

HERITAGE COMMERCE CORP
Form 10-Q
May 04, 2012

Table of Contents

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended March 31, 2012

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 ☐

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 ☐

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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 26,286,501 shares of Common Stock outstanding on April 13, 2012.

Table of Contents

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

	Page No.
<u>Cautionary Note on Forward-Looking Statements</u>	<u>3</u>
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1.</u> <u>Consolidated Financial Statements (unaudited)</u>	<u>5</u>
<u>Consolidated Balance Sheets</u>	<u>5</u>
<u>Consolidated Statements of Income</u>	<u>6</u>
<u>Consolidated Statements of Comprehensive Income</u>	<u>7</u>
<u>Consolidated Statements of Changes in Shareholders' Equity</u>	<u>8</u>
<u>Consolidated Statements of Cash Flows</u>	<u>9</u>
<u>Notes to Consolidated Financial Statements</u>	<u>10</u>
<u>Item 2.</u> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>32</u>
<u>Item 3.</u> <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>60</u>
<u>Item 4.</u> <u>Controls and Procedures</u>	<u>60</u>
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1.</u> <u>Legal Proceedings</u>	<u>61</u>
<u>Item 1A.</u> <u>Risk Factors</u>	<u>61</u>
<u>Item 2.</u> <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>61</u>
<u>Item 3.</u> <u>Defaults Upon Senior Securities</u>	<u>61</u>

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

<u>Item 4.</u>	<u>Mine Safety Disclosures</u>	<u>61</u>
<u>Item 5.</u>	<u>Other Information</u>	<u>61</u>
<u>Item 6.</u>	<u>Exhibits</u>	<u>62</u>
<u>SIGNATURES</u>		<u>63</u>
<u>EXHIBIT INDEX</u>		<u>64</u>

Table of Contents

Cautionary Note Regarding Forward-Looking Statements

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

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

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

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

Risks associated with concentrations in real estate related loans;

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

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

Stability of funding sources and continued availability of borrowings;

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

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

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

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

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

A prolonged slowdown in construction activity;

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

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

Changes in consumer spending, borrowings and saving habits;

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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

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

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

The ability to increase market share and control expenses; and

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

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

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

HERITAGE COMMERCE CORP
CONSOLIDATED BALANCE SHEETS (Unaudited)

	March 31, 2012	December 31, 2011
	(Dollars in thousands, except per share data)	
Assets		
Cash and due from banks	\$ 20,450	\$ 20,861
Interest-bearing deposits in other financial institutions	48,215	52,011
Total cash and cash equivalents	68,665	72,872
Securities available-for-sale, at fair value	385,826	380,455
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	4,778	753
Loans held-for-sale other, at lower of cost or fair value, including deferred costs	184	413
Loans, including deferred costs	756,894	764,591
Allowance for loan losses	(20,306)	(20,700)
Loans, net	736,588	743,891
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	9,928	9,925
Company owned life insurance	47,067	46,388
Premises and equipment, net	7,883	7,980
Intangible assets	2,368	2,491
Accrued interest receivable and other assets	42,011	41,026
Total assets	\$ 1,305,298	\$ 1,306,194
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 356,618	\$ 344,303
Demand, interest-bearing	144,022	134,119
Savings and money market	292,009	282,478
Time deposits under \$100	27,949	28,557
Time deposits \$100 and over	168,726	168,874
Time deposits CDARS	6,198	6,371
Time deposits brokered	84,728	84,726
Total deposits	1,080,250	1,049,428
Subordinated debt	23,702	23,702
Accrued interest payable and other liabilities	41,450	35,233
Total liabilities	1,145,402	1,108,363
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		39,846

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Series A fixed rate cumulative preferred stock, 40,000 shares issued and outstanding (liquidation preference of \$40,250) at December 31, 2011		
Discount on Series A preferred stock		(833)
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at March 31, 2012 and December 31, 2011 (liquidation preference of \$21,004 at March 31, 2012 and December 31, 2011)	19,519	19,519
Common stock, no par value; 60,000,000 shares authorized; 26,286,501 shares issued and outstanding at March 31, 2012 and 26,295,001 shares issued and outstanding at December 31, 2011	131,302	131,172
Retained earnings	7,887	7,172
Accumulated other comprehensive income	1,188	955
Total shareholders' equity	159,896	197,831
Total liabilities and shareholders' equity	\$ 1,305,298	\$ 1,306,194

See notes to consolidated financial statements

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

	Three Months Ended March 31,	
	2012	2011
	(Dollars in thousands, except per share data)	
Interest income:		
Loans, including fees	\$ 10,316	\$ 10,989
Securities	3,097	1,963
Interest-bearing deposits in other financial institutions	36	34
Total interest income	13,449	12,986
Interest expense:		
Deposits	716	1,271
Subordinated debt	474	466
Other		53
Total interest expense	1,190	1,790
Net interest income before provision for loan losses	12,259	11,196
Provision for loan losses	100	770
Net interest income after provision for loan losses	12,159	10,426
Noninterest income:		
Service charges and fees on deposit accounts	590	567
Servicing income	460	411
Increase in cash surrender value of life insurance	429	425
Gain on sale of SBA loans	36	379
Gain on sale of securities	27	
Other	181	135
Total noninterest income	1,723	1,917
Noninterest expense:		
Salaries and employee benefits	5,667	5,393
Professional fees	1,211	839
Occupancy and equipment	996	1,038
Software subscriptions	290	255
Low income housing investment losses	269	162
Data processing	245	220
FDIC deposit insurance premiums	225	524
Insurance expense	224	241
Other real estate owned expense	115	21
Other	1,614	1,738
Total noninterest expense	10,856	10,431
Income before income taxes	3,026	1,912
Income tax expense	951	331
Net income	2,075	1,581

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Dividends and discount accretion on preferred stock		(1,206)		(596)
Net income available to common shareholders	\$	869	\$	985
Earnings per common share:				
Basic	\$	0.03	\$	0.03
Diluted	\$	0.03	\$	0.03

See notes to consolidated financial statements

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

	Three Months Ended March 31,	
	2012	2011
	(Dollars in thousands)	
Net income	\$ 2,075	\$ 1,581
Net unrealized holding gains (losses) on available-for-sale securities and I/O strips	372	(367)
Reclassification adjustment for (gains) realized in income	(27)	
Deferred income taxes	(145)	154
Change in unrealized gains (losses) on available-for-sale securities and I/O strips, net of deferred income taxes	200	(213)
Net pension and other benefit plan liability adjustment	57	105
Deferred income tax	(24)	(44)
Change in pension and other benefit plan liability, net of deferred income taxes	33	61
Other comprehensive income (loss)	233	(152)
Total comprehensive income	\$ 2,308	\$ 1,429

See notes to consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)****Three Months Ended March 31, 2012 and 2011**

	Preferred Stock			Common Stock		Retained Earnings/	Accumulated Other Comprehensive	Total
	Shares	Amount	Discount	Shares	Amount	(Accumulated Deficit)	Income / (Loss)	Shareholders' Equity
(Dollars in thousands, except share data)								
Balance, January 1, 2011	61,004	\$ 59,365	\$ (1,227)	26,233,001	\$ 130,531	\$ (1,866)	\$ (4,651)	\$ 182,152
Net income						1,581		1,581
Net change in unrealized gain/(loss) on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes							(213)	(213)
Net change in pension and other benefit plan liability, net of deferred income taxes							61	61
Amortization of restricted stock awards, net of forfeitures and taxes					(36)			(36)
Cash dividends accrued on Series A preferred stock						(500)		(500)
Accretion of discount on Series A preferred stock			96			(96)		
Stock option expense, net of forfeitures and taxes					187			187
Balance, March 31, 2011	61,004	\$ 59,365	\$ (1,131)	26,233,001	\$ 130,682	\$ (881)	\$ (4,803)	\$ 183,232
Balance, January 1, 2012	61,004	\$ 59,365	\$ (833)	26,295,001	\$ 131,172	\$ 7,172	\$ 955	\$ 197,831
Net income						2,075		2,075
Net change in unrealized gain/(loss) on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes							200	200
Net change in pension and other benefit plan liability, net of deferred income taxes							33	33
Repurchase of Series A preferred stock	(40,000)	(40,000)						(40,000)
Series A preferred stock capitalized offering costs		154				(154)		
Forfeitures of restricted stock awards				(8,500)				
Amortization of restricted stock awards, net of forfeitures and taxes					28			28
Cash dividends paid on Series A preferred stock						(373)		(373)
Accretion of discount on Series A preferred stock			833			(833)		
Stock option expense, net of forfeitures and taxes					102			102
Balance, March 31, 2012	21,004	\$ 19,519	\$	26,286,501	\$ 131,302	\$ 7,887	\$ 1,188	\$ 159,896

See notes to consolidated financial statements

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

	Three Months Ended March 31,	
	2012	2011
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 2,075	\$ 1,581
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	533	271
Gain on sale of securities available-for-sale	(27)	
Gain on sale of SBA loans	(36)	(379)
Proceeds from sale of SBA loans originated for sale	632	4,710
Net change in SBA loans originated for sale	(4,621)	(2,830)
Write-downs on other loans held-for-sale		29
Provision for loan losses	100	770
Increase in cash surrender value of life insurance	(429)	(425)
Depreciation and amortization	195	197
Amortization of other intangible assets	123	130
Gain on sale of foreclosed assets, net	(31)	(10)
Stock option expense, net	102	187
Amortization of restricted stock awards, net	28	(36)
Effect of changes in:		
Accrued interest receivable and other assets	818	874
Accrued interest payable and other liabilities	(609)	(4,799)
Net cash (used in) provided by operating activities	(1,147)	270
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(19,943)	(18,339)
Maturities/paydowns/calls of securities available-for-sale	18,858	7,872
Proceeds from sale of securities available-for-sale	2,280	
Proceeds from sale of other loans transferred to held-for-sale	220	
Net change in other loans transferred to held-for-sale		8
Net change in loans	5,239	39,924
Change in Federal Home Loan Bank and Federal Reserve Bank stock	(3)	136
Purchase of premises and equipment	(98)	(19)
Proceeds from sale of foreclosed assets	188	1,305
Purchase of company owned life insurance	(250)	
Net cash provided by investing activities	6,491	30,887
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	30,822	9,405
Repurchase of Series A Preferred Stock	(40,000)	
Payment of cash dividends preferred stock	(373)	
Net change in securities sold under agreement to repurchase		(5,000)
Net change in short-term borrowings		(271)
Net cash provided (used in) by financing activities	(9,551)	4,134
Net (decrease) increase in cash and cash equivalents	(4,207)	35,291
Cash and cash equivalents, beginning of period	72,872	72,177
Cash and cash equivalents, end of period	\$ 68,665	\$ 107,468
Supplemental disclosures of cash flow information:		
Interest paid	\$ 1,557	\$ 1,425

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Income taxes paid	800	
Supplemental schedule of non-cash investing activity:		
Due to broker for securities purchased	\$ 11,921	\$ 8,231
Loans transferred to foreclosed assets	1,973	918
Cash dividend accrued on Series A preferred stock	500	

See notes to consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2012

(Unaudited)

1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company") and its wholly owned subsidiary, Heritage Bank of Commerce (sometimes referred to as "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, 2011. 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.

