

HERITAGE COMMERCE CORP
Form 10-Q
August 07, 2013

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2013

OR

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

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

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

California
(State or Other Jurisdiction of
Incorporation or Organization)

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

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

95113
(Zip Code)

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

N/A

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

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

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

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

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

(Do not check if a
smaller reporting company)

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

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

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QUARTERLY REPORT ON FORM 10-Q
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Cautionary Note Regarding Forward-Looking Statements

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

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

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

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

Risks associated with concentrations in real estate related loans;

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

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

Stability of funding sources and continued availability of borrowings;

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

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

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

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

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

A prolonged slowdown in construction activity;

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

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

Changes in consumer spending, borrowings and saving habits;

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

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

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

The ability to increase market share and control expenses; and

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

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

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

HERITAGE COMMERCE CORP
CONSOLIDATED BALANCE SHEETS (Unaudited)

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

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

See notes to consolidated financial statements

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

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

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

See notes to consolidated financial statements

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

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

See notes to consolidated financial statements

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

Six Months Ended June 30, 2013 and 2012

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

See notes to consolidated financial statements

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

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

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Supplemental schedule of non-cash investing activity:

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

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

1) Basis of Presentation

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

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

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

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

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

Reclassifications

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

Adoption of New Accounting Standards

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

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

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

2) Earnings Per Share

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

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

3) Accumulated Other Comprehensive Income ("AOCI")

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

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

(1) Amounts in parenthesis indicate debits.

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

(1) Amounts in parenthesis indicate debits.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

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

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

(1) Amounts in parenthesis indicate debits.

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

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

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

(1) Amounts in parenthesis indicate debits.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Loans were as follows:

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

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

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

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

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

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

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

Six Months Ended June 30, 2012

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

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

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

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

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

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

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

	June 30, 2013			December 31, 2012		
	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	\$ 1,031	\$ 948	\$	\$ 7,829	\$ 6,978	\$
Real estate:						
Commercial and residential	3,509	3,509		2,755	2,741	
Land and construction	2,070	2,070		2,310	2,223	
Home Equity	2,077	2,077		2,141	2,141	
Total with no related allowance recorded	8,687	8,604		15,035	14,083	
With an allowance recorded:						
Commercial	4,487	4,394	2,588	3,678	3,182	1,963
Real estate:						
Commercial and residential	1,560	1,560	480	3,183	1,937	465
Land and construction	59	59	12			
Home Equity	294	294	294	295	295	295
Consumer	135	135	28	147	147	17

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

5) Loans (Continued)

Six Months Ended June 30, 2012

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

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

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

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

	June 30, 2013			December 31, 2012		
	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	\$ 4,164	\$ 510	\$ 4,674	\$ 7,852	\$ 859	\$ 8,711
Real estate:						
Commercial and residential	5,069		5,069	4,676		4,676
Land and construction	2,129		2,129	2,223		2,223
Home equity	2,371		2,371	2,437		2,437
Consumer	135		135	147		147

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Total	\$	13,868	\$	510	\$	14,378	\$	17,335	\$	859	\$	18,194
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Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2013****(Unaudited)****5) Loans (Continued)**

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

	June 30, 2013					
	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	\$ 2,540	\$ 567	\$ 1,871	\$ 4,978	\$ 378,090	\$ 383,068
Real estate:						
Commercial and residential	139		1,639	1,778	368,842	370,620
Land and construction			59	59	26,646	26,705
Home equity			294	294	48,373	48,667
Consumer		99		99	12,998	13,097
Total	\$ 2,679	\$ 666	\$ 3,863	\$ 7,208	\$ 834,949	\$ 842,157

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

	December 31, 2012					
	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	\$ 1,699	\$ 355	\$ 5,120	\$ 7,174	\$ 368,295	\$ 375,469
Real estate:						
Commercial and residential	1,603		3,290	4,893	350,041	354,934
Land and construction			78	78	22,274	22,352
Home equity	742		2,045	2,787	41,078	43,865
Consumer					15,714	15,714
Total	\$ 4,044	\$ 355	\$ 10,533	\$ 14,932	\$ 797,402	\$ 812,334

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

5) Loans (Continued)

Credit Quality Indicators

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

6) Income Taxes

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

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

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

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

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

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

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

Split-Dollar Life Insurance Benefit Plan

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

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

8) Preferred Stock

Series A Preferred Stock

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

Series C Preferred Stock

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

9) Fair Value

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

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

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data (for example, interest rates and yield curves observable at commonly quoted intervals, prepayment speeds, credit risks, and default rates).

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

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

Financial Assets and Liabilities Measured on a Recurring Basis

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

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

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

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

Assets and Liabilities Measured on a Non-Recurring Basis

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

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

9) Fair Value (Continued)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

9) Fair Value (Continued)

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

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

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

Cash and Cash Equivalents

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

Loans

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

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

9) Fair Value (Continued)

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

FHLB and FRB Stock

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

Accrued Interest Receivable/Payable

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

Deposits

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

Subordinated Debt

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

Off-balance Sheet Instruments

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

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering for sale at one time the entire holdings of a particular financial instrument. Fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

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

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

Stock option activity under the 2004 Plan is as follows:

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

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

Restricted stock activity under the 2004 Plan is as follows:

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

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

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

11) Subordinated Debt

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

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

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

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

12) Loss Contingencies

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

13) Subsequent Event

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

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

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

CRITICAL ACCOUNTING POLICIES

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

EXECUTIVE SUMMARY

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

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

Performance Overview

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Recent Events

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

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

Deposits

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

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

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

Liquidity

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

Lending

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

Net Interest Income

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

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

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

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

Management of Credit Risk

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

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

Noninterest Income

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

Noninterest Expense

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

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Capital Management

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

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

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

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

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

RESULTS OF OPERATIONS

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

Net Interest Income and Net Interest Margin

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

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

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

Distribution, Rate and Yield

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

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

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

(1)

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

(2)

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

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

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

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

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

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

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

Provision for Loan Losses

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

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

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

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

Noninterest Income

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

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

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

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

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

Noninterest Expense

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

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

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

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

Noninterest Expense by Category

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

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

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

Income Tax Expense

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

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

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

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

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

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

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

FINANCIAL CONDITION

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

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

