

HERITAGE COMMERCE CORP

Form 10-Q

November 06, 2018

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 September 30, 2018

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)

150 Almaden Boulevard, San Jose, California

(Address of Principal Executive Offices)

77 0469558

(I.R.S. Employer Identification No.)

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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

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

Large accelerated filer	Accelerated filer	Non accelerated filer	Smaller reporting company
			Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 43,279,185 shares of Common Stock outstanding on October 30, 2018.



Table of Contents

HERITAGE COMMERCE CORP

QUARTERLY REPORT ON FORM 10 Q

TABLE OF CONTENTS

<u>Cautionary Note on Forward Looking Statements</u>	Page No. 3
<u>Part I. FINANCIAL INFORMATION</u>	
<u>Item 1. Consolidated Financial Statements (unaudited)</u>	5
<u>Consolidated Balance Sheets</u>	5
<u>Consolidated Statements of Income</u>	6
<u>Consolidated Statements of Comprehensive Income</u>	7
<u>Consolidated Statements of Changes in Shareholders' Equity</u>	8
<u>Consolidated Statements of Cash Flows</u>	9
<u>Notes to Unaudited Consolidated Financial Statements</u>	10
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	44
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	82
<u>Item 4. Controls and Procedures</u>	82
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	82
<u>Item 1A. Risk Factors</u>	82
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	82
<u>Item 3. Defaults Upon Senior Securities</u>	82
<u>Item 4. Mine Safety Disclosures</u>	82
<u>Item 5. Other Information</u>	82
<u>Item 6. Exhibits</u>	83

SIGNATURES

84

2

---

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, Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended, Rule 3b-6 promulgated thereunder and are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Any statements about our expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and may be forward looking. These forward looking statements often can be, but are not always, identified by the use of words such as “assume,” “expect,” “intend,” “plan,” “project,” “believe,” “estimate,” “predict,” “anticipate,” “may,” “might,” “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:

- current and future economic and market conditions in the United States generally or in the communities we serve, including the effects of declines in property values, high unemployment rates and overall slowdowns in economic growth should these events occur;
- 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;

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

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

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

- changes in consumer and business spending and saving habits and the related effect on our ability to increase assets and to attract deposits;

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

- risks associated with concentrations in real estate related loans;

other than temporary impairment charges to our securities portfolio;

changes in the level of nonperforming assets and charge offs and other credit quality measures, and their impact on the adequacy of the Heritage Commerce Corp's (the "Company") allowance for loan losses and the Company's provision for loan losses;

- increased capital requirements for our continual growth or as imposed by banking regulators, which may require us to raise capital at a time when capital is not available or favorable terms or at all;
- regulatory limits on Heritage Bank of Commerce's ability to pay dividends to the Company;

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

Table of Contents

- our inability to attract, recruit, and retain qualified officers and other personnel could harm our ability to implement our strategic plan, impair our relationships with customers and adversely affect our business, results of operations and growth prospects;
- the potential increase in reserves and allowance for loan loss as a result of the transition to the current expected credit loss standard (“CECL”) established by the Financial Accounting Standards Board to account for expected credit losses;

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

our ability to keep pace with technological changes, including our ability to identify and address cyber-security risks such as data security breaches, “denial of service” attacks, “hacking” and identity theft;

inability of our framework to manage risks associated with our business, including operational risk and credit risk;

risks of loss of funding of Small Business Administration or SBA loan programs, or changes in those programs;

compliance with governmental and regulatory requirements, including the Dodd-Frank Act and others relating to banking, consumer protection, securities, accounting and tax matters;

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

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;

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;

availability of and competition for acquisition opportunities;

risks resulting from domestic terrorism;

risks of natural disasters (including earthquakes) and other events beyond our control;

- fully realizing cost savings and other benefits, and/or business disruption following the mergers of Tri-Valley Bank and United American Bank; and
- our success in managing the risks involved in the foregoing factors.

Forward-looking statements speak only as of the date they are made. The Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events. You should consider any forward looking statements in light of this explanation, and we caution you about relying on forward-looking statements.