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

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

The results for the three months ended March 31, 2012 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2012.

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 May 2011, the FASB issued an accounting standards update to improve the comparability between U.S. GAAP fair value accounting and reporting requirements and International Financial Reporting Standards ("IFRS") fair value accounting and reporting requirements. Additional disclosures required by the update include: (i) disclosure of quantitative information regarding the unobservable inputs used in any fair value measurement classified as Level 3 in the fair value hierarchy in addition to an explanation of the valuation techniques used in valuing Level 3 items and information regarding the

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

1) Basis of Presentation (Continued)

sensitivity in the valuation of Level 3 items to changes in the values assigned to unobservable inputs; (ii) categorization by level within the fair value hierarchy of items not recognized on the Statement of Financial Position at fair value but for which fair values are required to be disclosed; and (iii) instances where the fair values disclosed for non-financial assets were based on a highest and best use assumption when in fact the assets are not being utilized in that capacity. The amendments in the update are effective for interim and annual periods beginning on or after December 15, 2011. 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 8.

In June 2011, the FASB issued an accounting standards update to increase the prominence of items included in Other Comprehensive Income and facilitate the convergence of U.S. GAAP with IFRS. The update prohibits continued presentation of Other Comprehensive Income in the statement of Stockholders' Equity. The update requires that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but continuous statements. The amendments in the update are effective for interim and annual periods beginning on or after December 15, 2011. The adoption of this amendment changed the presentation of the statement of comprehensive income for the Company to two consecutive statements, instead of presented as part of the consolidated statements of shareholder's equity.

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 21,004 shares of Series C Preferred Stock remain outstanding as of March 31, 2012, and are convertible into 5,601,000 shares of common stock. The Series C Preferred Stock participate in the earnings of the Company and, therefore, the shares issued on the conversion of the Series C Preferred Stock are considered outstanding under the two-class method of computing basic earnings per common share during periods of earnings. Diluted earnings per share reflect potential dilution from outstanding stock options and common stock warrants, using the treasury stock method. The common stock warrant was antidilutive at March 31, 2012 and 2011. A

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****2) Earnings Per Share (Continued)**

reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

(Dollars in thousands)	For the Three Months Ended March 31,	
	2012	2011
Net income available to common shareholders	\$ 869	\$ 985
Less: net income allocated to Series C Preferred Stock	153	173
Net income allocated to common shareholders	\$ 716	\$ 812
Weighted average common shares outstanding for basic earnings per common share	26,289,334	26,233,001
Dilutive effect of stock options outstanding, using the the treasury stock method	27,220	7,161
Shares used in computing diluted earnings per common share	26,316,554	26,240,162

3) Securities

The amortized cost and estimated fair value of securities at March 31, 2012 and December 31, 2011 were as follows:

March 31, 2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(Dollars in thousands)				
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 331,496	\$ 8,702	\$ (17)	\$ 340,181
Corporate bonds	10,353	283		10,636
Trust preferred securities	35,044	154	(189)	35,009
Total	\$ 376,893	\$ 9,139	\$ (206)	\$ 385,826

December 31, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(Dollars in thousands)				
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 341,901	\$ 8,484	\$ (37)	\$ 350,348
Trust preferred securities	29,947	194	(34)	30,107
Total	\$ 371,848	\$ 8,678	\$ (71)	\$ 380,455

At March 31, 2012 and December 31, 2011, all agency mortgage-backed securities were issued by the Federal National Mortgage Association ("Fannie Mae") the Federal Home Loan Mortgage

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****3) Securities (Continued)**

Corporation ("Freddie Mac"), or the Government National Mortgage Association ("Ginnie Mae"). At March 31, 2012 and December 31, 2011, trust preferred securities were issued by single entities. There were no holdings of securities of any one issuer, other than the U.S. Government and its sponsored entities, in an amount greater than 10% of shareholders' equity.

At March 31, 2012, the Company held 176 securities, of which nine had fair values below amortized cost. No securities had been carried with an unrealized loss for over 12 months. Unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not intend to sell any securities with an unrealized loss and does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company did not consider these securities to be other-than-temporarily impaired at March 31, 2012.

At December 31, 2011, the Company held 165 securities, of which five had fair values below amortized cost. No securities had been carried with an unrealized loss for over 12 months. The Company did not consider these securities to be other-than-temporarily impaired at December 31, 2011.

The amortized cost and fair values of debt securities as of March 31, 2012, 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	\$ 904	\$ 961
Due after five through ten years	9,449	9,675
Due after ten years	35,044	35,009
Agency mortgage-backed securities	331,496	340,181
Total	\$ 376,893	\$ 385,826

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****4) Loans**

Loans were as follows:

	March 31, 2012	December 31, 2011
	(Dollars in thousands)	
Loans held-for-sale:		
Loans held-for-sale SBA	\$ 4,778	\$ 753
Loans held-for-sale other	184	413
Total loans held-for-sale	\$ 4,962	\$ 1,166
Loans held-for-investment:		
Commercial	\$ 357,906	\$ 366,590
Real estate:		
Commercial and residential	319,914	311,479
Land and construction	18,583	23,016
Home equity	48,444	52,017
Consumer	11,810	11,166
Loans	756,657	764,268
Deferred loan origination costs and fees, net	237	323
Loans, including deferred costs	756,894	764,591
Allowance for loan losses	(20,306)	(20,700)
Loans, net	\$ 736,588	\$ 743,891

Changes in the allowance for loan losses were as follows:

	Three Months Ended March 31, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 13,215	\$ 7,338	\$ 147	\$ 20,700
Charge-offs	(910)	(45)		(955)
Recoveries	461			461
Net charge-offs	(449)	(45)		(494)
Provision/(credit) for loan losses	968	(884)	16	100
Balance, end of period	\$ 13,734	\$ 6,409	\$ 163	\$ 20,306

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****4) Loans (Continued)****Three Months Ended March 31, 2011**

	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 13,952	\$ 10,363	\$ 889	\$ 25,204
Charge-offs	(1,119)	(995)		(2,114)
Recoveries	139	10		149
Net charge-offs	(980)	(985)		(1,965)
Provision/(credit) for loan losses	622	161	(13)	770
Balance, end of period	\$ 13,594	\$ 9,539	\$ 876	\$ 24,009

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment, based on the impairment method as of March 31, 2012 and December 31, 2011:

	March 31, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 2,641	\$ 201	\$ 2	\$ 2,844
Collectively evaluated for impairment	11,093	6,208	161	17,462
Total allowance balance	\$ 13,734	\$ 6,409	\$ 163	\$ 20,306
Loans:				
Individually evaluated for impairment	\$ 10,947	\$ 5,633	\$ 11	\$ 16,591
Collectively evaluated for impairment	346,959	381,308	11,799	740,066
Total loan balance	\$ 357,906	\$ 386,941	\$ 11,810	\$ 756,657

	December 31, 2011			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 2,249	\$ 76	\$ 2	\$ 2,327
Collectively evaluated for impairment	10,966	7,262	145	18,373

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total allowance balance	\$	13,215	\$	7,338	\$	147	\$	20,700
-------------------------	----	--------	----	-------	----	-----	----	--------

Loans:

Individually evaluated for impairment	\$	11,954	\$	5,948	\$	12	\$	17,914
Collectively evaluated for impairment		354,636		380,564		11,154		746,354

Total loan balance	\$	366,590	\$	386,512	\$	11,166	\$	764,268
--------------------	----	---------	----	---------	----	--------	----	---------

[Table of Contents](#)**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****4) Loans (Continued)**

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of March 31, 2012 and December 31, 2011. The recorded investment included in the following table represents loan principal net of any partial charge-offs recognized on the loans. The unpaid principal balance represents the recorded balance prior to any partial charge-offs.

	March 31, 2012			December 31, 2011		
	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	\$ 4,730	\$ 4,651	\$	\$ 7,644	\$ 5,972	\$
Real estate:						
Commercial and residential	1,134	1,134		2,916	2,057	
Land and construction	2,224	2,224		3,491	3,039	
Total with no related allowance recorded	8,088	8,009		14,051	11,068	
With an allowance recorded:						
Commercial	6,307	6,296	2,641	6,526	5,982	2,249
Real estate:						
Commercial and residential	2,275	2,275	201	80	80	44
Land and construction				817	740	32
Home Equity				32	32	
Consumer	11	11	2	12	12	2
Total with an allowance recorded	8,593	8,582	2,844	7,467	6,846	2,327
Total	\$ 16,681	\$ 16,591	\$ 2,844	\$ 21,518	\$ 17,914	\$ 2,327

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

	Three Months Ended March 31, 2012						
	Commercial and Residential			Real Estate Land and Home Construction Equity		Consumer	Total
	Commercial	Residential	Construction	Equity	Consumer		Total
(Dollars in thousands)							
Average of impaired loans during the period	\$ 11,450	\$ 2,773	\$ 3,002	\$ 16	\$ 11		\$ 17,252
Interest income during impairment	\$	\$ 1	\$ 14	\$	\$		\$ 15
Cash-basis interest earned	\$	\$ 1	\$ 14	\$	\$		\$ 15

[Table of Contents](#)

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

4) Loans (Continued)

Three Months Ended March 31, 2011

	Real Estate					
	Commercial and Residential		Land and Construction	Home Equity	Consumer	Total
	Commercial	Residential				
	(Dollars in thousands)					
Average of impaired loans during the period	\$ 13,814	\$ 5,076	\$ 8,015	\$ 141	\$ 895	\$ 27,941
Interest income during impairment	\$ 1	\$	\$	\$ 1	\$	\$ 2
Cash-basis interest earned	\$ 1	\$	\$	\$	\$	\$ 1

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

	March 31, 2012	March 31, 2011	December 31, 2011
	(Dollars in thousands)		
Nonaccrual loans held-for-sale	\$ 184	\$ 1,989	\$ 186
Nonaccrual loans held-for-investment	14,005	22,896	14,353
Restructured and loans over 90 days past due and still accruing	2,155	282	2,291
Total	\$ 16,344	\$ 25,167	\$ 16,830
Other restructured loans	\$ 431	\$ 1,389	\$ 1,270
Impaired loans, excluding loans held-for-sale	\$ 16,591	\$ 24,567	\$ 17,914

The following table presents the nonperforming loans by class as of March 31, 2012 and December 31, 2011:

	March 31, 2012			December 31, 2011		
	Restructured and Loans Over 90 Days Past Due and Still Accruing			Restructured and Loans Over 90 Days Past Due and Still Accruing		
	Nonaccrual	Past Due and Still Accruing	Total	Nonaccrual	Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	\$ 8,360	\$ 2,155	\$ 10,515	\$ 8,876	\$ 1,803	\$ 10,679
Real estate:						
Commercial and residential	3,412		3,412	2,137		2,137
Land and construction	2,406		2,406	3,514	456	3,970
Home equity					32	32
Consumer	11		11	12		12

