components of other comprehensive loss, net of taxes, at December 31, 2015 include the following: an unrealized gain on available-for-sale securities of \$296,000; the remaining unamortized unrealized gain on securities available-for-sale transferred to held-to-maturity of \$402,000; a split dollar insurance contracts liability of (\$3.6) million; a supplemental executive retirement plan liability of (\$4.1) million; and an unrealized gain on interest-only strip from SBA loans of \$794,000.

***Series C Preferred Stock***

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of newly issued Series C Preferred Stock. The Series C Preferred Stock is mandatorily convertible into 5,601,000 shares of 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. The holders of Series C Preferred Stock receive dividends on an as converted basis when dividends are also declared for 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.

The book value per common share was \$7.03 at December 31, 2015, compared to \$6.22 at December 31, 2014, and \$5.84 at December 31, 2013. The tangible book value per common share was \$5.35 at December 31, 2015, compared to \$5.60 at December 31, 2014, and \$5.78 at December 31, 2013. On a full conversion of the Series C Preferred stock into common stock at December 31, 2015, December 31, 2014, and December 31, 2013: (i) the book value per common share would have been reduced to \$6.51, \$5.74, \$5.43, respectively; and (ii) the tangible book value per common share would have been reduced to \$5.07, \$5.23, \$5.38, respectively. A reduction in the book value per share and tangible

Table of Contents

book value per share upon full conversion would result primarily because of the 5,601,000 additional shares of common stock issued for the conversion of the 21,004 shares of Series C Preferred 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 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

Table of Contents

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 December 31, 2015. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

	<b>Increase/(Decrease) in Estimated Net Interest Income</b>	
	<b>Amount</b>	<b>Percent</b>
	<b>(Dollars in thousands)</b>	
<b>Change in Interest Rates (basis points)</b>		
+400	\$ 27,706	37.1%
+300	\$ 20,903	28.0%
+200	\$ 14,160	18.9%
+100	\$ 7,215	9.7%
0	\$	0.0%
100	\$ (8,739)	11.7%
200	\$ (17,057)	22.8%

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, if any.

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 7A QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As a financial institution, the Company's primary component of market risk is interest rate volatility. Fluctuations in interest rates will ultimately impact both the level of income and expense recorded on most of the Company's assets and liabilities and the market value of all interest-earning assets, other than those which have a short term to maturity. Based upon the nature of the Company's operations, the Company is not subject to foreign exchange or commodity price risk. The Company has no market risk sensitive instruments held for trading purposes. As of December 31, 2015, the Company did not use interest rate derivatives to hedge its interest rate risk.



Table of Contents

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 7 of this report.

**ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The financial statements and report of the Independent Registered Public Accounting Firm are set forth on pages 95 through 158.

**ITEM 9 CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES**

None.

**ITEM 9A 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 December 31, 2015. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls were effective as of December 31, 2015, the period covered by this report.

**Management's Annual Report on Internal Control over Financial Reporting**

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. As defined in Rule 13a-15(f) under the Exchange Act, internal control over financial reporting is a process designed by, or under the supervision of, a company's principal executive and principal financial officers and effected by a company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. It includes those policies and procedures that:

Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of a company;

Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of a company are being made only in accordance with authorizations of management and the board of directors of the company; and

Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of a company's assets that could have a material effect on its financial statements.

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

Table of Contents

The Company's management has used the criteria established in the 2013 *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") to evaluate the effectiveness of the Company's internal control over financial reporting. Management has selected the COSO framework for its evaluation as it is a control framework recognized by the SEC and the Public Company Accounting Oversight Board, that is free from bias, permits reasonably consistent qualitative and quantitative measurement of the Company's internal controls, is sufficiently complete so that relevant controls are not omitted and is relevant to an evaluation of internal controls over financial reporting.

Based on our assessment, management has concluded that our internal control over financial reporting, based on criteria established in the 2013 *Internal Control - Integrated Framework* issued by COSO was effective as of December 31, 2015.

The independent registered public accounting firm of Crowe Horwath LLP, as auditors of our consolidated financial statements, has issued an attestation report on the effectiveness of management's internal control over financial reporting based on criteria established in the 2013 *"Internal Control - Integrated Framework,"* issued by COSO.

**Inherent Limitations on Effectiveness of Controls**

The Company's management, including the Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls or our internal control over financial reporting will prevent or detect all errors and fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

**Changes in Internal Control over Financial Reporting**

There was no change in our internal control over financial reporting that occurred during the year ended December 31, 2015 that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

**ITEM 9B OTHER INFORMATION**

None.

**PART III**

**ITEM 10 DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

Information required by this item will be contained in our Definitive Proxy Statement for our 2016 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2015. Such information is incorporated herein by reference.

Table of Contents

We have adopted a code of ethics that applies to our Chief Executive Officer, Chief Financial Officer, and to our other principal financial officers. The code of ethics is available at the Governance Documents section of our website at [www.heritagecommercecorp.com](http://www.heritagecommercecorp.com). We intend to disclose future amendments to, or waivers from, certain provisions of our code of ethics on the above website within four business days following the date of such amendment or waiver.

**ITEM 11 EXECUTIVE COMPENSATION**

Information required by this item will be contained in our Definitive Proxy Statement for our 2016 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2015. Such information is incorporated herein by reference.

**ITEM 12 SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Information required by this item will be contained in our Definitive Proxy Statement for our 2016 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2015. Such information is incorporated herein by reference.

**ITEM 13 CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE**

Information required by this item will be contained in our Definitive Proxy Statement for our 2016 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2015. Such information is incorporated herein by reference.

**ITEM 14 PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Information required by this item will be contained in our Definitive Proxy Statement for our 2016 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2015. Such information is incorporated herein by reference.

**PART IV**

**ITEM 15 EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

**(a)(1) FINANCIAL STATEMENTS**

The Financial Statements of the Company and the Report of Independent Registered Public Accounting Firm are set forth on pages 95 through 158.

**(a)(2) FINANCIAL STATEMENT SCHEDULES**

All schedules to the Financial Statements are omitted because of the absence of the conditions under which they are required or because the required information is included in the Financial Statements or accompanying notes.

**(a)(3) EXHIBITS**

The exhibit list required by this Item is incorporated by reference to the Exhibit Index included in this report.

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

### Table of Contents

### SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report on Form 10-K to be signed on its behalf by the undersigned thereunto duly authorized.

HERITAGE COMMERCE CORP

BY:           /s/ WALTER T. KACZMAREK          

Walter T. Kaczmarek  
*Chief Executive Officer*

DATE: March 4, 2016

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated:

<b>Signature</b>	<b>Title</b>	<b>Date</b>
<u>          /s/ JULIANNE BIAGINI          </u> Julianne Biagini	Director	March 4, 2016
<u>          /s/ FRANK G. BISCEGLIA          </u> Frank G. Bisceglia	Director	March 4, 2016
<u>          /s/ JACK W. CONNER          </u> Jack W. Conner	Director and Chairman of the Board	March 4, 2016
<u>          /s/ J. PHILLIP DINAPOLI          </u> J. Phillip DiNapoli	Director	March 4, 2016
<u>          /s/ JOHN M. EGGEMEYER          </u> John M. Eggemeyer	Director	March 4, 2016
<u>          /s/ STEVEN L. HALLGRIMSON          </u> Steven L. Hallgrimson	Director	March 4, 2016
<u>          /s/ WALTER T. KACZMAREK          </u> Walter T. Kaczmarek	Director and Chief Executive Officer and President (Principal Executive Officer)	March 4, 2016
<u>          /s/ LAWRENCE D. MCGOVERN          </u> Lawrence D. McGovern	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 4, 2016
<u>          /s/ ROBERT T. MOLES          </u> Robert T. Moles	Director	March 4, 2016
<u>          /s/ HUMPHREY P. POLANEN          </u>	Director	March 4, 2016

---

Humphrey P. Polanen

/s/ LAURA RODEN

---

Director

March 4, 2016

Laura Roden

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

Table of Contents

<b>Signature</b>	<b>Title</b>	<b>Date</b>
<u>/s/ CHARLES T. TOENISKOETTER</u> Charles T. Toeniskoetter	Director	March 4, 2016
<u>/s/ RANSON W. WEBSTER</u> Ranson W. Webster	Director	March 4, 2016
<u>/s/ W. KIRK WYCOFF</u> W. Kirk Wycoff	Director	March 4, 2016
		93

---

Table of Contents

**HERITAGE COMMERCE CORP**

**INDEX TO FINANCIAL STATEMENTS  
DECEMBER 31, 2015**

	<b>Page</b>
<u>Report of Independent Registered Public Accounting Firm</u>	<u>95</u>
<u>Consolidated Balance Sheets as of December 31, 2015 and 2014</u>	<u>97</u>
<u>Consolidated Statements of Income for the years ended December 31, 2015, 2014 and 2013</u>	<u>98</u>
<u>Consolidated Statements of Comprehensive Income for the years ended December 31, 2015, 2014 and 2013</u>	<u>99</u>
<u>Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2015, 2014 and 2013</u>	<u>100</u>
<u>Consolidated Statements of Cash Flows for the years ended December 31, 2015, 2014 and 2013</u>	<u>101</u>
<u>Notes to Consolidated Financial Statements</u>	<u>102</u>

Table of Contents

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors  
Heritage Commerce Corp  
San Jose, California

We have audited the accompanying consolidated balance sheets of Heritage Commerce Corp (the "Company") as of December 31, 2015 and 2014, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2015. We also have audited Heritage Commerce Corp's internal control over financial reporting as of December 31, 2015, based on criteria established in the 2013 *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Heritage Commerce Corp's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heritage Commerce Corp as of December 31, 2015 and 2014, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2015 in conformity with accounting principles generally accepted in the United States of



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

### Table of Contents

America. Also in our opinion, Heritage Commerce Corp maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015, based on criteria established in the 2013 *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Sacramento, California  
March 4, 2016

/s/ Crowe Horwath LLP

Table of Contents

**HERITAGE COMMERCE CORP**  
**CONSOLIDATED BALANCE SHEETS**

	December 31, 2015	December 31, 2014
	(Dollars in thousands)	
<b>Assets</b>		
Cash and due from banks	\$ 24,112	\$ 23,256
Interest-bearing deposits in other financial institutions	319,980	99,147
Total cash and cash equivalents	344,092	122,403
Securities available-for-sale, at fair value	385,079	206,335
Securities held-to-maturity, at amortized cost (fair value of \$109,821 at December 31, 2015 and \$94,953 at December 31, 2014)	109,311	95,362
Loans held-for-sale SBA, at lower of cost or market, including deferred costs	7,297	1,172
Loans, net of deferred fees	1,358,716	1,088,643
Allowance for loan losses	(18,926)	(18,379)
Loans, net	1,339,790	1,070,264
Federal Home Loan Bank stock, Federal Reserve Bank stock and other investments, at cost	12,694	10,598
Company owned life insurance	60,021	51,257
Premises and equipment	7,773	7,451
Goodwill	45,664	13,044
Other intangible assets	8,518	3,276
Accrued interest receivable and other assets	41,340	35,941
Total assets	\$ 2,361,579	\$ 1,617,103
<b>Liabilities and Shareholders' Equity</b>		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 821,405	\$ 517,662
Demand, interest-bearing	496,278	225,821
Savings and money market	496,843	384,644
Time deposits-under \$250	62,026	55,943
Time deposits-\$250 and over	160,815	164,952
Time deposits-brokered	17,825	28,116
CDARS money market and time deposits	7,583	11,248
Total deposits	2,062,775	1,388,386
Short-term borrowings	3,000	
Accrued interest payable and other liabilities	50,368	44,359
Total liabilities	2,116,143	1,432,745
Commitments and contingencies (Notes 7 and 16)		
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 December 31, 2015 and December 31, 2014 (liquidation preference of \$21,004 at December 31, 2015 and December 31, 2014)	19,519	19,519

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

Common stock, no par value; 60,000,000 shares authorized; 32,113,479 shares issued and outstanding at December 31, 2015 and 26,503,305 shares issued and outstanding at December 31, 2014	193,364	133,676
Retained earnings	38,773	33,014
Accumulated other comprehensive loss	(6,220)	(1,851)
<b>Total shareholders' equity</b>	<b>245,436</b>	<b>184,358</b>
Total liabilities and shareholders' equity	\$ 2,361,579	\$ 1,617,103

See notes to consolidated financial statements

Table of Contents

**HERITAGE COMMERCE CORP**  
**CONSOLIDATED STATEMENTS OF INCOME**

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands, except per share data)		
<b>Interest income:</b>			
Loans, including fees	\$ 68,259	\$ 49,207	\$ 41,570
Securities, taxable	6,707	7,117	8,937
Securities, exempt from Federal tax	2,183	2,025	1,530
Other investments and interest-bearing deposits in other financial institutions	1,594	907	749
<b>Total interest income</b>	<b>78,743</b>	<b>59,256</b>	<b>52,786</b>
<b>Interest expense:</b>			
Deposits	2,403	2,032	2,369
Subordinated debt			229
Short-term borrowings	19	121	2
<b>Total interest expense</b>	<b>2,422</b>	<b>2,153</b>	<b>2,600</b>
Net interest income before provision for loan losses	76,321	57,103	50,186
Provision (credit) for loan losses	32	(338)	(816)
<b>Net interest income after provision for loan losses</b>	<b>76,289</b>	<b>57,441</b>	<b>51,002</b>
<b>Noninterest income:</b>			
Service charges and fees on deposit accounts	2,803	2,519	2,457
Increase in cash surrender value of life insurance	1,697	1,600	1,654
Servicing income	1,143	1,296	1,446
Gain on sales of SBA loans	843	971	449
Gain on sales of securities	642	97	38
Other	1,857	1,263	1,170
<b>Total noninterest income</b>	<b>8,985</b>	<b>7,746</b>	<b>7,214</b>
<b>Noninterest expense:</b>			
Salaries and employee benefits	35,146	26,250	23,450
Occupancy and equipment	4,300	4,053	4,043
Professional fees	1,828	1,891	2,588
Other	17,399	12,028	10,389
<b>Total noninterest expense</b>	<b>58,673</b>	<b>44,222</b>	<b>40,470</b>
Income before income taxes	26,601	20,965	17,746
Income tax expense	10,104	7,538	6,206
<b>Net income</b>	<b>16,497</b>	<b>13,427</b>	<b>11,540</b>
Dividends and discount accretion on preferred stock	(1,792)	(1,008)	(336)
<b>Net income available to common shareholders</b>	<b>\$ 14,705</b>	<b>\$ 12,419</b>	<b>\$ 11,204</b>

Earnings per common share:

Basic	\$	0.48	\$	0.42	\$	0.36
Diluted	\$	0.48	\$	0.42	\$	0.36

See notes to consolidated financial statements

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

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Net income	\$ 16,497	\$ 13,427	\$ 11,540
Other comprehensive income (loss):			
Change in net unrealized holding gains (losses) on available-for-sale securities and I/O strips	(3,809)	7,164	(14,302)
Deferred income taxes	1,605	(3,012)	6,007
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(55)	(54)	(54)
Deferred income taxes	23	23	23
Reclassification adjustment for gains realized in income	(642)	(97)	(38)
Deferred income taxes	270	41	16
Change in unrealized gains (losses) on securities and I/O strips, net of deferred income taxes	(2,608)	4,065	(8,348)
Change in net pension and other benefit plan liability adjustment	(3,036)	(3,253)	2,825
Deferred income taxes	1,275	1,366	(1,187)
Change in pension and other benefit plan liability, net of deferred income taxes	(1,761)	(1,887)	1,638
Other comprehensive income (loss)	(4,369)	2,178	(6,710)
Total comprehensive income	\$ 12,128	\$ 15,605	\$ 4,830