Table of Contents

## Part I—FINANCIAL INFORMATION

## ITEM 1—CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## HERITAGE COMMERCE CORP

## CONSOLIDATED BALANCE SHEETS (Unaudited)

	September 30, 2018	December 31, 2017
	(Dollars in thousands)	
Assets		
Cash and due from banks	\$ 40,831	\$ 31,681
Other investments and interest-bearing deposits in other financial institutions	340,198	284,541
Total cash and cash equivalents	381,029	316,222
Securities available-for-sale, at fair value	319,071	391,852
Securities held-to-maturity, at amortized cost (fair value of \$359,698 at September 30, 2018 and \$394,292 at December 31, 2017)	375,732	398,341
Loans held-for-sale - SBA, at lower of cost or fair value, including deferred costs	6,344	3,419
Loans, net of deferred fees	1,899,387	1,582,667
Allowance for loan losses	(27,426)	(19,658)
Loans, net	1,871,961	1,563,009
Federal Home Loan Bank and Federal Reserve Bank stock and other investments, at cost	25,210	17,911
Company-owned life insurance	61,630	60,814
Premises and equipment, net	7,246	7,353
Goodwill	83,752	45,664
Other intangible assets	12,614	5,589
Accrued interest receivable and other assets	48,321	33,278
Total assets	\$ 3,192,910	\$ 2,843,452
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 1,081,846	\$ 989,753
Demand, interest-bearing	670,624	601,929
Savings and money market	828,297	684,131
Time deposits - under \$250	68,194	51,710
Time deposits - \$250 and over	84,763	138,634
CDARS - interest-bearing demand, money market and time deposits	11,575	16,832

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total deposits	2,745,299	2,482,989
Subordinated debt, net of issuance costs	39,322	39,183
Accrued interest payable and other liabilities	54,723	50,041
Total liabilities	2,839,344	2,572,213
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized; none issued and outstanding		
at September 30, 2018 and December 31, 2017	—	—
Common stock, no par value; 60,000,000 shares authorized; 43,271,676 shares issued		
and outstanding at September 30, 2018 and 38,200,883 shares issued and outstanding at December 31, 2017	300,208	218,355
Retained earnings	70,531	62,136
Accumulated other comprehensive loss	(17,173)	(9,252)
Total shareholders' equity	353,566	271,239
Total liabilities and shareholders' equity	\$ 3,192,910	\$ 2,843,452

See notes to unaudited consolidated financial statements

Table of Contents

## HERITAGE COMMERCE CORP

## CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(Dollars in thousands, except per share amounts)			
Interest income:				
Loans, including fees	\$ 28,632	\$ 22,507	\$ 77,271	\$ 64,112
Securities, taxable	3,483	3,596	11,112	9,916
Securities, exempt from Federal tax	555	563	1,675	1,694
Other investments, interest-bearing deposits in other financial institutions and Federal funds sold	1,940	1,289	4,409	3,037
Total interest income	34,610	27,955	94,467	78,759
Interest expense:				
Deposits	1,575	1,051	3,772	2,867
Subordinated debt	583	583	1,731	811
Short-term borrowings	1	—	1	1
Total interest expense	2,159	1,634	5,504	3,679
Net interest income before provision for loan losses	32,451	26,321	88,963	75,080
Provision (credit) for loan losses	(425)	115	7,279	390
Net interest income after provision for loan losses	32,876	26,206	81,684	74,690
Noninterest income:				
Service charges and fees on deposit accounts	1,107	869	2,981	2,410
Gain on sales of SBA loans	236	147	551	635
Increase in cash surrender value of life insurance	216	417	816	1,259
Servicing income	163	246	533	736
Gain (loss) on sales of securities	—	—	266	(6)
Other	484	781	2,034	2,014
Total noninterest income	2,206	2,460	7,181	7,048
Noninterest expense:				
Salaries and employee benefits	10,719	9,071	35,302	27,766
Occupancy and equipment	1,559	1,142	3,927	3,426
Professional fees	721	695	1,116	2,439
Other	4,729	3,926	18,235	11,785
Total noninterest expense	17,728	14,834	58,580	45,416
Income before income taxes	17,354	13,832	30,285	36,322
Income tax expense	4,979	5,249	8,186	13,752
Net income	\$ 12,375	\$ 8,583	\$ 22,099	\$ 22,570

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Earnings per common share:

Basic	\$ 0.29	\$ 0.22	\$ 0.54	\$ 0.59
Diluted	\$ 0.28	\$ 0.22	\$ 0.53	\$ 0.59

See notes to unaudited consolidated financial statements

Table of Contents

## HERITAGE COMMERCE CORP

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(Dollars in thousands)			
Net income	\$ 12,375	\$ 8,583	\$ 22,099	\$ 22,570
Other comprehensive income:				
Change in net unrealized holding (losses) gains on available-for-sale				
securities and I/O strips	(1,880)	539	(11,009)	2,975
Deferred income taxes	545	(227)	3,192	(1,250)
Change in net unamortized unrealized gain on securities available-for-				
sale that were reclassified to securities held-to-maturity	(11)	(12)	(33)	(38)
Deferred income taxes	3	5	9	16
Reclassification adjustment for losses (gains) realized in income	—	—	(266)	6
Deferred income taxes	—	—	79	(2)
Change in unrealized (losses) gains on securities and I/O strips, net of				
deferred income taxes	(1,343)	305	(8,028)	1,707
Change in net pension and other benefit plan liability adjustment	51	39	152	116
Deferred income taxes	(15)	(17)	(45)	(49)
Change in pension and other benefit plan liability, net of deferred income taxes	36	22	107	67
Other comprehensive (loss) income	(1,307)	327	(7,921)	1,774
Total comprehensive income	\$ 11,068	\$ 8,910	\$ 14,178	\$ 24,344