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total	\$	14,189	\$	2,155	\$	16,344	\$	14,539	\$	2,291	\$	16,830
-------	----	--------	----	-------	----	--------	----	--------	----	-------	----	--------

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****4) Loans (Continued)**

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

	March 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	\$ 2,987	\$ 1,226	\$ 4,199	\$ 8,412	\$ 349,494	\$ 357,906
Real estate:						
Commercial and residential	854	1,455		2,309	317,605	319,914
Land and construction					18,583	18,583
Home equity					48,444	48,444
Consumer					11,810	11,810
Total	\$ 3,841	\$ 2,681	\$ 4,199	\$ 10,721	\$ 745,936	\$ 756,657

The following table presents the aging of past due loans as of December 31, 2011 by class of loans:

	December 31, 2011					
	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	\$ 1,999	\$ 508	\$ 3,394	\$ 5,901	\$ 360,689	\$ 366,590
Real estate:						
Commercial and residential	2,293			2,293	309,186	311,479
Land and construction			1,532	1,532	21,484	23,016
Home equity	753		32	785	51,232	52,017
Consumer					11,166	11,166
Total	\$ 5,045	\$ 508	\$ 4,958	\$ 10,511	\$ 753,757	\$ 764,268

Past due loans 30 days or greater totaled \$10,721,000 and \$10,511,000 at March 31, 2012 and December 31, 2011, respectively, of which \$6,576,000 and \$6,312,000, respectively, were on nonaccrual. At March 31, 2012, there were also \$7,428,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2011, there were also \$8,041,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

4) Loans (Continued)

Credit Quality Indicators

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

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

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

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

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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****4) Loans (Continued)**

The following table provides a summary of the loan portfolio by loan type and credit quality classification at March 31, 2012 and December 31, 2011:

	March 31, 2012			December 31, 2011		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)					
Commercial	\$ 328,099	\$ 29,807	\$ 357,906	\$ 333,506	\$ 33,084	\$ 366,590
Real estate:						
Commercial and residential	304,243	15,671	319,914	294,653	16,826	311,479
Land and construction	12,508	6,075	18,583	15,343	7,673	23,016
Home equity	47,795	649	48,444	51,368	649	52,017
Consumer	11,405	405	11,810	10,853	313	11,166
Total	\$ 704,050	\$ 52,607	\$ 756,657	\$ 705,723	\$ 58,545	\$ 764,268

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.

During the three months ended March 31, 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or more combination of the following: a reduction of the stated interest rate of the loan; or an extension of maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk.

The book balance of troubled debt restructurings at March 31, 2012 was \$7,442,000, which included \$4,856,000 of nonaccrual loans and \$2,586,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2011 was \$7,396,000, which included \$4,323,000 of nonaccrual loans and \$3,073,000 of accruing loans. Approximately \$1,429,000 and \$574,000 in specific reserves were established with respect to these loans as of March 31, 2012 and December 31, 2011, respectively. As of March 31, 2012 and December 31, 2011, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

The following table presents loans by class modified as troubled debt restructurings during the three month period ended March 31, 2012:

	During the Three Months Ended March 31, 2012			
	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment	
	(Dollars in thousands)			
Troubled Debt Restructurings:				
Commercial	2	\$ 412	\$ 412	
Total	2	\$ 412	\$ 412	

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

4) Loans (Continued)

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

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 months ended March 31, 2012.

5) Income Taxes

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

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

The Company had net deferred tax assets of \$21,274,000, and \$21,870,000, at March 31, 2012, and December 31, 2011, respectively. After consideration of the matters in the preceding paragraph, the Company determined that a valuation allowance for deferred tax assets should be \$0 at March 31, 2012 and December 31, 2011.

6) Benefit Plans

Supplemental Retirement Plan

The Company has a supplemental retirement plan (the "Plan") covering current and former key executives and directors. The Plan is a nonqualified defined benefit plan. Benefits are unsecured as

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****6) Benefit Plans (Continued)**

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

	Three Months Ended March 31,	
	2012	2011
	(Dollars in thousands)	
Components of net periodic benefit cost:		
Service cost	\$ 294	\$ 236
Interest cost	193	206
Amortization of prior service cost	7	9
Amortization of net actuarial loss	63	31
Net periodic benefit cost	\$ 557	\$ 482

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. During 2011, participants in the split-dollar life insurance benefit plan agreed to amend their agreements related to the designation of beneficiaries for life insurance policies owned by the Company. The agreements were amended to provide a benefit for as long as the policies are in force, including a commitment to provide replacement coverage if the policies are ever surrendered.

The following table sets forth the funded status of the split-dollar life insurance benefits for the three months ended March 31, 2012 and the twelve months ended December 31, 2011:

	March 31, 2012	December 31, 2011
	(Dollars in thousands)	
Change in projected benefit obligation	\$ 4,525	\$ 6,361
Interest cost	46	306
Actuarial (gain) loss	(10)	831
Amendments to split dollar agreements		(2,973)
Projected benefit obligation at end of period	\$ 4,561	\$ 4,525

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****6) Benefit Plans (Continued)**

Amounts recognized in accumulated other comprehensive loss at March 31, 2012 and December 31, 2011 consist of the following:

	March 31, 2012	December 31, 2011
	(Dollars in thousands)	
Net actuarial loss	\$ 484	\$ 454
Prior transition obligation	1,754	1,776
Accumulated other comprehensive loss	\$ 2,238	\$ 2,230

7) 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. The Company used available cash and proceeds from a \$30,000,000 distribution approved by the California State Department of Financial Institutions from HBC to the Company. The repurchase of the Series A Preferred Stock accelerated the accretion of the remaining issuance discount on the Series A Preferred Stock. Total dividends and discount accretion on Preferred Stock, including accelerated accretion of approximately \$765,000, reduced net income available to common shareholders by \$1,206,000 in the first quarter of 2012. The Company did not repurchase the related warrant that was issued to the U.S. Treasury, and the warrant remains outstanding as of the date of this report.

Series C Preferred Stock

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering.

The Series C Preferred Stock remains outstanding until it has been converted into common stock in accordance with its terms. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****8) Fair Value**

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

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

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

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

Financial Assets and Liabilities Measured on a Recurring Basis

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

The 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).

	Fair Value Measurements Using			
	Balance	Quoted Prices in	Significant	Significant
		Active Markets for	Other	Significant
		Identical Assets	Observable	Unobservable
		(Level 1)	Inputs	Inputs
			(Level 2)	(Level 3)
(Dollars in thousands)				
Assets at March 31, 2012:				
Available-for-sale securities:				
Agency mortgage-backed securities	\$ 340,181	\$	\$ 340,181	\$
Corporate bonds	10,636		10,636	
Trust preferred securities	35,009		35,009	
I/O strip receivables	2,113		2,113	
Assets at December 31, 2011:				
Available-for-sale securities:				
Agency mortgage-backed securities	\$ 350,348	\$	\$ 350,348	\$
Trust preferred securities	30,107		30,107	
I/O strip receivables	2,094		2,094	

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

8) Fair Value (Continued)

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.

At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Impaired loans carried at fair value generally receive specific allocations of the allowance for loan losses. For collateral dependent loans, fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent 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. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****8) Fair Value (Continued)**

	Fair Value Measurements Using			
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(Dollars in thousands)				
Assets at March 31, 2012:				
Impaired loans held-for-sale other:				
Real estate:				
Land and construction	\$ 184		\$ 184	
Impaired loans held-for-investment:				
Commercial	\$ 5,674			\$ 5,674
Real estate:				
Commercial and residential	3,016			3,016
Land and construction	1,724			1,724
Home equity				
Consumer	9			9
	\$ 10,423			\$ 10,423
Foreclosed assets:				
Commercial and residential	\$ 283			\$ 283
Land and construction	2,884			2,884
	\$ 3,167			\$ 3,167
Assets at December 31, 2011:				
Impaired loans held-for-sale other:				
Real estate:				
Land and construction	\$ 186		\$ 186	
Impaired loans held-for-investment:				
Commercial	\$ 6,526			\$ 6,526
Real estate:				
Commercial and residential	1,794			1,794
Land and construction	1,590			1,590
Home equity	32			32
Consumer	10			10
	\$ 9,952			\$ 9,952
Foreclosed assets:				
Commercial and residential	\$ 156			\$ 156
Land and construction	2,156			2,156

\$ 2,312

\$ 2,312

[Table of Contents](#)**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****8) 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:

	March 31, 2012	December 31, 2011
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	\$ 13,267	\$ 12,279
Book value of impaired loans held-for-investment carried at cost	3,324	5,635
 Total impaired loans held-for-investment	 \$ 16,591	 \$ 17,914
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	\$ 13,267	\$ 12,279
Specific valuation allowance	(2,844)	(2,327)
 Impaired loans held-for-investment carried at fair value, net	 \$ 10,423	 \$ 9,952

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were \$16,591,000 at March 31, 2012, after partial charge-offs of \$90,000 in the first three months of 2012. In addition, these loans had a specific valuation allowance of \$2,844,000 at March 31, 2012. Impaired loans held-for-investment totaling \$13,267,000 at March 31, 2012 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining \$3,324,000 of impaired loans were carried at cost at March 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 the first three months of 2012 on impaired loans held-for-investment carried at fair value at March 31, 2012 resulted in an additional provision for loan losses of \$713,000.

Foreclosed assets measured at fair value less costs to sell, had a net carrying amount of \$3,167,000, which is made up of the outstanding balance of \$3,167,000, with no valuation allowance at March 31, 2012.

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were \$17,914,000 at December 31, 2011, after partial charge-offs of \$3,604,000 in 2011. In addition, these loans had a specific valuation allowance of \$2,327,000 at December 31, 2011. Impaired loans held-for-investment totaling \$12,279,000 at December 31, 2011 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining \$5,635,000 of impaired loans were carried at cost at December 31, 2011, 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 2011 on impaired loans held-for-investment carried at fair value at December 31, 2011 resulted in an additional provision for loan losses of \$2,916,000.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****8) Fair Value (Continued)**

At December 31, 2011, other real estate owned had a net carrying amount of \$2,312,000, made up of the outstanding balance of \$2,312,000, with no valuation allowance at December 31, 2011.