See notes to consolidated financial statements

Table of Contents

## HERITAGE COMMERCE CORP

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years Ended December 31, 2015, 2014, and 2013

	Preferred Stock		Common Stock		Retained Earnings	Accumulated Other Comprehensive Income / (Loss)	Total Shareholders' Equity
	Shares	Amount	Shares	Amount			
(Dollars in thousands)							
<b>Balance, January 1, 2013</b>	21,004	\$ 19,519	26,322,147	\$ 131,820	\$ 15,721	\$ 2,681	\$ 169,741
Net income					11,540		11,540
Other comprehensive loss						(6,710)	(6,710)
Issuance of restricted stock awards, net			10,000				
Repurchase of warrant				(140)			(140)
Amortization of restricted stock awards, net of forfeitures and taxes				200			200
Cash dividend declared \$0.06 per share					(1,916)		(1,916)
Stock option expense, net of forfeitures and taxes				593			593
Stock options exercised			18,791	88			88
<b>Balance, December 31, 2013</b>	21,004	19,519	26,350,938	132,561	25,345	(4,029)	173,396
Net income					13,427		13,427
Other comprehensive income						2,178	2,178
Issuance of restricted stock awards, net			90,000				
Amortization of restricted stock awards, net of forfeitures and taxes				(9)			(9)
Cash dividend declared \$0.18 per share					(5,758)		(5,758)
Stock option expense, net of forfeitures and taxes				862			862
Stock options exercised			62,567	262			262
<b>Balance, December 31, 2014</b>	21,004	19,519	26,503,505	133,676	33,014	(1,851)	184,358
Net income					16,497		16,497
Other comprehensive loss						(4,369)	(4,369)
Issuance of 5,456,713 common shares to acquire Focus Business Bank, net of offering costs of \$144			5,456,713	58,134			58,134
Issuance of restricted stock awards, net			98,855				
Amortization of restricted stock awards, net of forfeitures and taxes				265			265
Cash dividend declared \$0.32 per share					(10,738)		(10,738)
Stock option expense, net of forfeitures and taxes				974			974
Stock options exercised			54,406	315			315
<b>Balance, December 31, 2015</b>	21,004	\$ 19,519	32,113,479	\$ 193,364	\$ 38,773	\$ (6,220)	\$ 245,436

See notes to consolidated financial statements

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

	<b>Year ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>2013</b>
	<b>(Dollars in thousands)</b>		
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 16,497	\$ 13,427	\$ 11,540
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of discounts and premiums on securities	1,384	1,163	2,231
Gain on sale of securities available-for-sale	(642)	(97)	(38)
Gain on sale of SBA loans	(843)	(971)	(449)
Proceeds from sale of SBA loans originated for sale	11,497	15,858	6,174
Net change in SBA loans originated for sale	(14,906)	(12,911)	(9,234)
Provision (credit) for loan losses	32	(338)	(816)
Increase in cash surrender value of life insurance	(1,697)	(1,600)	(1,654)
Gain on proceeds from company owned life insurance		(51)	
Depreciation and amortization	685	725	729
Amortization of other intangible assets	1,043	510	473
Gains on sale of foreclosed assets, net	(106)		(243)
Stock option expense, net	974	862	593
Amortization of restricted stock awards, net	265	(9)	200
Effect of changes in:			
Accrued interest receivable and other assets	16,274	(2,428)	4,694
Accrued interest payable and other liabilities	(1,963)	5,244	2,063
Net cash provided by operating activities	28,494	19,384	16,263
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchase of securities available-for-sale	(232,644)	(53,292)	(17,844)
Purchase of securities held-to-maturity	(9,482)	(4,595)	(51,044)
Maturities/paydowns/calls of securities available-for-sale	31,195	24,917	62,531
Maturities/paydowns/calls of securities held-to-maturity	3,931	3,899	3,851
Proceeds from sales of securities available-for-sale	71,832	108,603	26,944
Net change in loans	(97,898)	(131,648)	(97,910)
Changes in Federal Home Loan Bank stock, Federal Reserve Bank stock and other investments	(1,788)	(163)	293
Purchase of premises and equipment	(1,007)	(817)	(500)
Proceeds from sale of foreclosed assets	1,571		850
Proceeds from company owned life insurance		406	
Cash paid in bank acquisition, net of cash received	165,786	(21,918)	
Net cash used in investing activities	(68,504)	(74,608)	(72,829)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net change in deposits	269,266	102,165	(193,147)
Repurchase of warrant			(140)
Exercise of stock options	315	262	88
Offering costs	(144)		
Short-term borrowings	3,000		
Repayment of short-term borrowings		(31,647)	
Redemption of subordinated debt			(9,279)
Payment of cash dividends	(10,738)	(5,758)	(1,916)
Net cash provided by (used in) financing activities	261,699	65,022	(204,394)
Net increase (decrease) in cash and cash equivalents	221,689	9,798	(260,960)
Cash and cash equivalents, beginning of year	122,403	112,605	373,565
Cash and cash equivalents, end of year	\$ 344,092	\$ 122,403	\$ 112,605



Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

Supplemental disclosures of cash flow information:			
Interest paid	\$ 2,427	\$ 2,166	\$ 2,685
Income taxes paid	6,904	4,280	2,021
Supplemental schedule of non-cash investing activity:			
Due to broker for securities purchased, settling after year-end	\$	\$	\$ 961
Transfer of loans held-for-sale to loan portfolio	2,543		3,770
Loans transferred to foreclosed assets	1,236	229	33
Summary of assets acquired and liabilities assumed through acquisition:			
Cash and cash equivalents, net of cash paid for acquisition	165,786		
Securities available-for-sale	53,940		
Securities held-to-maturity	8,665		
Loans held-for-sale SBA	4,416		
Net loans	170,353	42,300	
Company owned life insurance	7,067		
Premises and equipment		119	
Goodwill and other intangible assets	38,905	15,303	
Other assets, net	20,250	738	
Deposits	(405,123)		
Borrowings		(31,647)	
Other liabilities	(5,981)	(4,895)	
Common stock issued to acquire Focus Business Bank	58,278		

See notes to consolidated financial statements

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1) Summary of Significant Accounting Policies**

*Description of Business and Basis of Presentation*

Heritage Commerce Corp ("HCC") operates as a registered bank holding company for its wholly-owned subsidiary Heritage Bank of Commerce ("HBC" or the "Bank"), collectively referred to as the "Company". HBC was incorporated on November 23, 1993 and commenced operations on June 8, 1994. HBC is a California state chartered bank which offers a full range of commercial and personal banking services to residents and the business/professional community in Santa Clara, Alameda, and Contra Costa counties, California.

On November 1, 2014, the Company acquired CSNK Working Capital Finance Corp. dba Bay View Funding ("Bay View Funding"), which provides business-essential working capital factoring financing to various industries throughout the United States. Bay View Funding's results of operations have been included in the Company's results of operations beginning November 1, 2014.

As discussed in Note 8, the Company completed its acquisition of Focus Business Bank ("Focus") on August 20, 2015. Focus was merged with HBC, with HBC as the surviving bank. Focus' results of operations have been included in the Company's results of operations beginning August 21, 2015.

The consolidated financial statements are prepared in accordance with accounting policies generally accepted in the United States of America and general practices in the banking industry. The financial statements include the accounts of the Company. All inter-company accounts and transactions have been eliminated in consolidation.

The Company also established the following wholly-owned Delaware business trusts that were formed to issue trust preferred and related common securities: Heritage Statutory Trust II, formed in 2001, and Heritage Statutory Trust III, formed in 2002 ("Trusts"). During the third quarter of 2013, the Company dissolved the Heritage Statutory Trust II and the Heritage Statutory Trust III.

The Trusts issued their preferred securities to investors, and used the proceeds to purchase subordinated debt issued by the Company. The subordinated debt payable to the Trusts was recorded as debt of the Company. The Company had fully and unconditionally guaranteed the trust preferred securities along with all obligations of the Trusts under the trust agreements. Interest income from the subordinated debt was the source of revenues for these Trusts. In accordance with generally accepted accounting principles, the Trusts were not consolidated in the Company's financial statements.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Cash and Cash Equivalents*

Cash and cash equivalents include cash on hand, amounts due from banks, amounts held at the Federal Reserve Bank, and Federal funds sold. The Company is required to maintain reserves against certain of the deposit accounts with the Federal Reserve Bank. Federal funds are generally sold and purchased for one-day periods.

Table of Contents

**HERITAGE COMMERCE CORP**

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

***Cash Flows***

Net cash flows are reported for customer loan and deposit transactions, notes payable, repurchase agreements and other short-term borrowings.

***Securities***

The Company classifies its securities as either available-for-sale or held-to-maturity at the time of purchase. Debt securities are classified as held-to-maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Debt securities not classified as held-to-maturity are classified as available-for-sale. Securities available-for-sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of taxes.

A decline in the fair value of any available-for-sale or held-to-maturity security below amortized cost that is deemed other than temporary results in a charge to earnings and the corresponding establishment of a new cost basis for the security. In estimating other-than-temporary losses, management considers (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the fair value decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the security or more likely than not will be required to sell the security before any anticipated recovery in fair value.

Interest income includes amortization of purchase premiums or discounts. Premiums and discounts are amortized, or accreted, over the life of the related security as an adjustment to income using a method that approximates the interest method. Realized gains and losses are recorded on the trade date and determined using the specific identification method for the cost of securities sold.

***Loan Sales and Servicing***

The Company holds for sale the conditionally guaranteed portion of certain loans guaranteed by the Small Business Administration or the U.S. Department of Agriculture (collectively referred to as "SBA loans"). These loans are carried at the lower of aggregate cost or fair value. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Gains or losses on SBA loans held-for-sale are recognized upon completion of the sale, based on the difference between the selling price and the carrying value of the related loan sold.

SBA loans are sold with servicing retained. Servicing assets recognized separately upon the sale of SBA loans consist of servicing rights and, for loans sold prior to 2009, interest-only strip receivables ("I/O strips"). The Company accounts for the sale and servicing of SBA loans based on the financial and servicing assets it controls and liabilities it has incurred, reversing recognition of financial assets when control has been surrendered, and reversing recognition of liabilities when extinguished. Servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sale of loans. Servicing rights are amortized in proportion to and over the period of net servicing income and are assessed for impairment on an ongoing basis. Impairment is determined by stratifying the servicing rights based on interest rates and terms. Any servicing assets in excess of the contractually specified servicing fees are reclassified at fair value as an I/O strip receivable and treated like an available for sale security. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance. The servicing rights, net of any required valuation allowance, and I/O strip receivable are included in other assets on the consolidated balance sheets.

Table of Contents

**HERITAGE COMMERCE CORP**

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

Servicing income, net of amortization of servicing rights, is recognized as noninterest income. The initial fair value of I/O strip receivables is amortized against interest income on loans.

***Loans***

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at the principal amount outstanding, net of deferred loan origination fees and costs on originated loans, or unamortized premiums or discounts on purchased or acquired loans, and an allowance for loan losses. The majority of the Company's loans have variable interest rates. Interest on loans is accrued on the unpaid principal balance and is credited to income using the effective yield interest method. Interest on purchased or acquired loans and the accretion (amortization) of the related purchase discount (premium) is also credited to income using the effective yield interest method.

A loan portfolio segment is defined as the level at which the Company uses a systematic methodology to determine the allowance for loan losses. A loan portfolio class is defined as a group of loans having similar risk characteristics and methods for monitoring and assessing risk.

For all loan classes, when a loan is classified as nonaccrual, the accrual of interest is discontinued, any accrued and unpaid interest is reversed, and the amortization of deferred loan fees and costs is discontinued. For all loan classes, loans are classified as nonaccrual when the payment of principal or interest is 90 days past due, unless the loan is well secured and in the process of collection. Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans. In certain circumstances, loans that are under 90 days past due may also be classified as nonaccrual. Any interest or principal payments received on nonaccrual loans are applied toward reduction of principal. Nonaccrual loans generally are not returned to performing status until the obligation is brought current, the loan has performed in accordance with the contract terms for a reasonable period of time, and the ultimate collectability of the contractual principal and interest is no longer in doubt.

Non-refundable loan fees and direct origination costs are deferred and recognized over the expected lives of the related loans using the effective yield interest method.

***Acquired Loans and Leases***

Loans and leases acquired through purchase or through a business combination are recorded at their fair value at the acquisition date. Credit discounts are included in the determination of fair value; therefore, an allowance for loan and lease losses is not recorded at the acquisition date. Should the Company's allowance for loan and lease losses methodology indicate that the credit discount associated with acquired, non-purchased credit impaired loans, is no longer sufficient to cover probable losses inherent in those loans, the Company will establish an allowance for those loans through a charge to provision for loan and lease losses. Acquired loans are evaluated upon acquisition for evidence of deterioration in credit quality since origination such that it is probable at acquisition that the Company will be unable to collect all contractually required payments. Such loans are classified as purchased credit impaired loans ("PCI loans"), while all other acquired loans are classified as non-PCI loans.

The Company has elected to account for PCI loans on an individual loan level. The Company estimates the amount and timing of expected cash flows for each loan. The expected cash flow in excess of the loan's carrying value, which is fair value on the date of acquisition, is referred to as the accretable yield, and is recorded as interest income over the remaining expected life of the loan. The excess of the loan's contractual principal and interest over expected cash flows is referred to as the non-accretable difference, and is not recorded in the Company's Consolidated Financial Statements.

Table of Contents

**HERITAGE COMMERCE CORP**

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

Quarterly, management performs an evaluation of expected future cash flows for PCI loans. If current expectations of future cash flows are less than management's previous expectations, other than due to decreases in interest rates and prepayment assumptions, an allowance for loan and lease losses is recorded with a charge to current period earnings through provision for loan and lease losses. If there has been a probable and significant increase in expected future cash flows over that which was previously expected, the Company would first reduce any previously established allowance for loan and lease losses, and then record an adjustment to interest income through a prospective increase in the accretible yield.

*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 loan is not collateral dependent. The amount of any impairment 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.

The formula driven allowance on pools of loans covers all loans that are not impaired and is based on historical losses of each loan segment adjusted for current factors. In calculating the historical component of our allowance, we aggregate our loans into one of three loan segments: Commercial, Real Estate and Consumer. Each segment of loans in the portfolio possess varying degrees of risk, based on, among other things, the type of loan being made, the purpose of the loan, the type of collateral securing the loan, and the sensitivity the borrower has to changes in certain external factors such as economic conditions. The following provides a summary of the risks associated with various segments of the Company's loan portfolio, which are factors management regularly considers when evaluating the adequacy of the allowance:

Commercial loans consist primarily of commercial and industrial loans (business lines of credit), and other commercial purpose loans. Repayment of commercial and industrial loans is generally provided from the cash flows of the related business to which the loan was made. Adverse changes in economic conditions may result in a decline in business activity, which may impact a borrower's ability to continue to make scheduled payments. The factored receivables at Bay View Funding are included in the Company's commercial loan portfolio; however, they are evaluated for risk primarily based on the agings of the receivables. Faster turning receivables imply less risk and therefore warrant a lower associated allowance. Should the overall aging for the portfolio increase, this structure will by formula increase the allowance to reflect the increasing risk. Should the portfolio turn more quickly, it would reduce the associated allowance to reflect the reducing risk.

**HERITAGE COMMERCE CORP**

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

Real estate loans consist primarily of loans secured by commercial and residential real estate. Also included in this segment are land and construction loans and home equity lines of credit secured by real estate. As the majority of this segment is comprised of commercial real estate loans, risks associated with this segment lay primarily within these loan types. Adverse economic conditions may result in a decline in business activity and increased vacancy rates for commercial properties. These factors, in conjunction with a decline in real estate prices, may expose the Company to the potential for losses if a borrower cannot continue to service the loan with operating revenues, and the value of the property has declined to a level such that it no longer fully covers the Company's recorded investment in the loan.