See notes to unaudited consolidated financial statements



Table of Contents

## HERITAGE COMMERCE CORP

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

	Nine Months Ended September 30, 2018 and 2017				
	Common Stock Shares (Dollars in thousands)	Amount	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balance, January 1, 2017	37,941,007	\$ 215,237	\$ 52,527	\$ (7,914)	\$ 259,850
Net income	—	—	22,570	—	22,570
Other comprehensive income	—	—	—	1,774	1,774
Issuance of restricted stock awards, net	64,136	—	—	—	—
Amortization of restricted stock awards, net of forfeitures and taxes	—	678	—	—	678
Cash dividend declared \$0.30 per share	—	—	(11,418)	—	(11,418)
Stock option expense, net of forfeitures and taxes	—	639	—	—	639
Stock options exercised	193,863	1,352	—	—	1,352
Balance, September 30, 2017	38,199,006	\$ 217,906	\$ 63,679	\$ (6,140)	\$ 275,445
Balance, January 1, 2018	38,200,883	\$ 218,355	\$ 62,136	\$ (9,252)	\$ 271,239
Net income	—	—	22,099	—	22,099
Other comprehensive loss	—	—	—	(7,921)	(7,921)
Issuance of common shares to acquire Tri-Valley Bank	1,889,613	30,725	—	—	30,725
Issuance of common shares to acquire United American Bank	2,826,032	47,280	—	—	47,280
Issuance of restricted stock awards, net	95,378	—	—	—	—
Amortization of restricted stock awards, net of forfeitures and taxes	—	814	—	—	814
Cash dividend declared \$0.33 per share	—	—	(13,704)	—	(13,704)
Stock option expense, net of forfeitures and taxes	—	535	—	—	535
Stock options exercised	259,770	2,499	—	—	2,499



Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Balance, September 30, 2018	43,271,676	\$ 300,208	\$ 70,531	\$ (17,173)	\$ 353,566
-----------------------------	------------	------------	-----------	-------------	------------

See notes to unaudited consolidated financial statements

Table of Contents

## HERITAGE COMMERCE CORP

## CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Nine Months Ended September 30,	
	2018	2017
	(Dollars in thousands)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 22,099	\$ 22,570
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	3,093	3,218
(Gain) loss on sale of securities available-for-sale	(266)	6
Gain on sale of SBA loans	(551)	(635)
Proceeds from sale of SBA loans originated for sale	9,315	8,304
SBA loans originated for sale	(11,689)	(8,957)
Provision for loan losses	7,279	390
Increase in cash surrender value of life insurance	(816)	(1,259)
Depreciation and amortization	566	586
Amortization of other intangible assets	1,336	1,083
Stock option expense, net	535	639
Amortization of restricted stock awards, net	814	678
Amortization of subordinated debt issuance costs	139	64
Effect of changes in:		
Accrued interest receivable and other assets	(19)	2,428
Accrued interest payable and other liabilities	1,723	(12)
Net cash provided by operating activities	33,558	29,103
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of securities available-for-sale	(15,193)	(123,561)
Purchase of securities held-to-maturity	(16,906)	(89,470)
Maturities/paydowns/calls of securities available-for-sale	44,832	41,463
Maturities/paydowns/calls of securities held-to-maturity	38,091	32,502
Proceeds from sales of securities available-for-sale	94,291	6,536
Net change in loans	20,215	(60,683)
Changes in Federal Home Loan Bank stock and other investments	(4,478)	(2,709)
Purchase of premises and equipment	(108)	(635)
Cash received in bank acquisition, net of cash paid	36,028	—
Net cash provided (used in) by investing activities	196,772	(196,557)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net change in deposits	(154,318)	218,464
Issuance of subordinated debt, net of issuance costs	—	39,073
Exercise of stock options	2,499	1,352

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Payment of cash dividends	(13,704)	(11,418)
Net cash (used in) provided by financing activities	(165,523)	247,471
Net increase in cash and cash equivalents	64,807	80,017
Cash and cash equivalents, beginning of period	316,222	266,103
Cash and cash equivalents, end of period	\$ 381,029	\$ 346,120