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 March 31, 2012:

	Fair Value (Dollars in thousands)	Valuation Techniques	Unobservable Inputs	Range (Weighted Average)
Impaired loans held-for-investment:				
Commercial	\$ 5,674	Third party appraisal	Discount adjustment for differences between comparable sales	2% to 11% (7%)
Real estate:				
Commercial and residential	3,016	Third party appraisal	Discount adjustment for differences between comparable sales	6% to 11% (9%)
Land and construction	1,724	Third party appraisal	Discount adjustment for differences between comparable sales	2% to 3% (3%)
Foreclosed assets:				
Land and construction	2,884	Third party appraisal	Discount adjustment for differences between comparable sales	0% to 6% (6%)

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2012****(Unaudited)****8) Fair Value (Continued)**

The carrying amounts and estimated fair values of financial instruments at March 31, 2012 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	\$ 68,665	\$ 20,450	\$ 48,215	\$	\$ 68,665
Securities available-for-sale	385,826		385,826		385,826
Loans (including loans held-for-sale), net	741,550		4,962	739,430	744,392
FHLB and FRB stock	9,928				N/A
Accrued interest receivable	4,542		4,542		4,542
Loan servicing rights and I/O strips receivables	2,843		5,205		5,205
Liabilities:					
Time deposits	\$ 287,601	\$	\$ 288,528	\$	\$ 288,528
Other deposits	792,649		792,649		792,649
Subordinated debt	23,702			15,950	15,950
Accrued interest payable	416		416		416

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2011:

	Carrying Amounts	Estimated Fair Value
Assets:		
Cash and cash equivalents	\$ 72,872	\$ 72,872
Securities available-for-sale	380,455	380,455
Loans (including loans held-for-sale), net	745,057	745,421
FHLB and FRB stock	9,925	N/A
Accrued interest receivable	3,719	3,719
Loan servicing rights and I/O strips receivables	2,886	5,261
Liabilities:		
Time deposits	\$ 288,528	\$ 289,512
Other deposits	760,900	760,900
Subordinated debt	23,702	15,950
Accrued interest payable	784	784

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

8) Fair Value (Continued)

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

Cash and Cash Equivalents

The carrying amounts of cash and short-term instruments approximate fair values and are classified as either Level 1 or Level 2. Cash on hand and noninterest due from bank accounts are Level 1, whereas, interest bearing due from bank accounts and fed funds sold are Level 2.

Loans

The fair value of loans held-for-sale is estimated based upon binding contracts and quotes from third party investors resulting in a Level 2 classification.

Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

FHLB and FRB Stock

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

Accrued Interest Receivable/Payable

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

8) Fair Value (Continued)

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.

9) Loss Contingencies

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. The Company's accounting policy for legal costs related to loss contingencies is to accrue for the probable fees that can be reasonably estimated. The Company's accounting policy for uncertain recoveries is to recognize the anticipated recovery when realization is deemed probable. During the first quarter of 2012, the Company accrued \$500,000 for probable costs related to an anticipated legal claim that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer. It is reasonably possible that the outcome may result in a liability exceeding the amount accrued in the financial statements; however, based on the status of the unasserted claim, a range of the reasonably possible gross loss or gross anticipated recoveries cannot be estimated.

Table of Contents

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

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 first quarter of 2012, net income was \$2.1 million. Net income available to common shareholders was \$869,000, or \$0.03 per diluted common share, for the first quarter of 2012, which included \$1.2 million in dividends and discount accretion on preferred stock. For the first quarter of 2011, net income was \$1.6 million. Net income available to common shareholders was \$985,000, or \$0.03 per diluted common share, for the first quarter of 2011, which included \$596,000 in dividends and discount accretion on preferred stock. The Company's annualized return on average assets was 0.64% and annualized return on average equity was 4.43% for the first quarter of 2012, compared to 0.51% and 3.51%, respectively, a year ago.

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

The net interest margin increased 11 basis points to 4.06% for the first quarter of 2012, compared with 3.95% for the first quarter of 2011, and increased 19 basis points compared with 3.87% for the fourth quarter of 2011, primarily as a result of a higher yield on loans and a lower cost of deposits.

The yield on the loan portfolio was 5.41% for the first quarter of 2012, compared to 5.28% for the first quarter of 2011, and 5.39% for the fourth quarter of 2011.

The total cost of deposits decreased 25 basis points to 0.27% for the first quarter of 2012 from 0.52% for the first quarter of 2011, and decreased one basis point from 0.28% for the fourth quarter of 2011, primarily as a result of maturing higher-cost wholesale funding and growth in core deposits.

Net interest income was \$12.3 million for the first quarter of 2012, compared to \$11.2 million for the first quarter of 2011, primarily due to an increase in the average balance of investment securities and a decrease in the rates paid on interest-bearing liabilities, partially offset by a decrease in average balance of loans.

The provision for loan losses was \$100,000 for the first quarter of 2012, compared to \$770,000 for the first quarter of 2011. The decrease in 2012 compared to 2011 reflects a lower volume of classified assets and nonperforming loans, and contraction of the loan portfolio.

Noninterest income decreased 10% to \$1.7 million for the first quarter of 2012 from \$1.9 million for the first quarter of 2011, primarily due to a decrease in the gain on sales of SBA loans to \$36,000 for the first quarter of 2012, compared to \$379,000 for the first quarter of 2011.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

Noninterest expense increased 4% to \$10.9 million for the first quarter of 2012 from \$10.4 million for the first quarter of 2011. The increase in noninterest expense from the first quarter of 2011 was primarily due to a \$500,000 accrual for probable costs related to an anticipated legal claim that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer.

The efficiency ratio was 77.64% for the first quarter of 2012, compared to 79.55% for the first quarter of 2011, primarily as a result of higher net interest income.

The income tax expense for the first quarter of 2012 was \$951,000, as compared to \$331,000 for the first quarter of 2011. The effective income tax rate was 31% for first quarter of 2012, compared to an effective income tax rate of 17% for the first quarter of 2011. 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, and tax credits related to investments in low income housing limited partnerships.

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

Cash and due from banks, interest-bearing deposits in other financial institutions and securities available-for-sale increased 27% to \$454.5 million at March 31, 2012, from \$357.6 million at March 31, 2011, and remained relatively flat from \$453.3 million at December 31, 2011.

Total loans, excluding loans held-for-sale, decreased \$46.5 million, or 6%, to \$756.9 million at March 31, 2012, compared to \$803.4 million at March 31, 2011, and decreased \$7.7 million, or 1%, from \$764.6 million at December 31, 2011. Land and construction loans decreased \$31.9 million, or 63%, to \$18.6 million at March 31, 2012, compared to \$50.5 million at March 31, 2011, and decreased \$4.4 million, or 19%, from \$23.0 million at December 31, 2011.

Classified assets (net of SBA guarantees) decreased to \$54.2 million at March 31, 2012, compared to \$81.4 million at March 31, 2011, and \$59.5 million at December 31, 2011.

The allowance for loan losses at March 31, 2012, was \$20.3 million, or 2.68% of total loans, representing 125.66% of nonperforming loans excluding nonaccrual loans in loans held-for-sale. The allowance for loan losses at March 31, 2011, was \$24.0 million, or 2.99% of total loans, representing 103.59% of nonperforming loans excluding nonaccrual loans in loans held-for-sale. The allowance for loan losses at December 31, 2011, was \$20.7 million, or 2.71% of total loans, representing 124.37% of nonperforming loans excluding nonaccrual loans in loans held-for-sale.

Nonperforming assets were \$19.5 million, or 1.49% of total assets at March 31, 2012, compared to \$26.1 million or 2.08% of total assets at March 31, 2011, and \$19.1 million, or 1.47% of total assets at December 31, 2011.

Net loan charge-offs were \$494,000 for the first quarter of 2012, compared to \$2.0 million for the first quarter of 2011, and \$1.6 million for the fourth quarter of 2011.

Core deposits continued to increase for the first quarter of 2012:

Noninterest-bearing demand deposits increased 10% to \$356.6 million at March 31, 2012, from \$325.1 million at March 31, 2011, and increased 4% from \$344.3 million at December 31, 2011.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Interest-bearing demand deposits increased 6% to \$144.0 million at March 31, 2012, from \$135.9 million at March 31, 2011, and increased 7% from \$134.1 million at December 31, 2011.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

Savings and money market deposits increased 11% to \$292.0 million at March 31, 2012, from \$262.8 million at March 31, 2011, and increased 3% from \$282.5 million at December 31, 2011.

The ratio of noncore funding (which consists of time deposits \$100,000 and over, CDARS deposits, brokered deposits, and short-term borrowings) to total assets was 19.89% at March 31, 2012, compared to 19.85% at March 31, 2011, and 19.90% at December 31, 2011.

The loan to deposit ratio was 70.07% at March 31, 2012, compared to 80.07% at March 31, 2011, and 72.86% at December 31, 2011.

Capital ratios substantially exceed regulatory requirements for a well-capitalized financial institution, both on a consolidated basis and at the bank level at March 31, 2012. The leverage ratio at the holding company was 12.7%, with a Tier 1 risk-based capital ratio of 16.6%, and a total risk-based capital ratio of 17.9% at March 31, 2012. The leverage ratio for HBC was 11.9%, with a Tier 1 risk-based capital ratio of 15.6%, and a total risk-based capital ratio of 16.9% at March 31, 2012. The regulatory well-capitalized guidelines are a minimum of a 5% leverage ratio, a 6% Tier 1 risk-based capital ratio, and a 10% total risk-based capital ratio.

Significant First Quarter 2012 Events

On March 7, 2012, the Company repaid the \$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 paid the final dividend of approximately \$122,000, in accordance with approvals received from the U.S. Treasury and the Federal Reserve. The Company used available cash and proceeds from a \$30 million cash distribution approved by the California State Department of Financial Institutions ("DFI") from HBC to the Company. The Series A Preferred Stock was recorded at a discount, and the repurchase accelerated the accretion of the discount on the Series A Preferred Stock. While the accelerated accretion did not impact net income, it resulted in a one-time non-cash reduction in net income available to common shareholders of approximately \$765,000 in the first quarter of 2012. Total dividends and discount accretion on preferred stock, including the accelerated accretion, reduced net income available to common shareholders by \$1.2 million in the first quarter of 2012. While participating in the TARP Capital Purchase Program, the Company paid \$6.6 million in cash dividends to the U.S. Treasury. The repayment of the TARP funds will save the Company \$2.0 million in preferred dividend payments on an annual basis, beginning in the second quarter of 2012.

In conjunction with the issuance of the Series A Preferred Stock, the Company issued a warrant to the U.S. Treasury to purchase 462,963 shares of the Company's common stock at an exercise price of \$12.96 per share in November 2008. The warrant is exercisable immediately and will expire after a period of 10 years from issuance and is transferable by the U.S. Treasury. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report.

Deposits

The composition and cost of the Company's deposit base are important in analyzing the Company's net interest margin and balance sheet liquidity characteristics. Except for brokered time deposits, the Company's depositors are generally located in its primary market area. Depending on loan demand and other funding requirements, the Company also obtains deposits from wholesale sources including deposit brokers. The Company had \$84.7 million in brokered deposits at March 31, 2012, compared to \$97.8 million at March 31, 2011, and \$84.7 million at December 31, 2011. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators increased to \$30.6 million at March 31, 2012, compared to \$34.7 million at March 31, 2011, and decreased from

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

\$37.6 million at December 31, 2011. Certificates of deposit from the State of California totaled \$50 million at March 31, 2012, compared to none at March 31, 2011, and \$50 million at December 31, 2011. 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. Deposits at March 31, 2012 were \$1.1 billion, compared to \$1.0 billion at March 31, 2011 and December 31, 2011.