Consumer loans consist primarily of a large number of small loans and lines of credit. The majority of installment loans are made for consumer and business purchases. Weakened economic conditions may result in an increased level of delinquencies within this segment, as economic pressures may impact the capacity of such borrowers to repay their obligations.

As a result of the matters mentioned above, changes in the financial condition of individual borrowers, economic conditions, historical loss experience and the condition of the various markets in which collateral may be sold may all affect the required level of the allowance for loan losses and the associated provision for loan losses.

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. Risk factors impacting loans in each of the portfolio segments include broad deterioration of property values, reduced consumer and business spending as a result of continued high unemployment and reduced credit availability and lack of confidence in a sustainable recovery. The historical loss experience is adjusted for management's estimate of the impact of other factors based on the risks present for each portfolio segment. These other factors include consideration of the following: the overall level of concentrations and trends of classified loans; loan concentrations within a portfolio segment or division of a portfolio segment; identification of certain loan types with higher risk than other loans; existing internal risk factors; and management's evaluation of the impact of local and national economic conditions on each of our loan types.

***Loan Commitments and Related Financial Instruments***

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

***Federal Home Loan Bank and Federal Reserve Bank Stock***

As a member of the Federal Home Loan Bank ("FHLB") system, the Bank is required to own common stock in the FHLB based on the Bank's level of borrowings and outstanding FHLB advances. FHLB stock is carried at cost and classified as a restricted security. Both cash and stock dividends are reported as income.

Table of Contents

**HERITAGE COMMERCE CORP**

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

As a member of the Federal Reserve Bank ("FRB") of San Francisco, the Bank is required to own stock in the FRB of San Francisco based on a specified ratio relative to our capital. FRB stock is carried at cost and may be sold back to the FRB at its carrying value. Cash dividends received are reported as income.

***Company Owned Life Insurance and Split-Dollar Life Insurance Benefit Plan***

The Company has purchased life insurance policies on certain directors and officers. Company owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement. The purchased insurance is subject to split-dollar insurance agreements with the insured participants, which continues after the participant's employment and retirement.

Accounting guidance requires that a liability be recorded primarily over the participant's service period when a split-dollar life insurance agreement continues after a participant's employment or retirement. The required accrued liability is based on either the post-employment benefit cost for the continuing life insurance or the future death benefit depending on the contractual terms of the underlying agreement.

***Premises and Equipment***

Land is carried at cost. Premises and equipment are stated at cost. Depreciation and amortization are computed on the straight-line basis over the lesser of the respective lease terms or estimated useful lives. The Company owns one building which is being depreciated over 40 years. Furniture, equipment, and leasehold improvements are depreciated over estimated useful lives generally ranging from five to fifteen years. The Company evaluates the recoverability of long-lived assets on an ongoing basis.

***Business Combinations***

The Company accounts for acquisitions of businesses using the acquisition method of accounting. Under the acquisition method, assets acquired and liabilities assumed are recorded at their estimated fair values at the date of acquisition. Management utilizes various valuation techniques including discounted cash flow analyses to determine these fair values. Any excess of the purchase price over amounts allocated to the acquired assets, including identifiable intangible assets, and liabilities assumed is recorded as goodwill.

***Goodwill and Other Intangible Assets***

Goodwill resulted from the acquisition of Bay View Funding on November 1, 2014 and Focus on August 20, 2015. Goodwill represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified.

Other intangible assets consist of core deposit and customer relationship intangible assets arising from the Diablo Valley Bank acquisition in June 2007, a core deposit intangible asset from the Focus acquisition in August 2015, and a below market value lease, customer relationship and non-compete agreement intangible assets arising from the Bay View Funding acquisition in November 2014. They are initially measured at fair value and then are amortized over their estimated useful lives. The core deposits intangible assets from the acquisitions of Diablo Valley Bank and Focus are being amortized on an accelerated method over ten years. The customer relationship intangible from the acquisition of Diablo Valley Bank was being amortized on an accelerated method over seven years, and was fully amortized at

Table of Contents

**HERITAGE COMMERCE CORP**

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

December 31, 2014. The below market value lease, customer relationship and non-compete agreement intangible assets from the acquisition of Bay View Funding are being amortized on the straight line method over three, ten, and three years, respectively.

***Foreclosed Assets***

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through operations. Operating costs after acquisition are expensed. Gains and losses on disposition are included in noninterest expense.

The carrying value of foreclosed assets was \$364,000 and \$696,000 at December 31, 2015 and 2014, respectively, and is included in other assets on the consolidated balance sheets.

***Retirement Plans***

Expenses for the Company's non-qualified, unfunded defined benefits plan consists of service and interest cost and amortization of gains and losses not immediately recognized. Employee 401(k) and profit sharing plan expense is the amount of matching contributions. Deferred compensation and supplemental retirement plan expense allocates the benefits over years of service.

***Loss Contingencies***

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. The Company's accounting policy for legal costs related to loss contingencies is to accrue for the probable fees that can be reasonably estimated. The Company's accounting policy for uncertain recoveries is to recognize the anticipated recovery when realization is deemed probable.

***Income Taxes***

The Company files consolidated Federal and combined state income tax returns. Income tax expense is the total of the current year income tax payable or refunded, the change in deferred tax assets and liabilities, and low income housing investment losses, net of tax benefits received. Some items of income and expense are recognized in different years for tax purposes 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 for Federal and California state income tax purposes. The amount of deferred tax assets considered realizable is subject to adjustment in future periods based on estimates of future taxable income. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.



Table of Contents

**HERITAGE COMMERCE CORP**

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

The Company had net deferred tax assets of \$22,218,000 and \$18,527,000 at December 31, 2015, and December 31, 2014, 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 December 31, 2015 and 2014 will be fully realized in future years.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The Company recognizes interest and penalties related to uncertain tax positions as income tax expense.

***Stock-Based Compensation***

Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. Compensation cost recognized reflects estimated forfeitures, adjusted as necessary for actual forfeitures.

***Comprehensive Income (Loss)***

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) refers to gains and losses that are included in comprehensive income (loss) but are excluded from net income (loss) because they have been recorded directly in equity under the provisions of certain accounting guidance. The Company's sources of other comprehensive income (loss) are unrealized gains and losses on securities available-for-sale, and I/O strips, which are treated like available-for-sale securities, and the liabilities related to the Company's defined benefit pension plan and the split-dollar life insurance benefit plan. Reclassification adjustments result from gains or losses on securities that were realized and included in net income (loss) of the current period that also had been included in other comprehensive income as unrealized holding gains and losses.

***Segment Reporting***

HBC is a commercial bank serving customers located in Santa Clara, Alameda, Contra Costa, and San Benito counties of California. Bay View Funding provides business essential working capital factoring financing to various industries throughout the United States. No customer accounts for more than 10 percent of revenue for HBC or the Company. With the acquisition of Bay View Funding, the Company now has two reportable segments consisting of Banking and Factoring. While the chief decision-makers monitor the revenue streams of the various products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Operating segments are aggregated into one as operating results for all segments are similar. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable segment.

***Reclassifications***

Certain items in the consolidated financial statements for the years ended December 31, 2014 and 2013 were reclassified to conform to the 2015 presentation. These reclassifications did not affect previously reported net income or shareholders equity.

Table of Contents

**HERITAGE COMMERCE CORP**

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

*Adoption of New Accounting Standards*

In January 2014, the Financial Accounting Standards Board ("FASB") amended existing guidance clarifying that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. For entities other than public business entities, the amendments in this update are effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. The Company has evaluated the adoption of the new guidance and has determined it did not have a material impact on the consolidated financial statements.

In January 2014, the FASB issued guidance for accounting for investments in qualified affordable housing projects, which represents a consensus of the Emerging Issues Task Force and sets forth new accounting for qualifying investments in flow through limited liability entities that invest in affordable housing projects. The new guidance allows a limited liability investor that meets certain conditions to amortize the cost of its investment in proportion to the tax credits and other tax benefits it receives. The new accounting method, referred to as the proportional amortization method, allows amortization of the tax credit investment to be reflected along with the primary benefits, the tax credits and other tax benefits, on a net basis in the income statement within the income tax expense (benefit) line. For public business entities, the guidance is effective for interim and annual periods beginning after December 15, 2014. For all other entities, the guidance is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. If elected, the proportional amortization method is required to be applied retrospectively. Early adoption is permitted in the annual period for which financial statements have not been issued.

The Company adopted the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014. The Company quantified the impact of adopting the proportional amortization method compared to the equity method to its current year and prior period financial statements. The Company determined that the adoption of the proportional amortization method did not have a material impact to its financial statements. The low income housing investment losses, net of the tax benefits received, are included in income tax expense for all periods reflected on the consolidated income statements. See *Note 12 - Income Taxes* for more information on the adoption of the proportional method of accounting for low income housing investments.

In May 2014, the FASB issued an update to the guidance for accounting for revenue from contracts with customers. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of

Table of Contents

**HERITAGE COMMERCE CORP**

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

financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2017. We are evaluating the impact of adopting the new guidance on the consolidated financial statements.

In September 2015, the FASB issued an update simplifying the accounting for measurement-period adjustments. This update applies to all entities that have reported provisional amounts for items in a business combination for which the accounting is incomplete by the end of the reporting period in which the combination occurs and during the measurement period have an adjustment to provisional amounts recognized. The amendments in this update require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments in this update require that the acquirer record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The amendments in this update require an entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The amendments in this update are effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. The amendments in this update should be applied prospectively to adjustments to provisional amounts that occur after the effective date of this update with earlier application permitted for financial statements that have not been issued. We are currently evaluating the impact of adopting the new guidance on the consolidated financial statements, but it is not expected to have a material impact.

On January 5, 2016, the FASB issued an update (ASU No. 2016-01, Financial Instruments - Recognition and Measurement of Financial Assets and Liabilities). The new guidance is intended to improve the recognition and measurement of financial instruments by requiring: equity investments (other than equity method or consolidation) to be measured at fair value with changes in fair value recognized in net income; public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; separate presentation of financial assets and financial liabilities by measurement category and form of financial assets (i.e. securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement to disclose the fair value of financial instruments measured at amortized cost for organizations that are not public business entities; eliminating the requirement for non-public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is to be required to be disclosed for financial instruments measured at amortized cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from the change in the instrument-specific credit risk (also referred to as "own credit") when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. The new guidance is effective for public business entities for fiscal years beginning after December 15, 2017. We are currently evaluating the impact of adopting the new guidance on the consolidated financial statements.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****2) Accumulated Other Comprehensive Income ("AOCI")**

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

	For the Years Ended December 31, 2015, 2014, and 2013				Total
	Unrealized Gains (Losses) on Available- for-Sale Securities and I/O Strips	Unamortized Unrealized Gain on Available- for-Sale Securities Reclassified to Held-to- Maturity	Defined Benefit Pension Plan Items		
	(Dollars in thousands)				
Beginning balance January 1, 2015, net of taxes	\$ 3,666	\$ 435	\$ (5,952)	\$ (1,851)	
Other comprehensive (loss) before reclassification, net of taxes	(2,204)		(1,919)	(4,123)	
Amounts reclassified from other comprehensive income (loss), net of taxes	(372)	(32)	158	(246)	
Net current period other comprehensive income (loss), net of taxes	(2,576)	(32)	(1,761)	(4,369)	
Ending balance December 31, 2015, net of taxes	\$ 1,090	\$ 403	\$ (7,713)	\$ (6,220)	
Beginning balance January 1, 2014, net of taxes	\$ (430)	\$ 466	\$ (4,065)	\$ (4,029)	
Other comprehensive (loss) before reclassification, net of taxes	4,152		(1,910)	2,242	
Amounts reclassified from other comprehensive income (loss), net of taxes	(56)	(31)	23	(64)	
Net current period other comprehensive income (loss), net of taxes	4,096	(31)	(1,887)	2,178	
Ending balance December 31, 2014, net of taxes	\$ 3,666	\$ 435	\$ (5,952)	\$ (1,851)	
Beginning balance January 1, 2013, net of taxes	\$ 7,887	\$ 497	\$ (5,703)	\$ 2,681	
Other comprehensive (loss) before reclassification, net of taxes	(8,295)		1,518	(6,777)	
Amounts reclassified from other comprehensive income (loss), net of taxes	(22)	(31)	120	67	
Net current period other comprehensive income (loss), net of taxes	(8,317)	(31)	1,638	(6,710)	
Ending balance December 31, 2013, net of taxes	\$ (430)	\$ 466	\$ (4,065)	\$ (4,029)	



Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Details About AOCI Components	Amounts Reclassified from AOCI For the Year Ended December 31,			Affected Line Item Where Net Income is Presented
	2015	2014	2013	
	(Dollars in thousands)			
Unrealized gains on available-for-sale securities and I/O strips	\$ 642	\$ 97	\$ 38	Realized gains on sale of securities
	(270)	(41)	(16)	Income tax expense
	372	56	22	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	55	54	54	Interest income on taxable securities
	(23)	(23)	(23)	Income tax (expense) benefit
	32	31	31	Net of tax
Amortization of defined benefit pension plan items(1)				
Prior transition obligation	113	102	84	
Actuarial losses	(386)	(142)	(291)	
	(273)	(40)	(207)	Income before income tax
	115	17	87	Income tax benefit
	(158)	(23)	(120)	Net of tax
Total reclassification for the year	\$ 246	\$ 64	\$ (67)	

(1) This AOCI component is included in the computation of net periodic benefit cost (see Note 14 – Benefit Plans).