Supplemental disclosures of cash flow information:

Interest paid	\$ 4,728	\$ 2,912
Income taxes paid	8,671	11,731

Supplemental schedule of non-cash investing activity:

Transfer of loans held-for-sale to loan portfolio	—	2,391
---	---	-------

Summary of assets acquired and liabilities assumed through acquisitions:

Cash and cash equivalents, net of cash paid	\$ 36,028	\$ —
Securities available-for-sale	63,723	—
Net loans	336,446	—
Premises and equipment, net	350	—
Goodwill	38,088	—
Other intangible assets	8,361	—
Other assets, net	14,736	—
Deposits	(416,628)	—
Other borrowings	(62)	—
Other liabilities	(3,037)	—
Common stock issued to acquire Tri-Valley and United American Bank	78,005	—

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2018

(Unaudited)

1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the “Company” or “HCC”) and its wholly owned subsidiary, Heritage Bank of Commerce (“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, 2017.

HBC is a commercial bank serving customers primarily located in Santa Clara, Alameda, Contra Costa, San Benito, and San Mateo counties of California. CSNK Working Capital Finance Corp. a California corporation, dba Bay View Funding (“Bay View Funding”) is a wholly owned subsidiary of HBC, and provides business-essential working capital factoring financing to various industries throughout the United States. No customer accounts for more than 10% of revenue for HBC or the Company. The Company reports its results for two segments: banking and factoring. The Company’s management uses segment results in its operating and strategic planning.

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

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

The results for the three and nine months ended September 30, 2018 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2018.

#### Business Combinations

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

#### Goodwill and Other Intangible Assets

Goodwill resulted from the acquisition of Tri-Valley Bank (“Tri-Valley”) on April 6, 2018 and United American Bank (“United American”) on May 4, 2018, and from acquisitions in prior years. Goodwill represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified.

Other intangible assets consist of core deposit intangible assets and a below market value lease intangible asset, arising from the United American and Tri-Valley acquisitions. They are initially measured at fair value and then are amortized over their estimated useful lives. The core deposit intangible assets from the acquisitions of United American and Tri-Valley are being amortized on an accelerated method over ten years. The below market value lease intangible assets are being amortized on the straight line method over three years for United American and eleven years for Tri-Valley.

## Table of Contents

### 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 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers", which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The standard replaces most existing revenue recognition guidance in GAAP. The new standard was effective for the Company on January 1, 2018. Adoption of the standard did not have a material impact on the Company's consolidated financial statements and related disclosures as the Company's primary sources of revenues are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of the standard. The Company's revenue recognition pattern for revenue streams within the scope of the standard, including but not limited to service charges on deposit accounts and gains/losses on the sale of other real estate owned ("OREO"), did not change significantly from current practice. The standard permits the use of either the full retrospective or modified retrospective transition method. The Company elected to use the modified retrospective transition method which requires application of the standard to uncompleted contracts at the date of adoption however, periods prior to the date of adoption were not retrospectively revised as the impact of the standard on uncompleted contracts at the date of adoption was not material. See Note 15 – Revenue Recognition for more information.

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities." The guidance affects the accounting for equity investments, financial liabilities under the fair value option and the presentation and disclosure requirements of financial instruments. The standard was effective for the Company on January 1, 2018 and resulted in the use of an exit price rather than an entrance price to determine the fair value of financial instruments not measured at fair value on a non-recurring basis in the consolidated balance sheets. See Note 10 – Fair Value regarding the valuation of the loan portfolio.

In March 2017, the FASB issued ASU 2017-07, Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. The standard amended existing guidance to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost. The amendments require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit costs are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. The amendments allow only the service cost component to be eligible for capitalization. The Company adopted the new guidance on January 1, 2018, and there was no material impact to the financial statements.

Newly Issued, but not yet Effective Accounting Standards

In February 2016, the FASB issued ASU No. 2016-02, Leases. The standard requires a lessee to recognize assets and liabilities on the balance sheet for leases with lease terms greater than 12 months. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right of use asset representing its right to use the underlying asset for the lease term. When measuring assets and liabilities arising from a lease, a lessee (and a lessor) should include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. Similarly, optional payments to purchase the underlying asset should be included in the measurement of lease assets and lease liabilities only if the lessee is reasonably certain to exercise that purchase option. Reasonably certain is a high threshold that is consistent with and intended to be applied in the same way as the reasonably assured threshold in the previous leases guidance. In addition, also consistent with the previous leases guidance, a lessee (and a lessor) should exclude most variable lease payments in measuring lease assets and lease liabilities, other than those that depend on an index or a rate or are in substance fixed payments. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight line basis over the lease term. The new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, and early adoption is permitted. We are