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 \$6.2 million at March 31, 2012, compared to \$21.0 million at March 31, 2011, and \$6.4 million at December 31, 2011.

Liquidity

Our liquidity position refers to our ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely fashion. At March 31, 2012, we had \$68.7 million in cash and cash equivalents and approximately \$336.7 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 \$288.7 million in unpledged securities available at March 31, 2012. Our loan to deposit ratio decreased to 70.07% at March 31, 2012, compared to 80.07% at March 31, 2011, and 72.86% at December 31, 2011, primarily due to a reduction in the loan portfolio.

Lending

Our lending business originates primarily through our branch offices located in our primary market. The Company also has an additional SBA loan production office in Santa Rosa, California. The total loan portfolio remains well diversified with commercial and industrial ("C&I") loans accounting for 47% of the portfolio at March 31, 2012. Commercial and residential real estate loans accounted for 42% of the total loan portfolio at March 31, 2012, of which 49% were owner-occupied by businesses. We have actively lowered our exposure to land and construction loans and our overall credit risk on these portfolios has been reduced. Land and construction loans decreased \$31.9 million to \$18.6 million at March 31, 2012, compared to \$50.5 million at March 31, 2011, and accounted for 3% of our total loan portfolio at March 31, 2012, compared to 6% at March 31, 2011, and 3% at December 31, 2011. Consumer and home equity loans accounted for the remaining 8% of total loans at March 31, 2012. The yield on the loan portfolio was 5.41% for the first quarter of 2012 and compared to 5.28% for the first quarter of 2011, and 5.39% for the fourth quarter of 2011. Loans, excluding loans held-for-sale, decreased 6% to \$756.9 million at March 31, 2012, from \$803.4 million at March 31, 2011, and decreased 1% from \$764.6 million at December 31, 2011. The decline in gross loans in the first quarter of 2012 was primarily due to diminished loan demand, loan payoffs exceeding draw downs of loan commitments and the result of efforts to reduce classified loans. Lower volume of loan originations can be attributed in part to lower demand for certain types of credit as well as more selectivity with respect to the types of loans the Company chooses to originate.

Net Interest Income

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

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

Table of Contents

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

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

Management of Credit Risk

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

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

Noninterest Income

While net interest income remains the largest single component of total revenues, noninterest income is an important component.

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

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company's performance. The Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. Nevertheless, noninterest expense increased \$425,000 for the first quarter of 2012, compared to the first quarter of 2011. The increase in noninterest expense from the first quarter of 2011 was primarily due to a \$500,000 accrual for probable costs related to an anticipated legal claim

Table of Contents

that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer and higher salaries and employee benefits expense.

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 March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve, the Company repurchased all shares of the Series A Preferred Stock and paid the related accrued and unpaid dividends. The repurchase of the Series A Preferred Stock will save \$2.0 million in annual dividends. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report.

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.

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. The Company is current with respect to interest accrued on trust preferred subordinated debt securities as of March 31, 2012 and December 31, 2011.

At March 31, 2012, HBC's total risk-based capital ratio was 16.9%, compared to the 10% regulatory requirement for well-capitalized banks under the regulatory framework for prompt corrective actions. HBC's Tier 1 risk-based capital ratio of 15.6% and leverage ratio of 11.9% at March 31, 2012 also exceeded regulatory guidelines for well-capitalized banks under the prompt corrective actions framework. On a consolidated basis, the Company has a total risk-based capital ratio of 17.9%, a Tier 1 risk-based capital ratio of 16.6%, and a leverage ratio of 12.7% at March 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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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, 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

	For the Three Months Ended March 31, 2012			For the Three Months Ended March 31, 2011		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
NET INTEREST INCOME AND NET INTEREST MARGIN						
(Dollars in thousands)						
Assets:						
Loans, gross(1)	\$ 767,288	\$ 10,316	5.41%	\$ 843,777	\$ 10,989	5.28%
Securities	389,919	3,097	3.19%	245,861	1,963	3.24%
Federal funds sold and interest-bearing deposits in other financial institutions	55,991	36	0.26%	60,423	34	0.23%
Total interest earning assets	1,213,198	13,449	4.46%	1,150,061	12,986	4.58%
Cash and due from banks	20,987			20,551		
Premises and equipment, net	7,978			8,330		
Goodwill and other intangible assets	2,441			2,961		
Other assets	67,381			66,430		
Total assets	\$ 1,311,985			\$ 1,248,333		
Liabilities and shareholders' equity:						
Deposits:						
Demand, noninterest-bearing	\$ 347,291			\$ 312,041		
Demand, interest-bearing	142,650	52	0.15%	135,756	67	0.20%
Savings and money market	288,202	166	0.23%	267,749	266	0.40%
Time deposits under \$100	28,223	38	0.54%	33,207	71	0.87%
Time deposits \$100 and over	169,694	256	0.61%	133,849	419	1.27%
Time deposits CDARS	6,262	3	0.19%	21,525	25	0.47%
Time deposits brokered	84,730	201	0.95%	95,064	423	1.80%
Total interest-bearing deposits	719,761	716	0.40%	687,150	1,271	0.75%
Total deposits	1,067,052	716	0.27%	999,191	1,271	0.52%
Subordinated debt	23,702	474	8.04%	23,702	466	7.97%
Securities sold under agreement to repurchase			N/A	2,889	24	3.37%
Short-term borrowings	39		N/A	2,734	29	4.30%
Total interest-bearing liabilities	743,502	1,190	0.64%	716,475	1,790	1.01%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,090,793	1,190	0.44%	1,028,516	1,790	0.71%
Other liabilities	32,671			37,366		
Total liabilities	1,123,464			1,065,882		
Shareholders' equity	188,521			182,451		
Total liabilities and shareholders' equity	\$ 1,311,985			\$ 1,248,333		

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Net interest income / margin	\$ 12,259	4.06%	\$ 11,196	3.95%
------------------------------	-----------	-------	-----------	-------

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

Table of Contents**Volume and Rate Variances**

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

	Three Months Ended March 31, 2012 vs. 2011		
	Increase (Decrease) Due to Change In:		
	Average Volume	Average Rate	Net Change
	(Dollars in thousands)		
Income from interest earning assets:			
Loans, gross	\$ (1,034)	\$ 361	\$ (673)
Securities	1,147	(13)	1,134
Federal funds sold and interest-bearing deposits in other financial institutions	(3)	5	2
Total interest income from interest earnings assets	110	353	463
Expense on interest-bearing liabilities:			
Demand, interest-bearing	1	(16)	(15)
Savings and money market	13	(113)	(100)
Time deposits under \$100	(7)	(26)	(33)
Time deposits \$100 and over	53	(216)	(163)
Time deposits CDARS	(7)	(15)	(22)
Time deposits brokered	(24)	(198)	(222)
Subordinated debt		8	8
Securities sold under agreement to repurchase	(24)		(24)
Short-term borrowings	(29)		(29)
Total interest expense on interest-bearing liabilities	(24)	(576)	(600)
Net interest income	\$ 134	\$ 929	\$ 1,063

The Company's net interest margin expressed as a percentage of average earning assets was 4.06% for the first quarter of 2012, an increase of 11 basis points from 3.95% for the first quarter of 2011, and an increase of 19 basis points from 3.87% for the fourth quarter of 2011. The increase in the net interest margin for the first quarter of 2012 was primarily attributed to a higher yield on loans and a lower cost of deposits. Net interest income for the first quarter of 2012 increased \$1.1 million, or 9% from first quarter of 2011, primarily due to an increase in the average balance of investment securities, and a decrease in rates paid on interest-bearing liabilities.

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, versus a large base of core deposits that are generally slower to re-price. This causes the Company's balance sheet to be asset-sensitive, which means that all else being equal, the Company's net interest margin will be lower during periods when short-term interest rates are falling and higher when rates are rising.

Table of Contents***Provision for Loan Losses***

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

For the first quarter of 2012, the Company had a provision for loan losses of \$100,000, compared to \$770,000 for the first quarter of 2011. The decrease in provision for loan losses for the first quarter of 2012 compared to the same period in 2011 reflects the improvement in credit quality, lower charge-offs, and a decrease in the size of the loan portfolio.

The allowance for loan losses represented 2.68%, 2.99% and 2.71% of total loans at March 31, 2012, March 31, 2011, and December 31, 2011, respectively. 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 March 31,		Increase (decrease) 2012 versus 2011	
	2012	2011	Amount	Percent
	(Dollars in thousands)			
Service charges and fees on deposit accounts	\$ 590	\$ 567	\$ 23	4%
Servicing income	460	411	49	12%
Increase in cash surrender value of life insurance	429	425	4	1%
Gain on sale of SBA loans	36	379	(343)	-91%
Gain on sale of securities	27		27	N/A
Other	181	135	46	34%
Total noninterest income	\$ 1,723	\$ 1,917	\$ (194)	-10%

The decrease in noninterest income in first quarter of 2012 compared to the same period in 2011 was primarily attributable to a lower gain on the sale of SBA loans, offset by a modest gain on sale of securities and an increase in servicing income.

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. During the first quarter of 2012, SBA loan sales resulted in a \$36,000 gain, compared to a \$379,000 gain on sale of SBA loans in the first quarter of 2011. The servicing assets that result from the sale 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.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

The increase in cash surrender value of life insurance approximates a 3.70% after tax yield on the policies. To realize this tax advantaged yield, the policies must be held until death of the insured individuals, who are current and former officers and directors of the Company.

Noninterest Expense

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

	For the Three Months Ended March 31,		Increase (decrease) 2012 versus 2011	
	2012	2011	Amount	Percent
(Dollars in thousands)				
Salaries and employee benefits	\$ 5,667	\$ 5,393	\$ 274	5%
Professional fees	1,211	839	372	44%
Occupancy and equipment	996	1,038	(42)	-4%
Software subscriptions	290	255	35	14%
Low income housing investment losses	269	162	107	66%
Data processing	245	220	25	11%
FDIC deposit insurance premiums	225	524	(299)	-57%
Insurance expense	224	241	(17)	-7%
Other real estate owned expense	115	21	94	448%
Other	1,614	1,738	(124)	-7%
Total noninterest expense	\$ 10,856	\$ 10,431	\$ 425	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 March 31,			
	2012	Percent of Total	2011	Percent of Total
(Dollars in thousands)				
Salaries and employee benefits	\$ 5,667	52%	\$ 5,393	52%
Professional fees	1,211	11%	839	8%
Occupancy and equipment	996	9%	1,038	10%
Software subscriptions	290	3%	255	2%
Low income housing investment losses	269	3%	162	2%
Data processing	245	2%	220	2%
FDIC deposit insurance premiums	225	2%	524	5%
Insurance expense	224	2%	241	2%
Other real estate owned expense	115	1%	21	0%
Other	1,614	15%	1,738	17%
Total noninterest expense	\$ 10,856	100%	\$ 10,431	100%

Noninterest expense for the first quarter of 2012 increased 4% to \$10.9 million, compared to \$10.4 million for the first quarter of 2011, primarily due to higher salaries and employee benefits, higher professional fees, and higher low income housing investment losses. Salaries and employee benefits increased \$274,000, or 5%, to \$5.7 million for the first quarter of 2012, from \$5.4 million for the first quarter of 2011. Full-time equivalent employees were 189 and 185 at March 31, 2012 and 2011,

Table of Contents

respectively. Professional fees increased \$372,000, or 44%, to \$1.2 million for the first quarter of 2012, compared to \$839,000 for the first quarter of 2011. The increase in noninterest expense from the first quarter of 2011 was primarily due to a \$500,000 accrual for probable costs related to an anticipated legal claim that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer. The claims, which have not been asserted as of the date of this report, relate to an apparent transfer of funds to personal use by an authorized signatory of a customer. FDIC deposit insurance premiums decreased \$299,000, or 57%, to \$225,000 for the first quarter of 2012, compared to \$524,000 for the same period in 2011, due to a decrease in the FDIC deposit assessment rate.