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****3) Securities**

The amortized cost and estimated fair value of securities at year-end were as follows:

2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
(Dollars in thousands)				
<b>Securities available-for-sale:</b>				
Agency mortgage-backed securities	\$ 324,077	\$ 2,457	\$ (2,304)	\$ 324,230
U.S. Treasury	30,047		(44)	30,003
Trust preferred securities	15,000	132		15,132
U.S. Government sponsored entities	9,042	13	(14)	9,041
Corporate bonds	6,412	261		6,673
<b>Total</b>	<b>\$ 384,578</b>	<b>\$ 2,863</b>	<b>\$ (2,362)</b>	<b>\$ 385,079</b>

**Securities held-to-maturity:**

Municipals tax exempt	\$ 93,518	\$ 1,517	\$ (863)	\$ 94,172
Agency mortgage-backed securities	15,793	24	(168)	15,649
<b>Total</b>	<b>\$ 109,311</b>	<b>\$ 1,541</b>	<b>\$ (1,031)</b>	<b>\$ 109,821</b>

2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
(Dollars in thousands)				
<b>Securities available-for-sale:</b>				
Agency mortgage-backed securities	\$ 150,570	\$ 3,867	\$ (265)	\$ 154,172
Corporate bonds	35,927	959	(23)	36,863
Trust preferred securities	15,000	300		15,300
<b>Total</b>	<b>\$ 201,497</b>	<b>\$ 5,126</b>	<b>\$ (288)</b>	<b>\$ 206,335</b>

**Securities held-to-maturity:**

Municipals tax exempt	\$ 79,882	\$ 1,011	\$ (1,346)	\$ 79,547
Agency mortgage-backed securities	15,480	44	(118)	15,406
<b>Total</b>	<b>\$ 95,362</b>	<b>\$ 1,055</b>	<b>\$ (1,464)</b>	<b>\$ 94,953</b>





Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Securities with unrealized losses at year end, aggregated by investment category and length of time that individual securities have been in an unrealized loss position, are as follows:

2015	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
(Dollars in thousands)						
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 241,067	\$ (2,258)	\$ 2,165	\$ (46)	\$ 243,232	\$ (2,304)
U.S. Treasury	30,003	(44)			30,003	(44)
U.S. Government sponsored entities	4,980	(14)			4,980	(14)
<b>Total</b>	<b>\$ 276,050</b>	<b>\$ (2,316)</b>	<b>\$ 2,165</b>	<b>\$ (46)</b>	<b>\$ 278,215</b>	<b>\$ (2,362)</b>
Securities held-to-maturity:						
Municipals Tax Exempt	\$ 9,920	\$ (78)	\$ 24,412	\$ (785)	\$ 34,332	\$ (863)
Agency mortgage-backed securities	7,152	(89)	4,409	(79)	11,561	(168)
<b>Total</b>	<b>\$ 17,072</b>	<b>\$ (167)</b>	<b>\$ 28,821</b>	<b>\$ (864)</b>	<b>\$ 45,893</b>	<b>\$ (1,031)</b>

2014	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
(Dollars in thousands)						
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 12,491	\$ (27)	\$ 35,614	\$ (238)	\$ 48,105	\$ (265)
Corporate bonds			5,148	(23)	5,148	(23)
<b>Total</b>	<b>\$ 12,491</b>	<b>\$ (27)</b>	<b>\$ 40,762</b>	<b>\$ (261)</b>	<b>\$ 53,253</b>	<b>\$ (288)</b>
Securities held-to-maturity:						
Municipals Tax Exempt	\$ 1,884	\$ (16)	\$ 42,867	\$ (1,330)	\$ 44,751	\$ (1,346)
Agency mortgage-backed securities	4,869	(29)	4,974	(89)	9,843	(118)
<b>Total</b>	<b>\$ 6,753</b>	<b>\$ (45)</b>	<b>\$ 47,841</b>	<b>\$ (1,419)</b>	<b>\$ 54,594</b>	<b>\$ (1,464)</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 December 31, 2015, the Company held 460 securities (193 available-for-sale and 267 held-to-maturity), of which 193 had fair values below amortized cost. At December 31, 2015, there were \$2,165,000 of agency mortgage-backed securities available-for-sale, \$4,409,000 of agency mortgage-backed securities held-to-maturity and \$24,412,000 of municipals bonds held-to-maturity carried with an unrealized loss for 12 months or greater. The total unrealized loss for securities 12 months or greater was \$910,000 at December 31, 2015. The 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 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 value. The Company does not consider these securities to be other-than-temporarily impaired at December 31, 2015.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

	2015	2014	2013
	(Dollars in thousands)		
Proceeds	\$ 71,832	\$ 108,603	\$ 26,944
Gross gains	751	1,008	310
Gross losses	(109)	(911)	(272)

The amortized cost and fair value of debt securities as of December 31, 2015, by contractual maturity, are shown below. The expected maturities will differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after 3 months through one year	\$ 1,999	\$ 1,996
Due after one through five years	39,454	39,659
Due after five through ten years	4,048	4,062
Due after ten years	15,000	15,132
Agency mortgage-backed securities	324,077	324,230
Total	\$ 384,578	\$ 385,079

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due less than 3 months	\$ 879	\$ 882
Due after 3 months through one year	1,353	1,362
Due after one through five years	5,554	5,626
Due after five through ten years	13,990	14,608
Due after ten years	71,742	71,694
Agency mortgage-backed securities	15,793	15,649
Total	\$ 109,311	\$ 109,821

Securities with amortized cost of \$134,235,000 and \$147,497,000 as of December 31, 2015 and 2014 were pledged to secure public deposits and for other purposes as required or permitted by law or contract.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4) Loans**

Loans at year-end were as follows:

	2015		2014
	(Dollars in thousands)		
Loans held-for-investment:			
Commercial	\$ 556,522	\$	462,403
Real estate:			
Commercial and residential	625,665		478,335
Land and construction	84,428		67,980
Home equity	76,833		61,644
Consumer	16,010		18,867
Loans	1,359,458		1,089,229
Deferred loan fees, net	(742)		(586)
Loans, net of deferred fees	1,358,716		1,088,643
Allowance for loan losses	(18,926)		(18,379)
Loans, net	\$ 1,339,790	\$	1,070,264

At December 31, 2015, total net loans included in the table above include \$141,343,000 of the non-PCI loans acquired in the Focus transaction.

Changes in the allowance for loan losses were as follows:

	For the Year Ended December 31, 2015			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of year	\$ 11,187	\$ 7,070	\$ 122	\$ 18,379
Charge-offs	(527)	(2)	(9)	(538)
Recoveries	877	146	30	1,053
Net recoveries	350	144	21	515
Provision (credit) for loan losses	(789)	862	(41)	32
Balance, end of year	\$ 10,748	\$ 8,076	\$ 102	\$ 18,926

	For the Year Ended December 31, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of year	\$ 12,533	\$ 6,548	\$ 83	\$ 19,164

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

Charge-offs	(815)	(87)	(25)	(927)
Recoveries	418	62		480
Net charge-offs	(397)	(25)	(25)	(447)
Provision (credit) for loan losses	(949)	547	64	(338)
Balance, end of year	\$ 11,187	\$ 7,070	\$ 122	\$ 18,379

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Year Ended December 31, 2013**

	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
Balance, beginning of year	\$ 12,866	\$ 6,034	\$ 127	\$ 19,027
Charge-offs	(1,676)	(276)		(1,952)
Recoveries	2,621	283	1	2,905
Net recoveries	945	7	1	953
Provision (credit) for loan losses	(1,278)	507	(45)	(816)
Balance, end of year	\$ 12,533	\$ 6,548	\$ 83	\$ 19,164

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 as follows at year-end:

	<b>December 31, 2015</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	\$ 174	\$ 112	\$	\$ 286
Collectively evaluated for impairment	10,574	7,964	102	18,640
Acquired with deteriorated credit quality				
Total allowance balance	\$ 10,748	\$ 8,076	\$ 102	\$ 18,926
<b>Loans:</b>				
Individually evaluated for impairment	\$ 2,014	\$ 4,272	\$ 4	\$ 6,290
Collectively evaluated for impairment	554,271	782,654	16,006	1,352,931
Acquired with deteriorated credit quality	237			237
Total loan balance	\$ 556,522	\$ 786,926	\$ 16,010	\$ 1,359,458

	<b>December 31, 2014</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	\$ 404	\$	\$	\$ 404

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

Collectively evaluated for impairment	10,783	7,070	122	17,975
<b>Total allowance balance</b>	<b>\$ 11,187</b>	<b>\$ 7,070</b>	<b>\$ 122</b>	<b>\$ 18,379</b>

Loans:

Individually evaluated for impairment	\$ 2,701	\$ 3,315	\$ 6	\$ 6,022
Collectively evaluated for impairment	459,702	604,644	18,861	1,083,207
<b>Total loan balance</b>	<b>\$ 462,403</b>	<b>\$ 607,959</b>	<b>\$ 18,867</b>	<b>\$ 1,089,229</b>

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Purchased Credit Impaired Loans:***

The Company has purchased loans, for which there was, at acquisition, evidence of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The carrying amount of these loans is as follows:

	<b>2015</b>	
	<b>(Dollars in thousands)</b>	
Commercial	\$	876
Outstanding balance		876
Carrying amount, net of discount of \$639,000		237

For those purchased credit impaired loans discussed above, the Company increased the allowance for loan losses by \$0 during 2015. No allowance for loan losses were reversed during 2015.

For these purchased credit impaired loans, the Company cannot reasonably estimate the cash flows expected to be collected on the loans and therefore has continued to account for those loans using the cost recovery method of income recognition. As such, no portion of a purchase discount adjustment has been determined to meet the definition of an accretable yield adjustment on those loans accounted for using the cost recovery method. If, in the future, cash flows from the borrowers can be reasonably estimated, a portion of the purchase discount would be allocated to an accretable yield adjustment based upon the present value of the future estimated cash flows versus the current carrying value of the loan and the accretable yield portion would be recognized as interest income over the remaining life of the loan. Until such accretable yield can be calculated, under the cost recovery method of income recognition, all payments will be used to reduce the carrying value of the loan and no income will be recognized on the loan until the carrying value is reduced to zero. Any loan accounted for under the cost recovery method is also still included as a nonaccrual loan.

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of December 31, 2015 and December 31, 2014. The recorded investment included in the



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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.

	December 31, 2015			December 31, 2014		
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
(Dollars in thousands)						
With no related allowance recorded:						
Commercial	\$ 745	\$ 745	\$	\$ 2,282	\$ 1,872	\$
Real estate:						
Commercial and residential	3,851	2,992		2,510	1,651	
Land and construction	237	219		1,808	1,319	
Home Equity	302	302		345	345	
Consumer	4	4		6	6	
Total with no related allowance recorded	5,139	4,262		6,951	5,193	
With an allowance recorded:						
Commercial	1,506	1,506	174	829	829	404
Real estate:						
Home Equity	759	759	112			
Total with an allowance recorded	2,265	2,265	286	829	829	404
Total	\$ 7,404	\$ 6,527	\$ 286	\$ 7,780	\$ 6,022	\$ 404

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

	For the Year Ended December 31, 2015					
	Commercial	Commercial and Residential	Real Estate Land and Construction	Home Equity	Consumer	Total
(Dollars in thousands)						
Average of impaired loans during the period	\$ 1,774	\$ 3,006	\$ 764	\$ 475	\$ 5	\$ 6,024
Interest income during impairment	\$ 14	\$	\$	\$ 2	\$	\$ 16
Cash-basis interest earned	\$	\$	\$	\$	\$	\$

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

For the Year Ended December 31, 2014

	Real Estate					Total
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	
	(Dollars in thousands)					
Average of impaired loans during the period	\$ 4,069	\$ 2,758	\$ 1,628	\$ 529	\$ 56	\$ 9,040
Interest income during impairment	\$ 56	\$	\$	\$	\$	\$ 56
Cash-basis interest earned	\$	\$	\$	\$	\$	\$

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 year-end:

	2015	2014
	(Dollars in thousands)	
Nonaccrual loans held-for-investment	\$ 4,716	\$ 5,855
Restructured and loans over 90 days past due and still accruing	1,662	
<b>Total nonperforming loans</b>	<b>\$ 6,378</b>	<b>\$ 5,855</b>
Other restructured loans	\$ 149	\$ 167
Impaired loans, excluding loans held-for-sale	\$ 6,527	\$ 6,022

The following table presents the nonperforming loans by class at year-end:

	2015			2014		
	Nonaccrual	Restructured and Loans over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	\$ 724	\$ 1,378	\$ 2,102	\$ 2,534	\$	\$ 2,534
Real estate:						
Commercial and residential	2,992		2,992	1,651		1,651
Land and construction	219		219	1,320		1,320
Home equity	777	284	1,061	344		344
Consumer	4		4	6		6
<b>Total</b>	<b>\$ 4,716</b>	<b>\$ 1,662</b>	<b>\$ 6,378</b>	<b>\$ 5,855</b>	<b>\$</b>	<b>\$ 5,855</b>



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table presents the aging of past due loans as of December 31, 2015 by class of loans:

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
(Dollars in thousands)						
Commercial	\$ 3,285	\$ 262	\$ 1,704	\$ 5,251	\$ 551,271	\$ 556,522
Real estate:						
Commercial and residential					625,665	625,665
Land and construction	219			219	84,209	84,428
Home equity			284	284	76,549	76,833
Consumer					16,010	16,010
<b>Total</b>	<b>\$ 3,504</b>	<b>\$ 262</b>	<b>\$ 1,988</b>	<b>\$ 5,754</b>	<b>\$ 1,353,704</b>	<b>\$ 1,359,458</b>

The following table presents the aging of past due loans as of December 31, 2014 by class of loans:

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
(Dollars in thousands)						
Commercial	\$ 3,002	\$ 195	\$ 1,978	\$ 5,175	\$ 457,228	\$ 462,403
Real estate:						
Commercial and residential			1,065	1,065	477,270	478,335
Land and construction					67,980	67,980
Home equity					61,644	61,644
Consumer					18,867	18,867
<b>Total</b>	<b>\$ 3,002</b>	<b>\$ 195</b>	<b>\$ 3,043</b>	<b>\$ 6,240</b>	<b>\$ 1,082,989</b>	<b>\$ 1,089,229</b>

Past due loans 30 days or greater totaled \$5,754,000 and \$6,240,000 at December 31, 2015 and December 31, 2014, respectively, of which \$591,000 and \$3,130,000 were on nonaccrual. At December 31, 2015, there were also \$4,125,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2014, there were also \$2,725,000 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.

***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

Table of Contents

**HERITAGE COMMERCE CORP**

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

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, and it is probable that the Company will not receive payment of the full contractual principal and interest. 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 December 31, 2015 or 2014.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table provides a summary of the loan portfolio by loan type and credit quality classification for the periods indicated:

	December 31, 2015			December 31, 2014		
	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total
	(Dollars in thousands)					
Commercial	\$ 547,536	\$ 8,986	\$ 556,522	\$ 455,767	\$ 6,636	\$ 462,403
Real estate:						
Commercial and residential	617,865	7,800	625,665	472,061	6,274	478,335
Land and construction	84,209	219	84,428	66,660	1,320	67,980
Home equity	75,511	1,322	76,833	60,736	908	61,644
Consumer	15,705	305	16,010	18,518	349	18,867
<b>Total</b>	<b>\$ 1,340,826</b>	<b>\$ 18,632</b>	<b>\$ 1,359,458</b>	<b>\$ 1,073,742</b>	<b>\$ 15,487</b>	<b>\$ 1,089,229</b>

---

\*

Classified loans in the table above include SBA guarantees.

---

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.

For the year ended December 31, 2015, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included a reduction of the stated interest rate of the loan, or an extension of maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk.

The book balance of troubled debt restructurings at December 31, 2015 was \$153,000, which included \$4,000 of nonaccrual loans and \$149,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2014 was \$1,083,000, which included \$916,000 of nonaccrual loans and \$167,000 of accruing loans. Approximately \$3,000 and \$113,000 in specific reserves were established with respect to these loans as of December 31, 2015 and December 31, 2014. As of December 31, 2015 and December 31, 2014, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

There were no loans by class modified as troubled debt restructurings during the twelve month period ended December 31, 2015 and 2014.

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 years ended December 31, 2015 and 2014.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

HBC makes loans to executive officers, directors, and their affiliates. The following table presents the loans outstanding to these related parties for the periods indicated:

	2015		2014
	(Dollars in thousands)		
Balance, beginning of year	\$ 576	\$	590
Advances on loans during the year	4,175		
Repayment on loans during the year	(4,189)	(14)	
Balance, end of year	\$ 562	\$	576

**5) Loan Servicing**

At December 31, 2015 and 2014, the Company serviced SBA loans sold to the secondary market of approximately \$175,457,000 and \$130,611,000, respectively.

Servicing assets represent the servicing spread generated from the sold guaranteed portions of SBA loans. The weighted average servicing rate for all loans serviced was 1.16% and 1.20% at December 31, 2015 and 2014, respectively.

Servicing rights are included in "accrued interest receivable and other assets" on the consolidated balance sheets. Activity for loan servicing rights follows:

	2015	2014	2013
	(Dollars in thousands)		
Balance, beginning of year	\$ 565	\$ 525	\$ 709
Additions	2,126	319	106
Amortization	(482)	(279)	(290)
Balance, end of year	\$ 2,209	\$ 565	\$ 525

There was no valuation allowance for servicing rights at December 31, 2015 and 2014, because the estimated fair value of the servicing rights was greater than the carrying value. The increase in loan servicing rights for the year ended December 31, 2015, compared to the prior year was primarily due to the Focus acquisition of \$1,976,000 at fair value. The estimated fair value of loan servicing rights was \$3,650,000 and \$2,426,000 at December 31, 2015 and 2014, respectively. The fair value of servicing rights at December 31, 2015, was estimated using a weighted average constant prepayment rate ("CPR") assumption of 7.42%, and a weighted average discount rate assumption of 12.52%. The fair value of servicing rights at December 31, 2014 was estimated using a weighted average constant prepayment rate ("CPR") assumption of 7.32%, and a weighted average discount rate assumption of 12.11%.