Table of Contents

currently evaluating the provisions of this ASU and have determined that the provisions of ASU No. 2016-02 will result in an increase in assets to recognize the present value of the lease obligations with a corresponding increase in liabilities; however, we do not expect this to have a material impact to the Company's results of operations or cash flows.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments – Credit Losses: Measurement of Credit Losses on Financial Instruments. The standard is the final guidance on the new current expected credit loss (“CECL”) model. The amendments in this update replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to estimate future credit loss estimates. As CECL encompasses all financial assets carried at amortized cost, the requirement that reserves be established based on an organization's reasonable and supportable estimate of expected credit losses extends to held-to-maturity debt securities. The update amends the accounting for credit losses on available for sale securities, whereby credit losses will be presented as an allowance as opposed to a write down. In addition, CECL will modify the accounting for purchased loans with credit deterioration since origination, so that reserves are established at the date of acquisition for purchased loans. Lastly, the amendment requires enhanced disclosures on the significant estimates and judgments used to estimate credit losses, as well as on the credit quality and underwriting standards of an organization's portfolio. These disclosures require organizations to present the currently required credit quality disclosures disaggregated by the year of origination or vintage. The guidance allows for a modified retrospective approach with a cumulative effect adjustment to the balance sheet upon adoption (charge to retained earnings instead of the income statement). The new guidance is effective for public business entities for fiscal years, and interim periods within those years, beginning after December 15, 2019, and early adoption is permitted. We have formed a committee that has assessed our data needs and is in the process of implementing a system to comply with the new guidance. The committee has also selected a vendor to assist in generating loan level cash flows and disclosures. We expect to recognize a one-time cumulative effect adjustment to the allowance for loan losses and a charge to equity as of the beginning of the first reporting period in which the new standard is effective, but cannot yet determine the magnitude of any such one-time adjustment or the overall impact of the new guidance on the consolidated financial statements.

In January 2017, the FASB issued accounting standards ASU No. 2017-04, Simplifying the Test for Goodwill Impairment. The provisions of the update eliminate the existing second step of the goodwill impairment test which provides for the allocation of reporting unit fair value among existing assets and liabilities, with the net remaining amount representing the implied fair value of goodwill. In replacement of the existing goodwill impairment rule, the update will provide that impairment should be recognized as the excess of any of the reporting unit's goodwill over the fair value of the reporting unit. Under the provisions of this update, the amount of the impairment is limited to the carrying value of the reporting unit's goodwill. For public business entities that are SEC filers, the amendments of the update will become effective in fiscal years beginning after December 15, 2019. Management does not expect the requirements of this update to have a material impact on the Company's financial position, results of operations or cash flows.





Table of Contents

## 2) Shareholders' Equity and Earnings Per Share

Basic earnings per common share is computed by dividing net income by the weighted average common shares outstanding. Diluted earnings per share reflect potential dilution from outstanding stock options using the treasury stock method. There were 512,261 and 227,409 stock options for the three months ended September 30, 2018 and 2017, and 505,686 and 140,659 for the nine months ended September 30, 2018 and 2017, respectively, considered to be antidilutive and excluded from the computation of diluted earnings per share. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(Dollars in thousands, except per share amounts)			
Net income	\$ 12,375	\$ 8,583	\$ 22,099	\$ 22,570
Weighted average common shares outstanding for basic earnings per common share	43,230,016	38,152,633	41,132,043	38,060,224
Dilutive effect of stock options outstanding, using the treasury stock method	501,354	428,665	551,001	504,910
Shares used in computing diluted earnings per common share	43,731,370	38,581,298	41,683,044	38,565,134
Basic earnings per share	\$ 0.29	\$ 0.22	\$ 0.54	\$ 0.59
Diluted earnings per share	\$ 0.28	\$ 0.22	\$ 0.53	\$ 0.59

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

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

Three Months Ended September 30, 2018 and 2017  
Unamortized  
Unrealized

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	Unrealized Gains (Losses) Available- for-Sale Securities and I/O Strips(1) (Dollars in thousands)	Gain on Available- for-Sale Securities Reclassified to Held-to- Maturity	Defined Benefit Pension Plan Items	Total
Beginning balance July 1, 2018, net of taxes	\$ (7,031)	\$ 359	\$ (9,194)	\$ (15,866)
Other comprehensive income (loss) before reclassification, net of taxes	(1,335)	—	(4)	(1,339)
Amounts reclassified from other comprehensive income (loss), net of taxes	—	(8)	40	32
Net current period other comprehensive income (loss), net of taxes	(1,335)	(8)	36	(1,307)
Ending balance September 30, 2018, net of taxes	\$ (8,366)	\$ 351	\$ (9,158)	\$ (17,173)
Beginning balance July 1, 2017, net of taxes	\$ 877	\$ 321	\$ (7,665)	\$ (6,467)
Other comprehensive income (loss) before reclassification, net of taxes	312	—	(7)	305
Amounts reclassified from other comprehensive income (loss), net of taxes	—	(7)	29	22
Net current period other comprehensive income (loss), net of taxes	312	(7)	22	327
Ending balance September 30, 2017, net of taxes	\$ 1,189	\$ 314	\$ (7,643)	\$ (6,140)