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, tax-exempt interest income, 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 was \$951,000 in the first quarter of 2012, compared to \$331,000 in the first quarter of 2011. The following table shows the Company's effective income tax rates for the periods indicated:

	For the Three Months Ended March 31,	
	2012	2011
Effective income tax rate	31.4%	17.3%

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 and tax credits related to investments in low income housing limited partnerships.

The Company has net investments of \$3.4 million in low-income housing limited partnerships as of March 31, 2012. These investments have generated annual tax credits of approximately \$846,000 and \$1.0 million in the years ended December 31, 2011 and 2010, respectively.

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

At March 31, 2012, and December 31, 2011, the Company had net deferred tax assets of \$21.3 million, and \$21.9 million, respectively. At March 31, 2012 and December 31, 2011, after consideration of the matters in the preceding paragraph, the Company determined that a valuation allowance for deferred tax assets should be \$0.

FINANCIAL CONDITION

As of March 31, 2012, total assets were \$1.31 billion, compared to \$1.26 billion as of March 31, 2011, and \$1.31 billion at December 31, 2011. Total securities available-for-sale (at fair value) were \$385.8 million at March 31, 2012, an increase of 54% from \$250.1 million at March 31, 2011, and an increase of 1% from \$380.5 million at December 31, 2011. The total loan portfolio, excluding loans held-for-sale, was \$756.9 million at March 31, 2012, a decrease of 6% from \$803.4 million at March 31, 2011, and a decrease of 1% from \$764.6 million at December 31, 2011. Total deposits increased 8% to \$1.08 billion at March 31, 2012, from \$1.00 billion at March 31, 2011, and increased 3% from \$1.05 billion at December 31, 2011. There were no securities sold under agreement to repurchase at March 31, 2012, March 31, 2011, and December 31, 2011.

Securities Portfolio

The following table reflects the estimated fair values for each category of securities at the dates indicated:

	March 31,		December 31,
	2012	2011	2011
	(Dollars in thousands)		
Securities available-for-sale (at fair value)			
Agency mortgage-backed securities	\$ 340,181	\$ 250,132	\$ 350,348
Corporate bonds	10,636		
Trust preferred securities	35,009		30,107
Total	\$ 385,826	\$ 250,132	\$ 380,455

The following table summarizes the weighted average life and weighted average yields of securities at March 31, 2012:

		March 31, 2012 Weighted Average Life							
		Within One Year		After One and Within Five Years		After Five and Within Ten Years		After Ten Years	
		Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
		(Dollars in thousands)							
Securities available-for-sale (at fair value):									
Mortgage-Backed Securities Residential		\$		\$ 215,536	2.99%	\$ 106,236	2.83%	\$ 18,409	3.41%
Corporate bonds				961	2.68%	9,675	3.30%		
Trust preferred securities		35,009	6.40%						
		\$ 35,009	6.40%	\$ 216,497	2.99%	\$ 115,911	2.87%	\$ 18,409	3.41%
								\$ 385,826	3.28%

The securities portfolio is the second largest component of the Company's interest-earning assets, and the structure and composition of this portfolio is important to an analysis of the financial condition of the Company. The portfolio serves the following purposes: (i) it provides a source of pledged assets for securing certain deposits and borrowed funds, as may be required by law or by specific agreement

Table of Contents

with a depositor or lender; (ii) it provides liquidity to even out cash flows from the loan and deposit activities of customers; (iii) it can be used as an interest rate risk management tool, since it provides a large base of assets, the maturity and interest rate characteristics of which can be changed more readily than the loan portfolio to better match changes in the deposit base and other funding sources of the Company; and (iv) it is an alternative interest-earning use of funds when loan demand is weak or when deposits grow more rapidly than loans.

The Company's securities are all currently classified under existing accounting rules as "available-for-sale" to allow flexibility for the management of the portfolio. Accounting guidance requires available-for-sale securities to be marked to fair value with an offset to accumulated other comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available-for-sale securities.

The Company's portfolio is historically comprised primarily of: (i) U.S. Treasury securities and U.S. Government sponsored entities' debt securities for liquidity and pledging; (ii) mortgage-backed securities, which in many instances can also be used for pledging, and which generally enhance the yield of the portfolio; (iii) municipal obligations, which provide tax free income and limited pledging potential; and (iv) collateralized mortgage obligations, which generally enhance the yield of the portfolio. More recently, in the first quarter of 2012, the Company purchased additional single entity issue trust preferred securities and corporate bonds to enhance the yield on the portfolio.

The securities portfolio increased by \$135.7 million, or 54%, and increased to 30% of total assets at March 31, 2012, from March 31, 2011, and increased by \$5.4 million, or 1%, from 29% of total assets at December 31, 2011. The Company increased its holding of mortgage-back securities by \$90.1 million to \$340.2 million at March 31, 2012, from \$250.1 million at March 31, 2011 to offset a portion of the contraction in the loan portfolio. Mortgage-backed securities decreased \$10.2 million at March 31, 2012, from \$350.3 million at December 31, 2011. At March 31, 2012, the investment portfolio included \$10.6 million of corporate bonds, compared to no corporate bonds in the investment portfolio at March 31, 2011 and December 31, 2011. The investment portfolio also included single entity issue trust preferred securities by three issuers with a market value of \$35.0 million at March 31, 2012, compared to no trust preferred securities at March 31, 2011, and \$30.1 million of single entity issue trust preferred securities at December 31, 2011. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities to otherwise mitigate interest rate risk.

Loans

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

Gross loans, excluding loans held-for-sale, represented 58% of total assets at March 31, 2012, as compared to 64% of total assets at March 31, 2011, and 59% of total assets at December 31, 2011. The ratio of loans to deposits decreased to 70.07% at March 31, 2012 from 80.07% at March 31, 2011 and 72.86% at December 31, 2011. Demand for loans has continued to decline within the Company's markets due to the economic environment over the last several years.

Table of Contents

Loan Distribution

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

	March 31, 2012		March 31, 2011		December 31, 2011	
	Balance	% of Total	Balance	% of Total	Balance	% of Total
(Dollars in thousands)						
Commercial	\$ 357,906	47%	\$ 365,748	46%	\$ 366,590	48%
Real estate:						
Commercial and residential	319,914	42%	320,950	40%	311,479	41%
Land and construction	18,583	3%	50,496	6%	23,016	3%
Home equity	48,444	6%	52,129	6%	52,017	7%
Consumer	11,810	2%	13,174	2%	11,166	1%
Total loans	756,657	100%	802,497	100%	764,268	100%
Deferred loan costs	237		853		323	
Loans, including deferred costs	756,894	100%	803,350	100%	764,591	100%
Allowance for loan losses	(20,306)		(24,009)		(20,700)	
Loans, net	\$ 736,588		\$ 779,341		\$ 743,891	

The Company's loan portfolio is concentrated in commercial loans, primarily manufacturing, wholesale, and services, and commercial real estate, with the balance in land development and construction and home equity and consumer loans. The decrease in the Company's loan portfolio in the first quarter of 2012 compared to the first and fourth quarters of 2011 is due to diminished loan demand, and loan payoffs exceeding draw downs of loan commitments. Outstanding loan balances to total loan commitments were 72% at March 31, 2012, 74% at March 31, 2011 and 73% at December 31, 2011. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 51% of its gross loans were secured by real property at March 31, 2012, compared to 52% at March 31, 2011, and 51% at December 31, 2011. While no specific industry concentration is considered significant, the Company's lending operations are located in areas that are dependent on the technology and real estate industries and their supporting companies.

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

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such guaranteed loans (collectively referred to as "SBA loans"). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold, the Company retains the servicing rights for the sold portion. During the three months ended March 31, 2012, loans were sold resulting in a gain on sale of SBA loans of \$36,000.

As of March 31, 2012, commercial and residential real estate mortgage loans of \$357.9 million consist primarily of adjustable and fixed rate loans secured by deeds of trust on commercial and residential property. The real estate mortgage loans at March 31, 2012 consist of \$157.4 million, or 49%, of commercial owner occupied properties, \$159.6 million, or 50%, of commercial investment properties, and \$2.9 million, or 1% in residential properties. Properties securing the commercial real

Table of Contents

estate mortgage loans are generally located in the Company's primary market, which is the Greater San Francisco Bay Area.

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

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Land and construction loans decreased \$31.9 million to \$18.6 million, or 3% of total loans at March 31, 2012, from \$50.5 million, or 6% of total loans at March 31, 2011, and decreased \$4.4 million from \$23.0 million, or 3% of total loans at December 31, 2011.

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

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

With certain exceptions, state chartered banks are permitted to make extensions of credit to any one borrowing entity up to 15% of the bank's capital and reserves for unsecured loans and up to 25% of the bank's capital and reserves for secured loans. For HBC, these lending limits were \$28.3 million and \$47.1 million at March 31, 2012, respectively.

Loan Maturities

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale) as of March 31, 2012. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

Street Journal. As of March 31, 2012, approximately 68% of the Company's loan portfolio consisted of floating interest rate loans.

	Due in One Year or Less	Over One Year But Less than Five Years	Over Five Years	Total
(Dollars in thousands)				
Commercial	\$ 245,195	\$ 38,118	\$ 74,593	\$ 357,906
Real estate:				
Commercial and residential	125,335	153,477	41,102	319,914
Land and construction	18,083	500		18,583
Home equity	45,916	812	1,716	48,444
Consumer	11,493	215	102	11,810
Loans	\$ 446,022	\$ 193,122	\$ 117,513	\$ 756,657
Loans with variable interest rates	\$ 395,204	\$ 44,456	\$ 77,573	\$ 517,233
Loans with fixed interest rates	50,818	148,666	39,940	239,424
Loans	\$ 446,022	\$ 193,122	\$ 117,513	\$ 756,657

Loan Servicing

As of March 31, 2012 and 2011, \$162.7 million and \$169.5 million, respectively, in SBA loans were serviced by the Company for others. Activity for loan servicing rights was as follows:

	For the Three Months Ended March 31,	
	2012	2011
(Dollars in thousands)		
Beginning of period balance	\$ 792	\$ 915
Additions	10	85
Amortization	(72)	(131)
End of period balance	\$ 730	\$ 869

Loan servicing rights are included in accrued interest receivable and other assets on the unaudited consolidated balance sheets and reported net of amortization. There was no valuation allowance as of March 31, 2012 and 2011, as the fair value of the assets was greater than the carrying value.