The weighted average discount rate and CPR assumptions used to estimate the fair value of the I/O strip receivables are the same as for the servicing rights. Management reviews the key economic assumptions used to estimate the fair value of I/O strip receivables on a quarterly basis. The fair value of the I/O strip can be adversely impacted by a significant increase in either the prepayment speed of the portfolio or the discount rate.



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

I/O strip receivables are included in "accrued interest receivable and other assets" on the consolidated balance sheets. Activity for I/O strip receivables follows:

	2015	2014	2013
	(Dollars in thousands)		
Balance, beginning of year	\$ 1,481	\$ 1,647	\$ 1,786
Unrealized loss	(114)	(166)	(139)
Balance, end of year	\$ 1,367	\$ 1,481	\$ 1,647

**6) Premises and Equipment**

Premises and equipment at year-end were as follows:

	2015	2014
	(Dollars in thousands)	
Building	\$ 3,279	\$ 3,256
Land	2,900	2,900
Furniture and equipment	8,468	8,082
Leasehold improvements	5,257	4,658
	19,904	18,896
Accumulated depreciation and amortization	(12,131)	(11,445)
Premises and equipment, net	\$ 7,773	\$ 7,451

Depreciation and amortization expense was \$685,000, \$725,000, and \$729,000 in 2015, 2014, and 2013, respectively.

**7) Leases***Operating Leases*

The Company owns one of its offices and leases the others under non-cancelable operating leases with terms, including renewal options, ranging from five to fifteen years. Future minimum payments under the agreements are as follows:

Year ending December 31,	(Dollars in thousands)
2016	3,434
2017	2,683
2018	2,172
2019	1,998
2020	956
Thereafter	232
Total	\$ 11,475

Rent expense under operating leases was \$2,997,000, \$2,692,000, and \$2,719,000 in 2015, 2014, and 2013, respectively.

Table of Contents

**HERITAGE COMMERCE CORP**

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

**8) Business Combinations**

***Bay View Funding***

On October 8, 2014, HBC entered into a Stock Purchase Agreement ("Purchase Agreement") with BVF/CSNK Acquisition Corp., a Delaware corporation ("BVF/CSNK") pursuant to which HBC agreed to acquire all of the outstanding common stock from the stockholders of BVF/CSNK for an aggregate purchase price of \$22,520,000 ("Acquisition"). The Acquisition closed on November 1, 2014. At the closing, the Bank paid in cash \$20,268,000 of the total purchase price to the BVF/CSNK shareholders, and \$2,252,000, or 10% of the purchase price, was deposited into an 18 month escrow account. CSNK Working Capital Finance Corp. dba Bay View Funding ("Bay View Funding") its wholly-owned subsidiary provides business essential working capital factoring financing to various industries throughout the United States. BVF/CSNK was subsequently merged into Bay View Funding and Bay View Funding became a wholly owned subsidiary of HBC. Bay View Funding's results of operations have been included in the Company's results beginning November 1, 2014.

The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate more accurate or appropriate values for the assets acquired and liabilities assumed, which may be reflective of conditions or events that existed at the acquisition date. As of December 31, 2015, adjustments to the fair value of assets acquired and liabilities assumed in the Bay View Funding transaction were complete.

The Acquisition purchase agreement contains customary representations and warranties by Bay View Funding and the Bay View Funding stockholders, covenants by Bay View Funding regarding the operation of its business between the date of signing of the purchase agreement and the closing date of the Acquisition, and indemnification provisions whereby the BVF/CSNK stockholders agreed to indemnify Bay View Funding and HBC and their affiliated parties for breaches of representations and warranties, breaches of covenants and certain other matters. Of the total purchase price, \$2,252,000, or 10%, was deposited into an escrow account with an independent escrow agent to support the indemnification obligations, if any, of indemnification claims against the BVF/CSNK stockholders. Any amounts remaining in the escrow account will be released to the BVF/CSNK stockholders after 18 months following the closing date of the Acquisition, net of any indemnification payments made from the escrow or amounts reserved for pending claims pursuant to any indemnification claims under the purchase agreement. Because it is uncertain whether any claims will be made against the escrow account the Company has assumed the entire amount will be paid to the BVF/CSNK stockholders.

The following table presents pro forma financial information as if the acquisition had occurred on January 1, 2013, which includes the pre-acquisition period for BVF/CSNK. The historical unaudited pro forma financial information has been adjusted to reflect supportable items that are directly attributable to the acquisition and expected to have a continuing impact on consolidated results of operations, as such, one-time acquisition costs are not included. The unaudited pro forma financial information is provided for informational purposes only. The unaudited pro forma financial information is not necessarily, and should not be assumed to be, an indication of the results that would have been achieved had the acquisition been completed as of the dates indicated or that may be achieved in the future. The preparation of the

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

unaudited pro forma combined consolidated financial statements and related adjustments required management to make certain assumptions and estimates.

UNAUDITED	2014	2013
	(Dollars in thousands, except per share amounts)	
Net interest income	\$ 66,105	\$ 59,998
Noninterest income	8,293	8,080
<b>Total revenue</b>	<b>\$ 74,398</b>	<b>\$ 68,078</b>
Net income	\$ 15,141	\$ 13,397
Net income per share basic	\$ 0.47	\$ 0.42
Net income per share diluted	\$ 0.47	\$ 0.42

***Focus Business Bank***

On April 23, 2015, the Company and Focus entered into a definitive agreement and plan of merger and reorganization whereby Focus would merge into HBC. The Company completed the merger of its wholly-owned bank subsidiary HBC with Focus on August 20, 2015 for an aggregate transaction value of \$66,558,000. Shareholders of Focus received a fixed exchange ratio at closing of 1.8235 shares of the Company's common stock for each share of Focus common stock. Upon closing of the transaction, the Company issued 5,456,713 shares of the Company's common stock to Focus shareholders for a total value of \$58,278,000, based on the Company's closing stock price of \$10.68 on August 20, 2015. In addition, the Company paid cash to the Focus holders of in-the-money stock options on August 20, 2015 totaling \$8,280,000.

Focus's results of operations have been included in the Company's results of operations beginning August 21, 2015. Pre-tax severance, retention, acquisition and integration costs totaled \$6,398,000 for the year ended December 31, 2015.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition. The Company is in the process of finalizing the purchase accounting for the acquisition.

	(Dollars in thousands)	
<b>Assets acquired:</b>		
Cash and cash item	\$	5,651
Federal funds sold and deposits in other financial institutions		168,415
Securities available-for-sale		53,940
Securities held-to-maturity		8,665
Loans held-for-sale		4,416
Net loans		170,353
Goodwill		32,620
Core deposit intangible asset		6,285
Corporate owned life insurance		7,067
Other assets, net		20,250
Total assets acquired		477,662
<b>Liabilities assumed:</b>		
Deposits		405,123
Other liabilities		5,981
Total liabilities		411,104
Net assets acquired	\$	66,558

The fair value of net assets acquired includes fair value adjustments to certain receivables of which some were considered impaired and some were not considered impaired as of the acquisition date. The fair value adjustments were determined using discounted contractual cash flows, adjusted for expected losses and prepayments, where appropriate. The gross contractual amount of four purchased credit impaired loans as of the acquisition date totaled \$1,124,000. As of that date, contractual cash flows not expected to be collected on the purchased credit impaired loans totaled \$819,000, which represents 72.9% of their gross outstanding principal balances. The receivables that were not considered impaired at the acquisition date were not subject to the guidance relating to purchased credit impaired loans, which have shown evidence of credit deterioration since origination. Receivables acquired that were not subject to these requirements include nonimpaired loans with a fair value and gross contractual amounts receivable of \$170,048,000 and \$174,660,000 respectively, on the date of acquisition. As of that date, the purchase discount on these nonimpaired loans totaled \$4,612,000, which represents 2.6% of their gross outstanding principal balances.

Goodwill of \$32,620,000 arising from the acquisition is largely attributable to synergies and cost savings resulting from combining the operations of the companies. As this transaction was structured as a taxfree exchange, the goodwill will not be deductible for tax purposes. The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate a more accurate or appropriate value for an asset or liability. The loans with a fair value of \$170,353,000 and \$1,758,000 of income tax attributes, on the acquisition date, related to the purchase accounting adjustments and Focus' legacy deferred tax assets are subject to change pending receipt of the final valuations and analyses. Loan valuations may be adjusted based on new information obtained by the Company in future periods that may reflect conditions or events

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

that existed on the acquisition date. Deferred tax assets may be adjusted for purchase accounting adjustments on open areas such as loans or upon filing Focus' final August 20, 2015 "stub" period tax returns.

The following table summarizes the consideration paid for Focus:

	<b>August 20, 2015</b>	
	<b>(Dollars in thousands)</b>	
Cash paid for Focus in-the-money stock options	\$	8,280
Common stock issued to Focus shareholders at \$10.68 per share		58,278
<b>Total consideration</b>	<b>\$</b>	<b>66,558</b>

The following table presents pro forma financial information as if the acquisition had occurred on January 1, 2014, which includes the pre-acquisition period for Focus. The historical unaudited pro forma financial information has been adjusted to reflect supportable items that are directly attributable to the acquisition and expected to have a continuing impact on consolidated results of operations, as such, one-time acquisition costs are not included. The unaudited pro forma financial information is provided for informational purposes only. The unaudited pro forma financial information is not necessarily, and should not be assumed to be, an indication of the results that would have been achieved had the acquisition been completed as of the dates indicated or that may be achieved in the future. The preparation of the unaudited pro forma combined consolidated financial statements and related adjustments required management to make certain assumptions and estimates.

<b>UNAUDITED</b>	<b>For the Year Ended</b>		<b>For the Year Ended</b>	
	<b>December 31, 2015</b>		<b>December 31, 2014</b>	
	<b>(Dollars in thousands, except per share amounts)</b>			
Net interest income	\$	83,876	\$	68,175
Provision (credit) for loan losses		82		(38)
Noninterest income		11,443		9,624
Noninterest expense		60,372		53,600
<b>Income before income taxes</b>		<b>34,865</b>		<b>24,237</b>
Income tax expense		13,941		8,784
<b>Net income</b>	<b>\$</b>	<b>20,924</b>	<b>\$</b>	<b>15,453</b>
Net income per share basic	\$	0.56	\$	0.41
Net income per share diluted	\$	0.55	\$	0.41

**9) Goodwill and Other Intangible Assets*****Goodwill***

At December 31, 2015, the carrying value of goodwill was \$45,664,000. The Company recognized \$13,044,000 of goodwill upon its acquisition of Bay View Funding on November 1, 2014, and \$32,620,000 from its acquisition of Focus on August 20, 2015. During the fourth quarter of 2015, adjustments were made to the purchase price allocations for the Focus transaction that affected the amounts allocated to goodwill and other assets.

Goodwill impairment exists when a reporting unit's carrying value exceeds its fair value, which is determined through a qualitative assessment whether it is more likely than not that the fair value of equity of the reporting unit exceeds the carrying value ("Step Zero"). If the qualitative assessment



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

indicates it is more likely than not that the fair value of equity of a reporting unit is less than book value, than a quantitative two-step impairment test is required. Step 1 includes the determination of the carrying value of the Company's single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess.

The Company completed its annual impairment analysis on the goodwill from the Bay View Funding acquisition as of November 30, 2015 with the assistance of an independent valuation firm. Based on the Step Zero qualitative analysis performed, the Company determined that it is more likely than not that the fair value of the reporting unit exceeded its reported book value of equity at November 30, 2015. As such, no impairment was indicated and no further testing was required.

***Other Intangible Assets***

Core deposit and customer relationship intangible assets acquired in the 2007 acquisition of Diablo Valley Bank were \$5,049,000 and \$276,000, respectively. These assets are amortized over their estimated useful lives of 10 years and 7 years, respectively. The customer relationship intangible asset was fully amortized at December 31, 2014. Accumulated amortization of these intangible assets was \$4,703,000 and \$4,257,000 at December 31, 2015 and December 31, 2014, respectively.

The core deposit intangible asset acquired in the acquisition of Focus in August 2015 was \$6,285,000. This asset is amortized over its estimated useful lives of 10 years. Accumulated amortization of this intangible asset was \$288,000 at December 31, 2015.

Other intangible assets acquired in the acquisition of Bay View Funding in November 2014 included: a below market value lease intangible asset of \$109,000 (amortized over 3 years), customer relationship and brokered relationship intangible assets of \$1,900,000, (amortized over the 10 year estimated useful lives), and a non compete agreement intangible asset of \$250,000 (amortized over 3 years). Accumulated amortization of these intangible assets was \$360,000 and \$51,000 at December 31, 2015 and December 31, 2014, respectively.

Estimated amortization expense for each of the next five years follows:

Year	Bay View Funding						Total Amortization Expense
	Diablo Valley Bank Core Deposit Intangible	Focus Core Deposit Intangible	Below Market Value Lease Intangible	Customer & Brokered Relationship Intangible	Non-Compete Agreement Intangible		
	(Dollars in thousands)						
2016	\$ 427	\$ 831	\$ 36	\$ 190	\$ 83	\$ 1,567	
2017	195	875	31	190	70	1,361	
2018		775		190		965	
2019		734		190		924	
2020		716		190		906	
	\$ 622	\$ 3,931	\$ 67	\$ 950	\$ 153	\$ 5,723	

Impairment testing of the intangible assets is performed at the individual asset level. The Company's intangibles are tested for recoverability whenever events or changes in circumstances indicate that their



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

carrying amounts may not be recoverable. If such events or changes in circumstances are identified, an impairment loss is recognized only if the carrying amount of the intangible asset is not recoverable and exceeds its fair value. For intangible assets, estimates of expected future cash flows (cash inflows less cash outflows) that are directly associated with an intangible asset are used to determine the fair value of that asset. Management makes certain estimates and assumptions in determining the expected future cash flows from core deposit and customer relationship intangibles including account attrition, expected lives, discount rates, interest rates, servicing costs and other factors. Significant changes in these estimates and assumptions could adversely impact the valuation of these intangible assets. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset. Based on its assessment, management did not identify any events or changes in circumstances indicating that such intangible assets may not be recoverable at December 31, 2015 or 2014.

**10) Deposits**

Time deposits of \$250,000 and over, including time deposits within the Certificate of Deposit Account Registry Service ("CDARS") and brokered deposits of \$250,000 and over, were \$178,640,000 and \$193,068,000 at December 31, 2015 and 2014, respectively. The following table presents the scheduled maturities of all time deposits and brokered deposits for the next five years:

	(Dollars in thousands)	
2016	\$	233,765
2017		7,986
2018		1,829
2019		1,056
2020		225
Total	\$	244,861

At December 31, 2015, total CDARS deposits of \$7,583,000 include money market deposits of \$3,388,000, which have no scheduled maturity date, and therefore, are excluded from the table above.

At December 31, 2015, the Company had securities pledged with a fair value of \$93,042,000 for \$78,026,000 in certificates of deposits (including accrued interest) with the State of California. At December 31, 2014, the Company had securities pledged with a fair value of \$109,764,000 for \$98,019,000 in certificates of deposits (including accrued interest) with the State of California.

The CDARS program allows customers with deposits in excess of FDIC-insured limits to obtain full coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through these programs are considered brokered deposits under current regulatory reporting guidelines. CDARS deposits were comprised of \$3,388,000 of money market accounts and \$4,195,000 of time deposits at December 31, 2015. CDARS deposits were comprised of \$4,036,000 of money market accounts and \$7,212,000 of time deposits at December 31, 2014.