Nine Months Ended  
September 30, 2018 and 2017  
Unamortized  
Unrealized

Table of Contents

	Unrealized Gains (Losses) Available-for-Sale Securities and I/O Strips (Dollars in thousands)	Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity	Defined Benefit Pension Plan Items	Total
Beginning balance January 1, 2018, net of taxes	\$ (362)	\$ 375	\$ (9,265)	\$ (9,252)
Other comprehensive (loss) before reclassification, net of taxes	(7,817)	—	(13)	(7,830)
Amounts reclassified from other comprehensive (loss) income, net of taxes	(187)	(24)	120	(91)
Net current period other comprehensive (loss) income, net of taxes	(8,004)	(24)	107	(7,921)
Ending balance September 30, 2018, net of taxes	\$ (8,366)	\$ 351	\$ (9,158)	\$ (17,173)
Beginning balance January 1, 2017, net of taxes	\$ (540)	\$ 336	\$ (7,710)	\$ (7,914)
Other comprehensive income (loss) before reclassification, net of taxes	1,725	—	(22)	1,703
Amounts reclassified from other comprehensive income (loss), net of taxes	4	(22)	89	71
Net current period other comprehensive income (loss), net of taxes	1,729	(22)	67	1,774
Ending balance September 30, 2017, net of taxes	\$ 1,189	\$ 314	\$ (7,643)	\$ (6,140)

Details About AOCI Components	Amounts Reclassified from AOCI(1)		Affected Line Item Where Net Income is Presented
	Three Months Ended September 30, 2018	2017	
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	\$ —	\$ —	Gain (loss) on sales of securities
	—	—	Income tax expense
	—	—	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	11	12	Interest income on taxable securities
	(3)	(5)	Income tax expense
	8	7	Net of tax

Amortization of defined benefit pension plan items

(1)			
Prior transition obligation	16	18	
Actuarial losses	(73)	(69)	
	(57)	(51)	Salaries and employee benefits
	17	22	Income tax benefit
	(40)	(29)	Net of tax
Total reclassification for the year	\$ (32)	\$ (22)	

---

(1) This AOCI component is included in the computation of net periodic benefit cost (see Note 9—Benefit Plans) and includes split-dollar life insurance benefit plan.

---

Amounts Reclassified from  
AOCI(1)

Table of Contents

Details About AOCI Components	Nine Months Ended		Net Income is Presented
	2018	2017	
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	\$ 266	\$ (6)	Gain (loss) on sales of securities
	(79)	2	Income tax expense
	187	(4)	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	33	38	Interest income on taxable securities
	(9)	(16)	Income tax expense
	24	22	Net of tax
Amortization of defined benefit pension plan items (1)			
Prior transition obligation	48	53	
Actuarial losses	(219)	(207)	
	(171)	(154)	Salaries and employee benefits
	51	65	Income tax benefit
	(120)	(89)	Net of tax
Total reclassification from AOCI for the year	\$ 91	\$ (71)	

---

(1) This AOCI component is included in the computation of net periodic benefit cost (see Note 9—Benefit Plans) and includes split-dollar life insurance benefit plan.

---

## 4) Securities

The amortized cost and estimated fair value of securities at September 30, 2018 and December 31, 2017 were as follows:

September 30, 2018	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
	(Dollars in thousands)			
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 324,309	\$ 18	\$ (12,662)	\$ 311,665
U.S. Government sponsored entities	7,419	—	(13)	7,406
Total	\$ 331,728	\$ 18	\$ (12,675)	\$ 319,071
Securities held-to-maturity:				
Agency mortgage-backed securities	\$ 288,594	\$ —	\$ (12,778)	\$ 275,816

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Municipals - exempt from Federal tax	87,138	242	(3,498)	83,882
Total	\$ 375,732	\$ 242	\$ (16,276)	\$ 359,698