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

	For the Three Months Ended March 31,	
	2012	2011
(Dollars in thousands)		
Beginning of period balance	\$ 2,094	\$ 2,140
Amortization		(40)
Unrealized holding gain	19	93
End of period balance	\$ 2,113	\$ 2,193

Financial institutions generally have a certain level of exposure to credit quality risk, and could potentially receive less than a full return of principal and interest if a debtor becomes unable or unwilling to repay. Since loans are the most significant assets of the Company and generate the largest

Table of Contents

portion of its revenues, the Company's management of credit quality risk is focused primarily on loan quality. Banks have generally suffered their most severe earnings declines as a result of customers' inability to generate sufficient cash flow to service their debts and/or downturns in national and regional economies and declines in overall asset values including real estate. In addition, certain debt securities that the Company may purchase have the potential of declining in value if the obligor's financial capacity to repay deteriorates.

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

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

Nonperforming assets are comprised of the following: loans and loans held-for-sale for which the Company is no longer accruing interest; restructured loans which have been current under six months; loans 90 days or more past due and still accruing interest (although they are generally placed on nonaccrual when they become 90 days past due, unless they are both well-secured and in the process of collection); and foreclosed assets. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued. Loans may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. Foreclosed assets consist of properties acquired by foreclosure or similar means that management is offering or will offer for sale. Total foreclosed assets were \$3.2 million at March 31, 2012, compared to \$918,000 at March 31, 2011, and \$2.3 million at December 31, 2011.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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

	March 31,		December 31
	2012	2011	2011
	(Dollars in thousands)		
Nonaccrual loans held-for-sale	\$ 184	\$ 1,989	\$ 186
Nonaccrual loans held-for-investment	14,005	22,896	14,353
Restructured and loans over 90 days past due and still accruing	2,155	282	2,291
Total nonperforming loans	16,344	25,167	16,830
Foreclosed assets	3,167	918	2,312
Total nonperforming assets	\$ 19,511	\$ 26,085	\$ 19,142
Nonperforming assets as a percentage of loans plus nonaccruals loans held-for-sale plus foreclosed assets	2.57%	3.24%	2.50%
Nonperforming assets as a percentage of total assets	1.49%	2.08%	1.47%
Allowance for Loan Losses			

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

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

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

Table of Contents

Loans that demonstrate a weakness for which there is a possibility of loss if the weakness is not corrected, are categorized as "classified." Classified assets include all loans considered as substandard, substandard-nonaccrual, and doubtful and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate), and OREO. The principal balance of classified assets, net of SBA guarantees was \$54.2 million at March 31, 2012, \$81.4 million at March 31, 2011, and \$59.5 million at December 31, 2011. Included in the \$54.2 million of classified assets at March 31, 2012, were \$184,000 of loans held-for-sale. Loans held-for-sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses. Reducing classified assets will continue to be a focus for executive management, the lending staff and the Company's Special Assets Department.

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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

Three Months Ended March 31, 2012				
	Commercial	Real Estate	Consumer	Total
(Dollars in thousands)				
Balance, beginning of period	\$ 13,215	\$ 7,338	\$ 147	\$ 20,700
Charge-offs	(910)	(45)		(955)
Recoveries	461			461
Net charge-offs	(449)	(45)		(494)
Provision for loan losses	968	(884)	16	100
Balance, end of period	\$ 13,734	\$ 6,409	\$ 163	\$ 20,306

RATIOS:

Net charge-offs to average loans(1)	0.24%	0.02%	0.00%	0.26%
Allowance for loan losses to total loans(1)	1.81%	0.85%	0.02%	2.68%
Allowance for loan losses to nonperforming loans	84.03%	39.21%	1.00%	124.24%

Three Months Ended March 31, 2011				
	Commercial	Real Estate	Consumer	Total
(Dollars in thousands)				
Balance, beginning of period	\$ 13,952	\$ 10,363	\$ 889	\$ 25,204
Charge-offs	(1,119)	(995)		(2,114)
Recoveries	139	10		149
Net charge-offs	(980)	(985)		(1,965)
Provision for loan losses	622	161	(13)	770
Balance, end of period	\$ 13,594	\$ 9,539	\$ 876	\$ 24,009

RATIOS:

Net charge-offs to average loans(1)	0.48%	0.48%	0.00%	0.96%
Allowance for loan losses to total loans(1)	1.69%	1.19%	0.11%	2.99%
Allowance for loan losses to nonperforming loans	51.19%	35.92%	3.30%	90.41%

(1)

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

The Company's allowance for loan losses decreased \$3.7 million at March 31, 2012 from March 31, 2011, and decreased \$394,000 from December 31, 2011. The decrease in the allowance for loan losses at March 31, 2012 was primarily due to a lower volume of classified loans and lower total loans.

Net loans charged-off reflects the realization of losses in the portfolio that were partially recognized previously through provisions for loan losses. Net charge-offs were \$494,000 for the first quarter of 2012, compared to net charge-offs of \$2.0 million for the first quarter of 2011. Historical net loan charge-offs are not necessarily indicative of the amount of net charge-offs that the Company will realize in the future.

The following table provides a summary of the allocation of the allowance for loan losses for specific class at the dates indicated. The allocation presented should not be interpreted as an indication that charges to the allowance for loan losses will be incurred in these amounts or proportions, or that the portion of the allowance allocated to each category represents the total amount available for charge-offs that may occur within these classes.

Table of Contents**Allocation of Allowance for Loan Losses**

	March 31, 2012		March 31, 2011		December 31, 2011	
	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans
(Dollars in thousands)						
Commercial	\$ 13,734	47%	\$ 13,594	46%	\$ 13,215	48%
Real estate:						
Commercial and residential	5,449	42%	5,437	40%	6,203	41%
Land and construction	431	3%	3,599	6%	594	3%
Home equity	529	6%	503	6%	541	7%
Consumer	163	2%	876	2%	147	1%
Total	\$ 20,306	100%	\$ 24,009	100%	\$ 20,700	100%

Deposits

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

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

	March 31, 2012		March 31, 2011		December 31, 2011	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
(Dollars in thousands)						
Demand deposits, noninterest-bearing	\$ 356,618	33%	\$ 325,058	32%	\$ 344,303	33%
Demand deposits, interest-bearing	144,022	13%	135,903	14%	134,119	13%
Savings and money market	292,009	27%	262,763	26%	282,478	27%
Time deposits under \$100	27,949	2%	32,592	3%	28,557	2%
Time deposits \$100 and over	168,726	16%	128,156	13%	168,874	16%
Time deposits CDARS	6,198	1%	21,025	2%	6,371	1%
Time deposits brokered	84,728	8%	97,826	10%	84,726	8%
Total deposits	\$ 1,080,250	100%	\$ 1,003,323	100%	\$ 1,049,428	100%

The Company obtains deposits from a cross-section of the communities it serves. The Company's business is not generally seasonal in nature. The Company is not dependent upon funds from sources outside the United States. Less than 1%, 1%, and 5% of deposits were from public sources, at March 31, 2012, March 31, 2011, and December 31, 2011, respectively.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

Noninterest-bearing demand deposits increased \$31.6 million to \$356.6 million at March 31, 2012, compared to \$325.1 million at March 31, 2011, and increased \$12.3 million compared to \$344.3 million at December 31, 2011. Interest-bearing demand deposits increased \$8.1 million to \$144.0 million at March 31, 2012, from \$135.9 million at March 31, 2011, and increased \$9.9 million from \$134.1 million at December 31, 2011. Savings and money market deposits increased \$29.2 million to \$292.0 million at March 31, 2012, from \$262.8 million at March 31, 2011, and increased \$9.5 million from \$282.5 million at December 31, 2011. At March 31, 2012, the Company had \$56.5 million of securities pledged for \$50.0 million in certificates of deposits with the State of California. There were no certificates of deposit with the State of California at March 31, 2011. At December 31, 2011, the Company had \$56.5 million of securities pledged for \$50.0 million in certificates of deposits with the State of California.

The following table indicates the contractual maturity schedule of the Company's time deposits of \$100,000 and over, and all CDARS and brokered deposits as of March 31, 2012:

	Balance	% of Total
	(Dollars in thousands)	
Three months or less	\$ 61,358	24%
Over three months through six months	78,877	30%
Over six months through twelve months	47,946	18%
Over twelve months	71,471	28%
Total	\$ 259,652	100%

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

Return on Equity and Assets

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

	Three Months Ended March 31,	
	2012	2011
Annualized return on average assets	0.64%	0.51%
Annualized return on average tangible assets	0.64%	0.51%
Annualized return on average equity	4.43%	3.51%
Annualized return on average tangible equity	4.48%	3.57%
Average equity to average assets ratio	14.37%	14.62%

Off-Balance Sheet Arrangements

In the normal course of business, the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in the contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, yet are not reflected on the Company's consolidated balance sheets. Total unused commitments to extend credit were \$294.2 million at March 31, 2012, as compared to \$285.6 million at March 31, 2011 and \$284.8 million at December 31, 2011. Unused commitments represented 39%,

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

36%, and 37% of outstanding gross loans at March 31, 2012 and 2011, and December 31, 2011, respectively.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted, because there is no certainty that lines of credit and letters of credit will ever be fully utilized. The following table presents the Company's commitments to extend credit for the periods indicated:

	March 31, 2012		March 31, 2011		December 31, 2011	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
(Dollars in thousands)						
Unused lines of credit and commitments to make loans	\$ 14,267	\$ 269,839	\$ 9,048	\$ 255,701	\$ 15,723	\$ 257,342
Standby letters of credit	2,291	7,852	2,291	18,587	2,291	9,482
	\$ 16,558	\$ 277,691	\$ 11,339	\$ 274,288	\$ 18,014	\$ 266,824

Liquidity and Asset/Liability Management

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

One of the measures we analyze for liquidity is our loan to deposit ratio. Our loan to deposit ratio decreased to 70.07% at March 31, 2012 compared to 80.07% at March 31, 2011, and 72.86% at December 31, 2011. At March 31, 2012, the Company had loan contraction, including loans held-for-sale, of \$50.9 million from March 31, 2011.