Deposits from executive officers, directors, and their affiliates were \$13,426,000 and \$2,593,000 at December 31, 2015 and 2014, respectively.

Table of Contents

**HERITAGE COMMERCE CORP**

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

**11) Borrowing Arrangements**

*Federal Home Loan Bank Borrowings, Federal Reserve Bank Borrowings, and Available Lines of Credit*

HBC maintains a collateralized line of credit with the FHLB of San Francisco. Under this line, the Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. As of December 31, 2015, and December 31, 2014, HBC had no overnight borrowings from the FHLB. HBC had \$245,607,000 of loans and no securities pledged to the FHLB as collateral on a line of credit of \$141,875,000 at December 31, 2015. HBC had \$246,635,000 of loans and no securities pledged to the FHLB as collateral on a line of credit of \$139,990,000 at December 31, 2014.

HBC can also borrow from the FRB's discount window. HBC had approximately \$395,006,000 of loans pledged to the FRB as collateral on an available line of credit of approximately \$243,156,000 at December 31, 2015, none of which was outstanding. HBC had approximately \$387,972,000 of loans pledged to the FRB as collateral on an available line of credit of approximately \$260,439,000 at December 31, 2014, none of which was outstanding.

At December 31, 2015, HBC had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at December 31, 2015 and 2014.

HCC has a \$5.0 million line of credit with a correspondent bank, of which \$3.0 million was outstanding at December 31, 2015.

HBC may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase at December 31, 2015, and 2014.

*Subordinated Debt*

The Company supported its growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt issued to the trusts was senior to the outstanding shares of common stock and Series C Preferred Stock. As a result, payments were required on the subordinated debt before any dividends could be paid on the common stock and Series C Preferred Stock. Under the terms of the subordinated debt, the Company could defer interest payments for up to five years. Interest payments on the subordinated notes payable to the Company's subsidiary grantor Trusts were deductible for tax purposes.

During the third quarter of 2013, the Company redeemed its Company's variable rate subordinated debentures in the amount of \$5,000,000 issued to Heritage Statutory Trust II and the Company's variable rate subordinated debentures in the amount of \$4,000,000 issued to Heritage Statutory Trust III. The related trust securities issued by Statutory Trust II and Statutory Trust III were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****12) Income Taxes**

Income tax (benefit) consisted of the following for the year ended December 31, as follows:

	2015	2014	2013
	(Dollars in thousands)		
Currently payable tax:			
Federal	\$ 5,445	\$ 4,392	\$ 5,015
State	2,544	818	63
Total currently payable	7,989	5,210	5,078
Deferred tax (benefit):			
Federal	2,029	1,114	(130)
State	86	1,214	1,258
Total deferred tax	2,115	2,328	1,128
Income tax expense	\$ 10,104	\$ 7,538	\$ 6,206

The effective tax rate differs from the Federal statutory rate for the years ended December 31, as follows:

	2015	2014	2013
Statutory Federal income tax rate	35.0%	35.0%	35.0%
State income taxes, net of federal tax benefit	6.9%	6.5%	5.3%
Low income housing credits, net of investment losses	0.0%	0.8%	0.6%
Increase in cash surrender value of life insurance	2.2%	2.7%	3.5%
Non-taxable interest income	2.7%	3.2%	2.9%
Split-dollar term insurance	0.1%	0.1%	0.2%
Other, net	0.9%	0.5%	0.3%
Effective tax rate	38.0%	36.0%	35.0%

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Deferred tax assets and liabilities that result from the tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes at December 31, are as follows:

	2015	2014
	(Dollars in thousands)	
Deferred tax assets:		
Defined postretirement benefit obligation	\$ 11,049	\$ 10,327
Allowance for loan losses	7,815	7,728
Federal net operating loss carryforwards	2,397	
Stock compensation	2,008	1,693
Accrued expenses	1,689	1,446
State income taxes	889	213
Premises and equipment	945	702
California net operating loss carryforwards	591	
Split-dollar life insurance benefit plan	107	112
Tax credit carryforwards	57	2,441
Loans		2
Nonaccrual interest		25
Other	742	359
<b>Total deferred tax assets</b>	<b>28,289</b>	<b>25,048</b>
Deferred tax liabilities:		
Intangible assets	(2,101)	(1,334)
Loan fees	(1,331)	(1,131)
Prepaid expenses	(1,022)	(464)
I/O strips	(574)	(621)
Securities available-for-sale	(505)	(2,351)
FHLB stock	(245)	(245)
Other	(293)	(375)
<b>Total deferred tax liabilities</b>	<b>(6,071)</b>	<b>(6,521)</b>
<b>Net deferred tax assets</b>	<b>\$ 22,218</b>	<b>\$ 18,527</b>

At December 31, 2015, the Company's federal net operating loss carryforwards were \$6,850,000 and the Company's California net operating loss carryforwards were \$8,389,000. These amounts are attributable to the Focus transaction. The Company did not have any net operating loss carryforwards as of December 31, 2014. These Federal and State net operating loss carryforwards will expire in 2035. The realization of these net operating loss carryforwards for federal and state tax purposes is limited under current tax law with limitations placed on the amount of net operating losses that can be utilized annually. The Company does not, however, believe that these annual limitations will impact the ultimate deductibility of the net operating loss carry-forwards.

The State tax credit carryforwards, net of Federal tax effects, were \$57,000 as of December 31, 2015, which will begin to expire in 2019. The Company has Federal and State net operating loss carryforwards that arose from the acquisition of Focus. There is an Internal Revenue Code Section 382 annual limit of \$1,877,000. As the Company will be able to fully utilize the net operating loss carryforwards before they expire in 2035, no valuation allowance is required against the deferred tax assets.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Under generally accepted accounting principles, a valuation allowance is required 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. In accordance with Accounting Standards Codification (ASC) 740-10 Accounting for Uncertainty in Income Taxes, the Company estimated the need for a reserve for income taxes of \$130,000, net of Federal benefit, for uncertain state income tax positions of Bay View Funding. The Company does not expect this amount to significantly increase or decrease in the next twelve months.

At December 31, 2015, and December 31, 2014, the Company had net deferred tax assets of \$22,218,000 and \$18,527,000, respectively. At December 31, 2015, the Company determined that a valuation allowance for deferred tax assets was not necessary.

The Company and its subsidiaries are subject to U.S. Federal income tax as well as income tax of the State of California. The Company is no longer subject to examination by Federal and state taxing authorities for years before 2012 and 2011, respectively.

The Company adopted the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014. The Company quantified the impact of adopting the proportional amortization method compared to the equity method to its current year and prior period financial statements. The Company determined that the adoption of the proportional amortization method did not have a material impact to its financial statements. The low income housing investment losses, net of the tax benefits received, are included in income tax expense for all periods reflected on the consolidated income statements.

The following table reflects the carry amounts of the low income housing investments included in accrued interest receivable and other assets, and the future commitments as of December 31, 2015 and 2014:

	December 31, 2015	December 31, 2014
	(Dollars in thousands)	
Low income housing investments	\$ 4,304	\$ 5,268
Future commitments	\$ 1,271	\$ 1,827

The Company expects \$550,000 of the future commitments to be paid in 2016, \$14,000 in 2017, and \$707,000 in 2018 through 2023.

For tax purposes, the Company had low income housing tax credits of \$685,000 and \$581,000 for the years ended December 31, 2015 and December 2014, respectively, and low income housing investment losses of \$916,000 and \$338,000, respectively. The Company recognized low income housing investment expense as a component of income tax expense.

**13) Equity Plan**

The Company maintained an Amended and Restated 2004 Equity Plan (the "2004 Plan") for directors, officers, and key employees. The 2004 Plan was terminated on May 23, 2013. On May 23, 2013, the Company's shareholders approved the 2013 Equity Incentive Plan (the "2013 Plan"). The equity plans provide for the grant of incentive and nonqualified stock options and restricted stock. The equity plans provide that the option price for both incentive and nonqualified 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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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. Restricted stock is subject to time vesting. In 2015, the Company granted 243,000 shares of nonqualified stock options and 103,855 shares of restricted stock subject to time vesting requirements. There were 940,985 shares available for the issuance of equity awards under the 2013 Plan as of December 31, 2015.

Stock option activity under the equity plans is as follows:

Total Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2015	1,726,106	\$ 11.23		
Granted	243,000	\$ 9.50		
Exercised	(54,406)	\$ 5.79		
Forfeited or expired	(139,673)	\$ 18.12		
Outstanding at December 31, 2015	1,775,027	\$ 10.62	5.8	\$ 6,381,061
Vested or expected to vest	1,686,276		5.8	\$ 6,062,008
Exercisable at December 31, 2015	1,259,434		4.7	\$ 4,527,179

Information related to the equity plans for each of the last three years:

	2015	2014	2013
Intrinsic value of options exercised	\$ 216,681	\$ 258,467	\$ 51,000
Cash received from option exercise	\$ 315,076	\$ 262,035	\$ 88,000
Tax benefit realized from option exercises	\$ 85,411	\$ 102,710	\$ 17,245
Weighted average fair value of options granted	\$ 3.15	\$ 3.90	\$ 3.84

As of December 31, 2015, there was \$1,842,000 of total unrecognized compensation cost related to nonvested stock options granted under the equity plans. That cost is expected to be recognized over a weighted-average period of approximately 2.48 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model that uses the assumptions noted in the following table, including the weighted average assumptions for the option grants in each year.

	2015	2014	2013
Expected life in months(1)	72	84	96
Volatility(1)	47%	57%	54%
Weighted average risk-free interest rate(2)	1.57%	2.09%	1.49%
Expected dividends(3)	3.37%	2.06%	0.12%

(1)

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

The expected life of employee stock options represents the weighted average period the stock options are expected to remain outstanding based on historical experience. Volatility is based on the historical volatility of the stock price over the same period of the expected life of the option.

- (2) Based on the U.S. Treasury constant maturity interest rate with a term consistent with the expected life of the option granted.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(3)

Each grant's dividend yield is calculated by annualizing the most recent quarterly cash dividend and dividing that amount by the market price of the Company's common stock as of the grant date.

The Company estimates the impact of forfeitures based on historical experience. Should the Company's current estimate change, additional expense could be recognized or reversed in future periods. The Company issues authorized shares of common stock to satisfy stock option exercises.

Restricted stock activity under the equity plans is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
<b>Total Restricted Stock Award</b>		
Nonvested shares at January 1, 2015	100,000	\$ 8.25
Granted	103,855	\$ 9.80
Vested	(31,250)	\$ 7.81
Forfeited or expired	(5,000)	\$ 8.70
<b>Nonvested shares at December 31, 2015</b>	<b>167,605</b>	<b>\$ 9.28</b>

As of December 31, 2015, there was \$1,363,000 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the 2004 Plan and 2013 Plan. The cost is expected to be recognized over a weighted-average period of approximately 3.16 years.

**14) Benefit Plans*****401(k) Savings Plan***

The Company offers a 401(k) savings plan that allows employees to contribute up to a maximum percentage of their compensation, as established by the Internal Revenue Code. The Company made a discretionary matching contribution of up to \$1,500 for each employee's contributions in 2015. The Company made a discretionary matching contribution of up to \$1,000 for each employee's contributions in 2014 and 2013. Contribution expense was \$342,000, \$206,000, and \$196,000 in 2015, 2014 and 2013, respectively.

***Employee Stock Ownership Plan***

The Company sponsors a non-contributory employee stock ownership plan. To participate in this plan, an employee must have worked at least 1,000 hours during the year and must be employed by the Company at year-end. Employer contributions to the ESOP are discretionary. The Company has suspended contributions to the ESOP since 2010. At December 31, 2015, the ESOP owned 123,707 shares of the Company's common stock.

***Deferred Compensation Plan***

The Company has a nonqualified deferred compensation plan for its directors ("Deferral Agreements"). Under the Deferral Agreements, a participating director may defer up to 100% of his or her board fees into a deferred account. The director may elect a distribution schedule of up to ten years. Amounts deferred earn interest. The Company's deferred compensation obligation of \$20,000 and \$50,000 as of December 31, 2015 and 2014 is included in "Accrued interest payable and other liabilities."



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company has purchased life insurance policies on the life of one of its former directors who has a Deferral Agreement. It is expected that the earnings on these policies will offset the cost of the program. In addition, the Company will receive death benefit payments upon the death of the former director. The proceeds will permit the Company to "complete" the deferral program as the former director originally intended if he dies prior to the completion of the deferral program. The disbursement of deferred fees is accelerated at death and commences one month after the former director dies.

In the event of the former director's disability prior to attainment of his benefit eligibility date, the former director may request that the Board permit him to receive an immediate disability benefit equal to the annualized value of the director's deferral account.

***Nonqualified Defined Benefit Pension Plan***

The Company has a supplemental retirement plan covering some current and some former key executives and directors ("SERP"). The SERP is an unfunded, nonqualified defined benefit plan. The combined number of active and retired/terminated participants in the SERP was 53 at December 31, 2015. The defined benefit represents a stated amount for key executives and directors that generally vests over nine years and is reduced for early retirement. The projected benefit obligation is included in "Accrued interest payable and other liabilities" on the consolidated balance sheets. The SERP has no assets and the entire projected benefit obligation is unfunded. The measurement date of the SERP is December 31.

The following table sets forth the SERP's status at December 31:

	2015	2014
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$ 24,570	\$ 20,712
Service cost	862	714
Actuarial loss (gain)	805	3,059
Interest cost	883	911
Benefits paid	(833)	(826)
Projected benefit obligation at end of year	\$ 26,287	\$ 24,570

Amounts recognized in accumulated other comprehensive loss:

Net actuarial loss	\$ 7,149	\$ 6,730
--------------------	----------	----------

Weighted-average assumptions used to determine the benefit obligation at year-end:

	2015	2014
Discount rate	4.00%	3.65%
Rate of compensation increase	N/A	N/A

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Estimated benefit payments over the next ten years, which reflect anticipated future events, service and other assumptions, are as follows:

Year	Estimated Benefit Payments (Dollars in thousands)
2016	\$ 919
2017	1,413
2018	1,549
2019	1,585
2020	1,635
2021 to 2025	9,468

The components of pension cost for the SERP follow:

	2015	2014
	(Dollars in thousands)	
Components of net periodic benefit cost:		
Service cost	\$ 862	\$ 714
Interest cost	883	911
Amortization of net actuarial loss	386	142
<b>Net periodic benefit cost</b>	<b>\$ 2,131</b>	<b>\$ 1,767</b>

The estimated net actuarial loss and prior service cost for the SERP that will be amortized from Accumulated Other Comprehensive Loss into net periodic benefit cost over the next fiscal year are \$239,000 and \$386,000 as of December 31, 2015 and 2014, respectively.

Net periodic benefit cost was determined using the following assumption:

	2015	2014
Discount rate	3.65%	4.50%
Rate of compensation increase	N/A	N/A

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

The Company maintains life insurance policies for some current and some former directors and officers that are subject to split-dollar life insurance agreements, which continues after the participant's employment and retirement. All participants are fully vested in their split-dollar life insurance benefits. The accrued benefit liability for the split-dollar insurance agreements represents either the present value of the future death benefits payable to the participants' beneficiaries or the present value of the estimated cost to maintain life insurance, depending on the contractual terms of the participant's underlying agreement.

The split-dollar life insurance projected benefit obligation is included in "Accrued interest payable and other liabilities" on the consolidated balance sheets. The measurement date of the split-dollar life insurance benefit plan is December 31.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following sets forth the funded status of the split dollar life insurance benefits.