December 31, 2017	Amortized Cost (Dollars in thousands)	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 378,339	\$ 786	\$ (4,392)	\$ 374,733
Trust preferred securities	15,000	2,119	—	17,119
Total	\$ 393,339	\$ 2,905	\$ (4,392)	\$ 391,852
Securities held-to-maturity:				
Agency mortgage-backed securities	\$ 309,616	\$ 6	\$ (4,394)	\$ 305,228
Municipals - exempt from Federal tax	88,725	946	(607)	89,064
Total	\$ 398,341	\$ 952	\$ (5,001)	\$ 394,292

Table of Contents

Securities with unrealized losses at September 30, 2018 and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

September 30, 2018	Less Than 12 Months Fair Unrealized Value (Losses) (Dollars in thousands)		12 Months or More Fair Unrealized Value (Losses)		Total Fair Value	Unrealized (Losses)
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 76,522	\$ (2,290)	\$ 231,110	\$ (10,372)	\$ 307,632	\$ (12,662)
U.S. Government sponsored entities	7,405	(13)	—	—	7,405	(13)
Total	\$ 83,927	\$ (2,303)	\$ 231,110	\$ (10,372)	\$ 315,037	\$ (12,675)
Securities held-to-maturity:						
Agency mortgage-backed securities	\$ 71,766	\$ (2,639)	\$ 203,293	\$ (10,139)	\$ 275,059	\$ (12,778)
Municipals - exempt from Federal tax	33,027	(996)	33,211	(2,502)	66,238	(3,498)
Total	\$ 104,793	\$ (3,635)	\$ 236,504	\$ (12,641)	\$ 341,297	\$ (16,276)
December 31, 2017	Less Than 12 Months Fair Unrealized Value (Losses) (Dollars in thousands)		12 Months or More Fair Unrealized Value (Losses)		Total Fair Value	Unrealized (Losses)
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 185,824	\$ (1,623)	\$ 146,670	\$ (2,769)	\$ 332,494	\$ (4,392)
Total	\$ 185,824	\$ (1,623)	\$ 146,670	\$ (2,769)	\$ 332,494	\$ (4,392)
Securities held-to-maturity:						
Agency mortgage-backed securities	\$ 168,439	\$ (1,368)	\$ 130,759	\$ (3,026)	\$ 299,198	\$ (4,394)
Municipals - exempt from Federal tax	18,159	(182)	19,240	(425)	37,399	(607)
Total	\$ 186,598	\$ (1,550)	\$ 149,999	\$ (3,451)	\$ 336,597	\$ (5,001)

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 September 30, 2018, the Company held 495 securities



(172 available-for-sale and 323 held to maturity), of which 428 had fair values below amortized cost. At September 30, 2018, there were \$231,110,000 of agency mortgage-back securities available-for-sale, \$203,293,000 of agency mortgage-backed securities held-to-maturity, and \$33,211,000 of municipal bonds held-to-maturity, carried with an unrealized loss for 12 months or more. The total unrealized loss for securities 12 months or more was \$23,013,000 at September 30, 2018. The unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company does not consider these securities to be other than temporarily impaired at September 30, 2018.

The proceeds from sales of securities and the resulting gains and losses were as follows for the periods indicated:

	Three Months Ended September 30, 2018		September 30, 2017	
	(Dollars in thousands)		(Dollars in thousands)	
Proceeds	\$	—	\$	—
Gross gains		—		—
Gross losses		—		—

The amortized cost and estimated fair values of securities as of September 30, 2018 are shown by contractual maturity below. The expected maturities will differ from contractual maturities if borrowers have the right to call or

Table of Contents

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	\$ 7,419	\$ 7,406
Agency mortgage-backed securities	324,309	311,665
Total	\$ 331,728	\$ 319,071

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due 3 months or less	\$ 503	\$ 503
Due after 3 months through one year	286	286
Due after one through five years	4,558	4,587
Due after five through ten years	23,713	23,417
Due after ten years	58,078	55,089
Agency mortgage-backed securities	288,594	275,816
Total	\$ 375,732	\$ 359,698

Securities with amortized cost of \$44,595,000 and \$110,874,000 as of September 30, 2018 and December 31, 2017 were pledged to secure public deposits and for other purposes as required or permitted by law or contract.

## 5) Loans

Loans were as follows for the periods indicated:

	September 30, 2018	December 31, 2017
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	\$ 600,594	\$ 573,296
Real estate:		

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

CRE	988,491	772,867
Land and construction	131,548	100,882
Home equity	116,657	79,176
Residential mortgages	52,441	44,561
Consumer	9,932	12,395
Loans	1,899,663	1,583,177
Deferred loan fees, net	(276)	(510)
Loans, net of deferred fees	1,899,387	1,582,667
Allowance for loan losses	(27,426)	(19,658)
Loans, net	\$ 1,871,961	\$ 1,563,009

At September 30, 2018, total net loans included in the table above include \$43,311,000, \$115,158,000 and \$193,787,000, of the loans acquired in the Focus Business Bank (“Focus”), Tri-Valley, and United American acquisitions that were not purchased credit impaired loans, respectively. At December 31, 2017, total net loans included in the table above include \$58,551,000, of the loans acquired in the Focus transaction that were not purchased credit impaired loans.