FHLB and FRB Borrowings & Available Lines of Credit

The Company has off-balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. The Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. The Company had no overnight borrowings from the FHLB at March 31, 2012, March 31, 2011 and December 31, 2011. The Company had \$188.0 million of loans pledged to the FHLB as collateral on an available line of credit of \$108.0 million at March 31, 2012.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

The Company can also borrow from FRB's discount window. The Company had \$243.6 million of loans pledged to the FRB as collateral on an available line of credit of \$173.7 million at March 31, 2012, none of which was outstanding.

At March 31, 2012, the Company had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at March 31, 2012, March 31, 2011, and December 31, 2011.

The Company may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase at March 31, 2012, March 31, 2011 and December 31, 2011.

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

	March 31, 2012	March 31, 2011	December 31, 2011
	(Dollars in thousands)		
Average balance year-to-date	\$	\$ 2,889	\$ 712
Average interest rate year-to-date	N/A	3.41%	3.37%
Maximum month-end balance during the quarter	\$	\$ 5,000	\$ 5,000
Average rate at period-end	N/A	N/A	N/A

Capital Resources

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

Table of Contents

	March 31, 2012		December 31, 2011				
	(Dollars in thousands)						
Capital components:							
Tier 1 Capital	\$	162,701	\$	188,348	\$ 199,423		
Tier 2 Capital		12,334		11,969	12,181		
Total risk-based capital	\$	175,035	\$	200,317	\$ 211,604		
Risk-weighted assets	\$	978,513	\$	945,089	\$ 965,756		
Average assets for capital purposes	\$	1,283,316	\$	1,228,763	\$ 1,300,002		
				Well-Capitalized Regulatory Requirements	Minimum Regulatory Requirements		
Capital ratios:							
Total risk-based capital		17.9%		21.9%	10.00%		
Tier 1 risk-based capital		16.6%		20.6%	6.00%		
Leverage(1)		12.7%		15.3%	N/A		

	March 31,		December 31,		
	2012	2011	2011		
	(Dollars in thousands)				
Capital components:					
Tier 1 Capital	\$ 153,285	\$ 163,478	\$ 178,697		
Tier 2 Capital	12,361	11,992	12,207		
Total risk-based capital	\$ 165,646	\$ 175,470	\$ 190,904		
Risk-weighted assets	\$ 980,708	\$ 946,961	\$ 967,898		
Average assets for capital purposes	\$ 1,285,488	\$ 1,230,163	\$ 1,301,859		
				Well-Capitalized Regulatory Requirements	Minimum Regulatory Requirements
Capital ratios:					
Total risk-based capital	16.9%	18.5%	19.7%	10.00%	8.00%
Tier 1 risk-based capital	15.6%	17.3%	18.5%	6.00%	4.00%
Leverage(1)	11.9%	13.3%	13.7%	5.00%	4.00%

(1)

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

Table of Contents

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

Due primarily to the \$40 million repurchase of the Series A Preferred Stock during the first quarter of 2012, the Company's total risk-based capital ratio, tier 1 risk-based capital ratio, and leverage ratio at March 31, 2012 decreased to 17.9%, 16.6%, and 12.7%, compared to 21.2%, 19.9%, and 15.3% at March 31, 2011, and 21.9%, 20.6%, and 15.3% at December 31, 2011, respectively. HBC's total risk-based capital ratio, tier 1 risk-based capital ratio, and leverage ratio at March 31, 2012 decreased to 16.9%, 15.6%, and 11.9%, compared to 18.5%, 17.3%, and 13.3% at March 31, 2011, and 19.7%, 18.5%, and 13.7% at December 31, 2011, respectively. However, at March 31, 2011, the Company's and HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under prompt corrective action provisions.

At March 31, 2012, the Company had total shareholders' equity of \$159.9 million, including \$19.5 million in preferred stock, \$131.3 million in common stock, \$7.9 million in retained earnings, and \$1.2 million of accumulated other comprehensive income. The components of other comprehensive income, net of taxes, at March 31, 2012 include the following: an unrealized gain on available-for-sale securities of \$5.2 million; an unrealized loss on the supplemental executive retirement plan of (\$3.0) million; an unrealized loss on the split dollar life insurance benefit plan of (\$2.2) million; and an unrealized gain on interest-only strip from SBA loans of \$1.2 million.

Mandatory Redeemable Cumulative Trust Preferred Securities

To enhance regulatory capital and to provide liquidity, the Company, through unconsolidated subsidiary grantor trusts, issued the following mandatory redeemable cumulative trust preferred securities of subsidiary grantor trusts: In the first quarter of 2000, the Company issued \$7.2 million aggregate principal amount of 10.87% subordinated debt due on March 8, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2000, the Company issued \$7.2 million aggregate principal amount of 10.60% subordinated debt due on September 7, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2001, the Company issued \$5.2 million aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on July 31, 2031 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2002, the Company issued \$4.1 million of aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on September 26, 2032 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. The subordinated debt is recorded as a component of long-term debt and includes the value of the common stock issued by the trusts to the Company. The common stock is recorded as other assets for the amount issued. Under applicable regulatory guidelines, the trust preferred securities currently qualify as Tier I capital. The subsidiary trusts are not consolidated in the Company's consolidated financial statements. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, certain trust preferred securities will no longer be eligible to be included as Tier 1 capital for regulatory purposes. However, an exception to this statutory prohibition applies to securities issued prior to May 19, 2010 by bank holding companies with less than \$15 billion of total assets; therefore, our trust preferred securities will continue to be eligible to be treated as Tier 1 capital, subject to other rules and limitations.

U.S. Treasury Capital Purchase Program

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

Table of Contents

On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve, the Company repurchased all of the Series A Preferred Stock and paid the related accrued and unpaid dividends. The repurchase of the Series A Preferred Stock will save \$2.0 million in annual dividends. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report.

Series C Preferred Stock

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of newly issued Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon a subsequent transfer of the Series C Preferred stock to third parties not affiliates with the holder in a widely dispersed offering.

The Series C Preferred Stock remains outstanding until it has been converted into common stock in accordance with its terms. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

Market Risk

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

Interest Rate Management

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

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

The planning of asset and liability maturities is an integral part of the management of an institution's net interest margin. To the extent maturities of assets and liabilities do not match in a

Table of Contents

changing interest rate environment, the net interest margin may change over time. Even with perfectly matched repricing of assets and liabilities, risks remain in the form of prepayment of loans or securities or in the form of delays in the adjustment of rates of interest applying to either earning assets with floating rates or to interest bearing liabilities. The Company has generally been able to control its exposure to changing interest rates by maintaining primarily floating interest rate loans and a majority of its time certificates with relatively short maturities.

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

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

The following table sets forth the estimated changes in the Company's annual net interest income that would result from the designated instantaneous parallel shift in interest rates noted, as of March 31, 2012. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

	Increase/(Decrease) in Estimated Net Interest Income	
	Amount	Percent
	(Dollars in thousands)	
Change in Interest Rates (basis points)		
+400	\$ 12,426	24.4%
+300	\$ 9,147	18.0%
+200	\$ 5,811	11.4%
+100	\$ 2,542	5.0%
0	\$	0.0%
-100	\$ (3,638)	-7.1%
-200	\$ (7,501)	-14.7%

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

As with any method of gauging interest rate risk, there are certain shortcomings inherent to the methodology noted above. The model assumes interest rate changes are instantaneous parallel shifts in the yield curve. In reality, rate changes are rarely instantaneous. The use of the simplifying assumption that short-term and long-term rates change by the same degree may also misstate historic rate patterns,

Table of Contents

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

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are discussed in our Form 10-K for the year ended December 31, 2011. There are no changes to these policies as of March 31, 2012.

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4 CONTROLS AND PROCEDURES

Disclosure Control and Procedures

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of March 31, 2012. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded the Company's disclosure controls were effective as of March 31, 2012, the period covered by this report on Form 10-Q.

During the three months ended March 31, 2012, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to affect, our internal controls over financial reporting.

Table of Contents

Part II OTHER INFORMATION

ITEM 1 LEGAL PROCEEDINGS

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

ITEM 1A RISK FACTORS

In addition to the other information set forth in this Report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2011, which could materially affect our business, financial condition and/or operating results. There were no material changes from risk factors previously disclosed in our 2011 Annual Report on Form 10-K. The risk factors identified are in addition to those contained in any other cautionary statements, written or oral, which may be made or otherwise addressed in connection with a forward-looking statement or contained in any of our subsequent filings with the Securities and Exchange Commission.

ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 MINE SAFETY DISCLOSURES

None

ITEM 5 OTHER INFORMATION

None

Table of Contents

ITEM 6 EXHIBITS

Exhibit	Description
3.1	Heritage Commerce Corp Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 4, 2010)
3.2	Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp as filed with the California Secretary of State on June 1, 2010 (incorporated by reference to Exhibit 3.1 to the Registrant's Registration Statement on Form S-1 filed July 23, 2010).
3.3	Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Registration Statement Form S-1 filed on July 23, 2010)
4.1	Warrant to Purchase Common Stock dated November 21, 2008 (incorporated by reference to Exhibit 4.2 to the Registrant's Form 8-K filed on November 26, 2008)
4.2	Certificate of Determination for Series C Convertible Perpetual Preferred Stock (incorporated by reference to the Registrant's Form 8-K filed on June 22, 2010)
12.1	Calculation of Ratio of Earnings to Fixed Charges and Ratio of Earnings to Fixed Charges and Preferred Stock Dividends
31.1	Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350
32.2	Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350
101.INS	XBRL Instance Document, furnished herewith
101.SCH	XBRL Taxonomy Extension Schema Document, furnished herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, furnished herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, furnished herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, furnished herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, furnished herewith

Table of Contents

SIGNATURES

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

Date: May 4, 2012

Heritage Commerce Corp (Registrant)

/s/ WALTER T. KACZMAREK

Walter T. Kaczmarek
Chief Executive Officer

Date: May 4, 2012

/s/ LAWRENCE D. MCGOVERN

Lawrence D. McGovern
Chief Financial Officer

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

EXHIBIT INDEX

Exhibit	Description
3.1	Heritage Commerce Corp Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 4, 2010)
3.2	Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp as filed with the California Secretary of State on June 1, 2010 (incorporated by reference to Exhibit 3.1 to the Registrant's Registration Statement on Form S-1 filed July 23, 2010).
3.3	Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Registration Statement Form S-1 filed on July 23, 2010)
4.1	Warrant to Purchase Common Stock dated November 21, 2008 (incorporated by reference to Exhibit 4.2 to the Registrant's Form 8-K filed on November 26, 2008)
4.2	Certificate of Determination for Series C Convertible Perpetual Preferred Stock (incorporated by reference to the Registrant's Form 8-K filed on June 22, 2010)
12.1	Calculation of Ratio of Earnings to Fixed Charges and Ratio of Earnings to Fixed Charges and Preferred Stock Dividends
31.1	Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350
32.2	Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350
101.INS	XBRL Instance Document, furnished herewith
101.SCH	XBRL Taxonomy Extension Schema Document, furnished herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, furnished herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, furnished herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, furnished herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, furnished herewith