	2015	2014
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$ 4,641	\$ 4,353
Interest cost	169	196
Actuarial loss.	1,405	92
Projected benefit obligation at end of year	\$ 6,215	\$ 4,641

Amounts recognized in accumulated other comprehensive loss at December 31 consist of:

	2015	2014
	(Dollars in thousands)	
Net actuarial loss	\$ 2,147	\$ 540
Prior transition obligation	1,418	1,507
Accumulated other comprehensive loss	\$ 3,565	\$ 2,047

Weighted-average assumption used to determine the benefit obligation at year-end follow:

	2015	2014
Discount rate	4.00%	3.65%

Components of net periodic benefit cost during the year are:

	2015	2014
	(Dollars in thousands)	
Amortization of prior transition obligation	\$ (113)	\$ (102)
Interest cost	169	196
Net periodic benefit cost	\$ 56	\$ 94

The estimated net actuarial loss and prior transition obligation for the split-dollar life insurance benefit plan that will be amortized from accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year are \$90,000 as of December 31, 2015 and 2014.

Weighted-average assumption used to determine the net periodic benefit cost:

	2015	2014
Discount rate	3.65%	4.50%

**15) Fair Value**

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

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.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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.

***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 Company uses matrix pricing (Level 2 inputs) to establish the fair value of its securities available-for-sale.

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

	Balance	Fair Value Measurements Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Unobservable Inputs (Level 2)
(Dollars in thousands)			
Assets at December 31, 2015:			
Available-for-sale securities:			
Agency mortgage-backed securities	\$ 324,230		\$ 324,230
U.S. Treasury	\$ 30,003	\$ 30,003	\$
Trust preferred securities	\$ 15,132		\$ 15,132
U.S. Government sponsored entities	\$ 9,041		\$ 9,041
Corporate bonds	\$ 6,673		\$ 6,673
I/O strip receivables	\$ 1,367		\$ 1,367
Assets at December 31, 2014:			
Available-for-sale securities:			
Agency mortgage-backed securities	\$ 154,172		\$ 154,172
Corporate bonds	\$ 36,863		\$ 36,863
Trust preferred securities	\$ 15,300		\$ 15,300
I/O strip receivables	\$ 1,481		\$ 1,481

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

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

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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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.

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 Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
(Dollars in thousands)			
Assets at December 31, 2015:			
Impaired loans held-for-investment:			
Commercial	\$ 1,333		\$ 1,333
Real estate:			
Commercial and residential	503		503
Land and construction	219		219
Home equity	647		647
	\$ 2,702		\$ 2,702
Assets at December 31, 2014:			
Impaired loans held-for-investment:			
Commercial	\$ 859		\$ 859
Real estate:			
Commercial and residential	587		587
Land and construction	1,176		1,176
	\$ 2,622		\$ 2,622
Foreclosed assets:			
Land and construction	\$ 31		\$ 31
	\$ 31		\$ 31

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (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:

	December 31, 2015	December 31, 2014
	(Dollars in thousands)	
<b>Impaired loans held-for-investment:</b>		
Book value of impaired loans held-for-investment carried at fair value	\$ 2,988	\$ 3,026
Book value of impaired loans held-for-investment carried at cost	3,539	2,996
Total impaired loans held-for-investment	\$ 6,527	\$ 6,022
<b>Impaired loans held-for-investment carried at fair value:</b>		
Book value of impaired loans held-for-investment carried at fair value	\$ 2,988	\$ 3,026
Specific valuation allowance	(286)	(404)
Impaired loans held-for-investment carried at fair value, net	\$ 2,702	\$ 2,622

Impaired loans held-for-investment were \$6,527,000 at December 31, 2015. There were no partial charge-offs at December 31, 2015. In addition, these loans had a specific valuation allowance of \$286,000 at December 31, 2015. Impaired loans held-for-investment totaling \$2,988,000 at December 31, 2015 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining \$3,539,000 of impaired loans were carried at cost at December 31, 2015, 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 2015 on impaired loans held-for-investment carried at fair value at December 31, 2015 resulted in an additional provision for loan losses of \$156,000.

At December 31, 2015, foreclosed assets had a carrying amount of \$364,000, with no valuation allowance at December 31, 2015.

Impaired loans held for investment of \$6,022,000 at December 31, 2014, after partial charge offs of \$107,000 in 2014, were analyzed for additional impairment primarily using the fair value of collateral. In addition, these loans had a specific valuation allowance of \$404,000 at December 31, 2014. Impaired loans held for investment totaling \$3,026,000 at December 31, 2014 were carried at fair value as a result of the aforementioned partial charge offs and specific valuation allowances at year end. The remaining \$2,996,000 of impaired loans were carried at cost at December 31, 2014, 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 2014 on impaired loans held for investment carried at fair value at December 31, 2014 resulted in a credit to the provision for loan losses of \$100,000.

At December 31, 2014, foreclosed assets had a carrying amount of \$696,000, with no valuation allowance at December 31, 2014.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis, except for consumer loans, at December 31, 2015 and 2014:

		<b>December 31, 2015</b>			<b>Range (Weighted Average)</b>
		<b>Fair Value</b>	<b>Valuation Techniques</b>	<b>Unobservable Inputs</b>	
<b>(Dollars in thousands)</b>					
<b>Impaired loans held-for-investment:</b>					
Commercial	\$ 1,333	Market Approach	Discount adjustment for differences between comparable sales	0% to 5% (5%)	
<b>Real estate:</b>					
Commercial and residential	503	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)	
Land and construction	219	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%	
Home equity	647	Market Approach	Discount adjustment for differences between comparable sales	0% to 2% (2%)	
		<b>December 31, 2014</b>			<b>Range (Weighted Average)</b>
		<b>Fair Value</b>	<b>Valuation Techniques</b>	<b>Unobservable Inputs</b>	
<b>(Dollars in thousands)</b>					
<b>Impaired loans held-for-investment:</b>					
Commercial	\$ 859	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)	
<b>Real estate:</b>					
Commercial and residential	587	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)	
Land and construction	1,176	Market Approach	Discount adjustment for differences between comparable sales	1% to 2% (2%)	
<b>Foreclosed assets:</b>					
Land and construction	31	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%	

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.



Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The carrying amounts and estimated fair values of the Company's financial instruments, at year-end were as follows:

	December 31, 2015 Estimated Fair Value				Total
	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
(Dollars in thousands)					
<b>Assets:</b>					
Cash and cash equivalents	\$ 344,092	\$ 344,092	\$	\$	\$ 344,092
Securities available-for-sale	385,079	30,003	355,076		385,079
Securities held-to-maturity	109,311		109,821		109,821
Loans (including loans held-for-sale), net	1,347,087		7,297	1,337,939	1,345,236
FHLB stock, FRB stock, and other investments	12,694				N/A
Accrued interest receivable	5,043		1,654	3,389	5,043
I/O strips receivables	1,367		1,367		1,367
<b>Liabilities:</b>					
Time deposits	\$ 244,861	\$	\$ 245,279	\$	\$ 245,279
Other deposits	1,817,914		1,817,914		1,817,914
Short-term borrowings	3,000		3,000		3,000
Accrued interest payable	195		195		195

	December 31, 2014 Estimated Fair Value				Total
	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
(Dollars in thousands)					
<b>Assets:</b>					
Cash and cash equivalents	\$ 122,403	\$ 122,403	\$	\$	\$ 122,403
Securities available-for-sale	206,335		206,335		206,335
Securities held-to-maturity	95,362		94,953		94,953
Loans (including loans held-for-sale), net	1,071,436		1,172	1,071,854	1,073,026
FHLB and FRB stock	10,598				N/A
Accrued interest receivable	5,044		1,435	3,609	5,044
I/O strips receivables	1,481		1,481		1,481
<b>Liabilities:</b>					
Time deposits	\$ 256,223	\$	\$ 256,589	\$	\$ 256,589
Other deposits	1,132,163		1,132,163		1,132,163
Accrued interest payable	201		201		201

Table of Contents

**HERITAGE COMMERCE CORP**

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

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 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.

***FHLB and FRB Stock***

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

***Off-Balance Sheet Items***

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.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***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.

**16) Commitments and Contingencies***Financial Instruments with Off-Balance Sheet Risk*

HBC is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its clients. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheets.

HBC's exposure to credit loss in the event of non-performance of the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. HBC uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Credit risk is the possibility that a loss may occur because a party to a transaction failed to perform according to the terms of the contract. HBC controls the credit risk of these transactions through credit approvals, limits, and monitoring procedures. Management does not anticipate any significant losses as a result of these transactions.

Commitments to extend credit were as follows:

	December 31, 2015		December 31, 2014	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)			
Unused lines of credit and commitments to make loans	\$ 16,917	\$ 539,897	\$ 8,164	\$ 415,146
Standby letters of credit	3,402	13,458	3,235	12,783
	\$ 20,319	\$ 553,355	\$ 11,399	\$ 427,929

Commitments generally expire within one year.

Standby letters of credit are written with conditional commitments issued by HBC to guarantee the performance of a client to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to clients.

The Company is required to maintain interest-bearing reserves. Reserve requirements are based on a percentage of certain deposits. As of December 31, 2015, the Company maintained reserves of \$29,015,000 in the form of vault cash and balances at the Federal Reserve Bank of San Francisco, which satisfied the regulatory requirements.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Loss Contingencies***

The Company's policy is to accrue for legal costs associated with both asserted and unasserted claims when it is probable that such costs will be incurred and such costs can be reasonably estimated. A number of parties have filed complaints in the Superior Court of California for the County of Santa Clara asserting certain claims against the Company arising from the transfer of funds. One complaint composed of numerous claims has been set for trial in late 2016. Three of the remaining complaints are in the pleading stage and in mid-discovery. One other complaint is in mid-discovery. As to all claims, 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. The Company intends to vigorously defend the litigation.

**17) Shareholders' Equity and Earnings Per Share**

***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.

***Warrants*** On November 21, 2008, in conjunction with the issuance of the Series A Preferred Stock, the Company issued a warrant to the U.S. Treasury with an initial exercise price of \$12.96 per share of common stock, with an allocated fair value of \$1,979,000. The warrant was exercisable at any time on or before November 21, 2018. The warrant was transferable at any time. On June 12, 2013, the Company completed the repurchase of the common stock warrant for \$140,000.

***Series C Preferred Stock*** On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into 5,601,000 shares of 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. The holders of Series C Preferred Stock receive dividends on an as converted basis when dividends are also declared for 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.

***Dividends*** On January 28, 2016, the Company announced that its Board of Directors declared a \$0.09 per share quarterly cash dividend to holders of common stock and Series C preferred stock (on an as converted basis). The dividend was paid on February 25, 2016, to shareholders of record on February 10, 2016.

***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. The Series C Preferred Stock participates 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 December 31, 2013. The Company

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

repurchased the warrant for \$140,000 in the second quarter of 2013. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	Year ended December 31,		
	2015	2014	2013
	(Dollars in thousands, except per share amounts)		
Net income available to common shareholders	\$ 14,705	\$ 12,419	\$ 11,204
Less: undistributed earnings allocated to Series C Preferred Stock	(912)	(1,342)	(1,687)
Distributed and undistributed earnings allocated to common shareholders	\$ 13,793	\$ 11,077	\$ 9,517
Weighted average common shares outstanding for basic earnings per common share	28,567,213	26,390,615	26,338,161
Dilutive effect of stock options outstanding, using the treasury stock method	218,865	135,667	48,291
Shares used in computing diluted earnings per common share	28,786,078	26,526,282	26,386,452
Basic earnings per share	\$ 0.48	\$ 0.42	\$ 0.36
Diluted earnings per share	\$ 0.48	\$ 0.42	\$ 0.36

**18) Capital Requirements**

The Company and its subsidiary bank are subject to various regulatory capital requirements administered by the banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements and operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and HBC must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off balance sheet items as calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

As of January 1, 2015, HCC and HBC along with other community banking organizations became subject to new capital requirements on January 1, 2015 and certain provisions of the new rules will be phased in from 2015 through 2019. The Federal Banking regulators approved the new rules to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of The Dodd Frank Wall Street Reform and Consumer Protection Act of 2010, as amended. The Company's consolidated capital ratios and the Bank's capital ratios exceeded the regulatory guidelines for a well-capitalized financial institution under the Basel III regulatory requirements at December 31, 2015.

Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios (set forth in the tables below) of total, Tier 1 capital, and common equity Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of December 31, 2015 and December 31, 2014, the Company and HBC met all capital adequacy guidelines to which they were subject.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company's consolidated capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of December 31, 2015, and under the Basel I regulatory requirements as of December 31, 2014.

	Actual		Required For Capital Adequacy Purposes Under Basel III	
	Amount	Ratio	Amount	Ratio
(Dollars in thousands)				
As of December 31, 2015:				
Total Capital (to risk-weighted assets)	\$ 218,915	12.5%	\$ 140,041	8.0%
Tier 1 Capital (to risk-weighted assets)	\$ 199,299	11.4%	\$ 105,031	6.0%
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 181,221	10.4%	\$ 78,773	4.5%
Tier 1 Capital (to average assets)	\$ 199,299	8.6%	\$ 92,918	4.0%

	Actual		To Be Well-Capitalized Under Basel I Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel I	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
As of December 31, 2014:						
Total Capital (to risk-weighted assets)	\$ 186,068	13.9%	\$ 134,109	10.0%	\$ 107,287	8.0%
Tier 1 Capital (to risk-weighted assets)	\$ 169,278	12.6%	\$ 80,465	6.0%	\$ 53,644	4.0%
Tier 1 Capital (to average assets)	\$ 169,278	10.6%	N/A	N/A	\$ 63,949	4.0%

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

HBC's actual capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of December 31, 2015, and under the Basel I regulatory requirements as of December 31, 2014.

	Actual		To Be Well-Capitalized Under Basel III Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel III	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
As of December 31, 2015:						
Total Capital (to risk-weighted assets)	\$ 219,943	12.6%	\$ 175,022	10.0%	\$ 140,018	8.0%
Tier 1 Capital (to risk-weighted assets)	\$ 200,327	11.4%	\$ 140,018	8.0%	\$ 105,013	6.0%
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 200,327	11.4%	\$ 113,764	6.5%	\$ 78,760	4.5%
Tier 1 Capital (to average assets)	\$ 200,327	8.6%	\$ 116,112	5.0%	\$ 92,889	4.0%

	Actual		To Be Well-Capitalized Under Basel I Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel I	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
As of December 31, 2014:						
Total Capital (to risk-weighted assets)	\$ 175,765	13.1%	\$ 134,095	10.0%	\$ 107,276	8.0%
Tier 1 Capital (to risk-weighted assets)	\$ 158,976	11.9%	\$ 80,457	6.0%	\$ 53,638	4.0%
Tier 1 Capital (to average assets)	\$ 158,976	9.9%	\$ 79,959	5.0%	\$ 63,967	4.0%

HCC is dependent upon dividends from HBC. Under California General Corporation Law, the holders of common stock are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available. The California Financial Code provides that a state licensed bank may not make a cash distribution to its shareholders in excess of the lesser of the following: (i) the bank's retained earnings; or (ii) the bank's net income for its last three fiscal years, less the amount of any distributions made by the bank to its shareholders during such period. However, a bank, with the prior approval of the Commissioner of the California Department of Business Oversight - Division of Financial Institutions ("DBO") may make a distribution to its shareholders of an amount not to exceed the greater of (i) a bank's retained earnings; (ii) its net income for its last fiscal year; or (iii) its net income for the current fiscal year. Also with the prior approval of the Commissioner of the DBO and the shareholders of the bank, the bank may make a distribution to its shareholders, as a reduction in capital of the bank. In the event that the Commissioner determines that the shareholders' equity of a bank is inadequate or that the making of a distribution by a bank would be unsafe or unsound, the Commissioner may order a bank to refrain from making such a proposed distribution. As of December 31, 2015, HBC would be required to obtain regulatory approval from the DBO for a dividend or other distribution to HCC, however,

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

commencing January 1, 2016 HBC will not be required to obtain regulatory approval. The amount available for cash dividend is \$22,361,000 as of January 1, 2016. Similar restrictions applied to the amount and sum of loan advances and other transfers of funds from HBC to the parent company.

**19) Noninterest Expense**

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

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Salaries and employee benefits	\$ 35,146	\$ 26,250	\$ 23,450
Occupancy and equipment	4,300	4,053	4,043
Acquisition and integration related costs(1)	3,546	895	
Professional fees	1,828	1,891	2,588
Data processing	1,371	969	1,078
Software subscriptions	1,214	999	1,289
Insurance expense	1,127	1,126	1,032
FDIC deposit insurance premiums	1,092	892	894
Correspondent bank charges	1,021	760	684
Amortization on intangible assets	1,043	510	473
Foreclosed assets	(94)	53	(251)
Other	7,079	5,824	5,190
<b>Total</b>	<b>\$ 58,673</b>	<b>\$ 44,222</b>	<b>\$ 40,470</b>

---

(1)

Does not include pre-tax severance and retention cost of \$2,887,000, which is included in salaries and employee benefits for the year ended December 31, 2015.

**20) Business Segment Information**

The following presents the Company's operating segments. The Company operates through two business segments: Banking segment and Factoring segment. Transactions between segments consist primarily of borrowed funds. Intersegment interest expense is allocated to the Factoring segment based on the Company's prime rate and funding costs. The provision for loan loss is allocated based on the segment's allowance for loan loss determination which considers the effects of charge-offs. Noninterest income and expense directly attributable to a segment are assigned to it. Taxes are paid on a consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring originated by Bay



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

View Funding, which has been included in the results of operations since the acquisition on November 1, 2014.

	<b>For the Twelve Months Ended December 31, 2015</b>		
	<b>Banking(1)</b>	<b>Factoring</b>	<b>Consolidated</b>
	<b>(Dollars in thousands)</b>		
Interest income	\$ 66,306	\$ 12,437	\$ 78,743
Intersegment interest allocations	1,087	(1,087)	
Total interest expense	2,422		2,422
Net interest income	64,971	11,350	76,321
Provision (credit) for loan losses	(156)	188	32
Net interest income after provision	65,127	11,162	76,289
Noninterest income	8,234	751	8,985
Noninterest expense	51,438	7,235	58,673
Intersegment expense allocations	386	(386)	
Income before income taxes	22,309	4,292	26,601
Income tax expense	8,301	1,803	10,104
Net income	\$ 14,008	\$ 2,489	\$ 16,497
Total assets	\$ 2,306,543	\$ 55,036	\$ 2,361,579
Loans, net of deferred fees	\$ 1,318,657	\$ 40,059	\$ 1,358,716
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

(1) Includes the holding company's results of operations

	<b>For the Twelve Months Ended December 31, 2014</b>		
	<b>Banking(1)</b>	<b>Factoring(2)</b>	<b>Consolidated</b>
	<b>(Dollars in thousands)</b>		
Interest income	\$ 57,178	\$ 2,078	\$ 59,256
Intersegment interest allocations	31	(31)	
Total interest expense	2,033	120	2,153
Net interest income	55,176	1,927	57,103
Provision (credit) for loan losses	(338)		(338)
Net interest income after provision	55,514	1,927	57,441
Noninterest income	7,662	84	7,746
Noninterest expense	43,132	1,090	44,222
Income before income taxes	20,044	921	20,965

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-K

Income tax expense	7,151	387	7,538
--------------------	-------	-----	-------

Net income	\$ 12,893	\$ 534	\$ 13,427
------------	-----------	--------	-----------

Total assets	\$ 1,561,911	\$ 55,192	\$ 1,617,103
--------------	--------------	-----------	--------------

Loans, net of deferred fees	\$ 1,048,631	\$ 40,012	\$ 1,088,643
-----------------------------	--------------	-----------	--------------

Goodwill	\$	\$ 13,044	\$ 13,044
----------	----	-----------	-----------

(1) Includes the holding company's results of operations

(2) Includes two months of Bay View Funding's results of operations

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****21) Parent Company only Condensed Financial Information**

The condensed financial statements of Heritage Commerce Corp (parent company only) are as follows:

**Condensed Balance Sheets**

	December 31,	
	2015	2014
	(Dollars in thousands)	
<b>Assets</b>		
Cash and cash equivalents	\$ 1,686	\$ 10,159
Investment in subsidiary bank	246,357	173,453
Other assets	400	953
<b>Total assets</b>	<b>\$ 248,443</b>	<b>\$ 184,565</b>

**Liabilities and Shareholder's Equity**

Short-term borrowings	3,000	
Other liabilities	7	207
Shareholder's equity	245,436	184,358
<b>Total liabilities and shareholder's equity</b>	<b>\$ 248,443</b>	<b>\$ 184,565</b>

**Condensed Statements of Operations**

	For the Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Dividend from subsidiary bank	\$	\$	\$ 16,000
Interest expense	(18)		(229)
Other expenses	(2,705)	(2,033)	(2,080)
Income (loss) before income taxes and equity in net income of subsidiary bank	(2,723)	(2,033)	13,691
Equity in net income of subsidiary bank:			
Reduction in contributed capital and distribution from subsidiary bank			(16,000)
Net income of subsidiary bank	18,081	14,614	13,155
Income tax benefit	1,139	846	694
<b>Net income</b>	<b>16,497</b>	<b>13,427</b>	<b>11,540</b>
Dividends and discount accretion on preferred stock	(1,792)	(1,008)	(336)
<b>Net income available to common shareholders</b>	<b>\$ 14,705</b>	<b>\$ 12,419</b>	<b>\$ 11,204</b>



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Condensed Statements of Cash Flows**

	<b>For the Year Ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>2013</b>
	<b>(Dollars in thousands)</b>		
<b>Cash flows from operating activities:</b>			
Net Income	\$ 16,497	\$ 13,427	\$ 11,540
<b>Adjustments to reconcile net income to net cash provided by (used in) operations:</b>			
Amortization of restricted stock award, net of forfeitures and taxes	265	(9)	200
Equity in undistributed loss/(net income) of subsidiary bank	(18,081)	(14,614)	2,845
Net change in other assets and liabilities	269	(2,158)	4,478
<b>Net cash (used in) provided by operating activities</b>	<b>(1,050)</b>	<b>(3,354)</b>	<b>19,063</b>
<b>Cash flows from financing activities:</b>			
Repayment of subordinated debt			(9,279)
Net change in purchased funds and other short-term borrowings	3,000		
Payment of cash dividends	(10,738)	(5,758)	(1,916)
Proceeds from issuance of common stock, net of issuance costs	315	262	88
Payment of repurchase of common stock warrant			(140)
<b>Net cash used in financing activities</b>	<b>(7,423)</b>	<b>(5,496)</b>	<b>(11,247)</b>
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(8,473)</b>	<b>(8,850)</b>	<b>7,816</b>
Cash and cash equivalents, beginning of year	10,159	19,009	11,193
<b>Cash and cash equivalents, end of year</b>	<b>\$ 1,686</b>	<b>\$ 10,159</b>	<b>\$ 19,009</b>

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****22) Quarterly Financial Data (Unaudited)**

The following table discloses the Company's selected unaudited quarterly financial data:

	For the Quarter Ended(1)			
	12/31/15	09/30/15	06/30/15	03/31/15
	(Dollars in thousands, except per share amounts)			
Interest income	\$ 22,896	\$ 20,306	\$ 18,175	\$ 17,366
Interest expense	758	623	533	508
Net interest income	22,138	19,683	17,642	16,858
Provision (credit) for loan losses	371	(301)	22	(60)
Net interest income after provision for loan losses	21,767	19,984	17,620	16,918
Noninterest income	2,829	2,066	2,164	1,926
Noninterest expense	17,361	16,419	12,617	12,276
Income before income taxes	7,235	5,631	7,167	6,568
Income tax expense	2,812	2,172	2,690	2,430
Net income	4,423	3,459	4,477	4,138
Dividends on preferred stock	(448)	(448)	(448)	(448)
Net income available to common shareholders	3,975	3,011	4,029	3,690
Undistributed earnings allocated to Series C Preferred Stock	(209)	(111)	(331)	(274)
Distributed and undistributed earnings allocated to common shareholders	\$ 3,766	\$ 2,900	\$ 3,698	\$ 3,416
<b>Earnings per common share</b>				
Basic	\$ 0.12	\$ 0.10	\$ 0.14	\$ 0.13
Diluted	\$ 0.12	\$ 0.10	\$ 0.14	\$ 0.13

(1) Pre-tax severance, retention and acquisition and integration costs included in noninterest expense were \$2,991,000, \$2,865,000, \$423,000, and \$119,000, for the fourth, third, second, and first quarters of 2015, respectively.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	For the Quarter Ended			
	12/31/2014(1)	9/30/2014(2)	06/30/14	03/31/14
	(Dollars in thousands, except per share amounts)			
Interest income	\$ 16,717	\$ 14,492	\$ 14,192	\$ 13,855
Interest expense	625	500	507	521
Net interest income	16,092	13,992	13,685	13,334
Provision (credit) for loan losses	(106)	(24)	(198)	(10)
Net interest income after provision for loan losses	16,198	14,016	13,883	13,344
Noninterest income	1,812	1,870	2,047	2,017
Noninterest expense	12,415	10,492	10,769	10,546
Income before income taxes	5,595	5,394	5,161	4,815
Income tax expense	1,993	1,969	1,837	1,739
Net income	3,602	3,425	3,324	3,076
Dividends on preferred stock	(280)	(280)	(224)	(224)
Net income available to common shareholders	3,322	3,145	3,100	2,852
Undistributed earnings allocated to Series C Preferred Stock	(349)	(320)	(358)	(315)
Distributed and undistributed earnings allocated to common shareholders	\$ 2,973	\$ 2,825	\$ 2,742	\$ 2,537
<b>Earnings per common share</b>				
Basic	\$ 0.11	\$ 0.11	\$ 0.10	\$ 0.10
Diluted	\$ 0.11	\$ 0.11	\$ 0.10	\$ 0.10

(1) The Company's selected unaudited quarterly financial data for the quarter ended December 31, 2014 includes Bay View Funding acquisition and integration costs of \$609,000, and the results of operations for Bay View Funding for the months of November and December 2014.

(2) The Company's selected unaudited quarterly financial data for the quarter ended September 30, 2014 includes Bay View Funding acquisition and integration costs of \$234,000.

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

### Table of Contents

#### EXHIBIT INDEX

<b>Exhibit Number</b>	<b>Description</b>
2.1	Agreement and Plan of Merger, dated April 23, 2015, by and among Heritage Commerce Corp, Heritage Bank of Commerce and Focus Business Bank (incorporated by reference from the Registrant's Current Report on Form 8-K filed on April 23, 2015)
3.1	Restated Articles of Incorporation of Heritage Commerce Corp (incorporated by reference from 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 from the Registration Statement on Form S-1 filed July 23, 2010)
3.3	Bylaws, as amended, of Heritage Commerce Corp (incorporated by reference from the Registrant's Current Report Form 8-K filed June 28, 2013)
4.1	Certificate of Determination of Series C Convertible Perpetual Preferred Stock, as filed with the California Secretary of State on June 17, 2010 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed on June 22, 2010)
10.1	Real Property Lease for Registrant's Principle Office dated April 13, 2000 (incorporated by reference from Registrant's Annual Report on Form 10-K filed on March 6, 2015)
10.2	Sixth Amendment to Lease for Registrant's Principle Office dated November 17, 2014 (incorporated by reference from Registrant's Annual Report on Form 10-K filed on March 6, 2015)
*10.3	Heritage Commerce Corp Management Incentive Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed May 3, 2005)
*10.4	Amended and Restated 2004 Equity Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed June 2, 2009)
*10.5	Restricted Stock Agreement with Walter Kaczmarek dated March 17, 2005 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed March 22, 2005)
*10.6	2004 Stock Option Agreement with Walter Kaczmarek dated March 17, 2005 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed March 22, 2005)
*10.7	Non-qualified Deferred Compensation Plan (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 31, 2005)
*10.8	Amended and Restated Employment Agreement with Walter Kaczmarek, dated October 17, 2007 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed October 22, 2007)
*10.9	Amended and Restated Employment Agreement with Lawrence McGovern, dated July 21, 2011 (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed July 21, 2011)
*10.10	Employment Agreement with Michael E. Benito, dated February 1, 2012 (incorporated by reference from the Registrant's Current Report on Form 8-K filed February 1, 2012)
*10.11	Employment Agreement with David Porter, dated June 25, 2012 (incorporated by reference from the Registrant's Current Report on Form 8-K filed June 25, 2012)



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

### Table of Contents

<b>Exhibit Number</b>	<b>Description</b>
*10.12	Employment Agreement with Keith Wilton, dated February 18, 2014 (incorporated by reference from the Registrant's Current Report on Form 8-K filed February 20, 2014)
*10.13	Form of Stock Option Agreement For Amended and Restated 2004 Equity Plan (incorporated by reference from the Registrant's Annual Report on Form 10-K filed March 9, 2012)
*10.14	Form of Restricted Stock Agreement For Amended and Restated 2004 Equity Plan (incorporated by reference from the Registrant's Annual Report on Form 10-K filed March 9, 2012)
*10.15	2013 Equity Incentive Plan (incorporated by reference from the Registrant's Registration Statement in Form S-8 filed July 15, 2013)
*10.16	Form of Restricted Stock Agreement For 2013 Equity Incentive Plan (incorporated by reference from the Registrant's Registration Statement on Form S-8 filed July 15, 2013)
*10.17	Form of Stock Option Agreement for 2013 Equity Incentive Plan (incorporated by reference from the Registrant's Registration Statement on Form S-8 filed July 15, 2013)
*10.18	2005 Amended and Restated Heritage Commerce Corp Supplemental Retirement Plan (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed September 30, 2008)
*10.19	Form of Endorsement Method Split Dollar Plan Agreement for Executive Officers (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 17, 2008)
*10.20	Form of Endorsement Method Split Dollar Plan Agreement for Directors (incorporated herein by reference from the Registrant's Annual Report on Form 10-K filed March 17, 2008)
*10.21	Amendment No. 1 to Employment Agreement, dated December 29, 2008 between the Company and Walter T. Kaczmarek (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.22	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Jack Conner and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.23	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Frank Bisceglia and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.24	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Robert Moles and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.25	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Humphrey Polanen and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.26	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Charles Toeniskoetter and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)
*10.27	First Amended and Restated Director Compensation Benefits Agreement dated December 29, 2008 between Ranson Webster and the Company (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed January 2, 2009)

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

### Table of Contents

<b>Exhibit Number</b>	<b>Description</b>
10.28	Form of Indemnification Agreement between the Registrant and its directors and executive officers (incorporated herein by reference from the Registrant's Current Report on Form 8-K filed December 23, 2009)
10.29	Securities Purchase Agreement between the Company and each of the Purchasers, dated as of June 18, 2010 (incorporated herein from the Registrant's Current Report on Form 8-K as filed June 22, 2010)
10.30	Registration Rights Agreement between the Company and each of the Purchasers, dated as of June 18, 2010 (incorporated herein from the Registrant's Current Report on Form 8-K as filed June 22, 2010)
10.31	Stock Purchase Agreement, between Heritage Bank of Commerce, BVF Acquisition Corp and the stockholders named therein dated October 8, 2014 (incorporated herein from the Registrant's Current Report on Form 8-K, as filed October 9, 2014)
12.1	Calculation of consolidated ratio of earnings to fixed charges and consolidated ratio of earnings to fixed charges and preferred stock dividends
21.1	Subsidiaries of the Registrant
23.1	Consent of Crowe Horwath LLP
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

\*

Management contract or compensatory plan or arrangement.