There was a (\$425,000) credit to the provision for loan losses for the third quarter of 2018, compared to a provision for loan losses of \$115,000 for the third quarter of 2017. The credit to the provision for loan losses for the third quarter of 2018 was primarily due to net recoveries of \$1,187,000. For the nine months ended September 30, 2018, there was a \$7,279,000 provision for loan losses compared to a \$390,000 provision for loan losses for the nine months ended September 30, 2017. The increase in the provision for loan losses for the first nine months of 2018 compared to the first nine months of 2017 was primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018. At September 30, 2018, the recorded investment of this lending relationship was \$21,764,000,

Table of Contents

and the Company had a \$7,000,000 specific loan loss reserve allocated for this lending relationship. Additionally, subsequent to the end of the third quarter of 2018, the recorded investment of this lending relationship was reduced to \$17,384,000. Net recoveries totaled \$1,187,000 for the third quarter of 2018, and \$489,000 for the first nine months of 2018, compared to net recoveries of \$236,000 for the third quarter of 2017, and net recoveries of \$269,000 for the first nine months of 2017.

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

	Three Months Ended September 30, 2018			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 17,522	\$ 9,020	\$ 122	\$ 26,664
Charge-offs	(719)	—	(25)	(744)
Recoveries	1,897	34	—	1,931
Net (charge-offs) recoveries	1,178	34	(25)	1,187
Provision (credit) for loan losses	(1,427)	1,022	(20)	(425)
End of period balance	\$ 17,273	\$ 10,076	\$ 77	\$ 27,426

	Three Months Ended September 30, 2017			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 11,259	\$ 7,982	\$ 156	\$ 19,397
Charge-offs	(111)	—	—	(111)
Recoveries	281	66	—	347
Net recoveries	170	66	—	236
Provision (credit) for loan losses	(441)	592	(36)	115
End of period balance	\$ 10,988	\$ 8,640	\$ 120	\$ 19,748

	Nine Months Ended September 30, 2018			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 10,608	\$ 8,950	\$ 100	\$ 19,658
Charge-offs	(1,835)	—	(25)	(1,860)
Recoveries	2,229	120	—	2,349
Net (charge-offs) recoveries	394	120	(25)	489
Provision for loan losses	6,271	1,006	2	7,279
End of period balance	\$ 17,273	\$ 10,076	\$ 77	\$ 27,426

	Nine Months Ended September 30, 2017			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 10,656	\$ 8,327	\$ 106	\$ 19,089
Charge-offs	(2,179)	—	—	(2,179)
Recoveries	1,453	995	—	2,448
Net (charge-offs) recoveries	(726)	995	—	269
Provision (credit) for loan losses	1,058	(682)	14	390
End of period balance	\$ 10,988	\$ 8,640	\$ 120	\$ 19,748

Table of Contents

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

	September 30, 2018		Consumer	Total
	Commercial	Real Estate		
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 7,089	\$ —	\$ —	\$ 7,089
Collectively evaluated for impairment	10,184	10,076	77	20,337
Acquired with deteriorated credit quality	—	—	—	—
Total allowance balance	\$ 17,273	\$ 10,076	\$ 77	\$ 27,426
Loans:			—	
Individually evaluated for impairment	\$ 18,843	\$ 6,206	\$ —	\$ 25,049
Collectively evaluated for impairment	581,751	1,282,931	9,932	1,874,614
Acquired with deteriorated credit quality	—	—	—	—
Total loan balance	\$ 600,594	\$ 1,289,137	\$ 9,932	\$ 1,899,663

  

	December 31, 2017		Consumer	Total
	Commercial	Real Estate		
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 290	\$ —	\$ —	\$ 290
Collectively evaluated for impairment	10,318	8,950	100	19,368
Acquired with deteriorated credit quality	—	—	—	—
Total allowance balance	\$ 10,608	\$ 8,950	\$ 100	\$ 19,658
Loans:				
Individually evaluated for impairment	\$ 1,775	\$ 998	\$ 1	\$ 2,774
Collectively evaluated for impairment	571,521	996,488	12,394	1,580,403
Acquired with deteriorated credit quality	—	—	—	—
Total loan balance	\$ 573,296	\$ 997,486	\$ 12,395	\$ 1,583,177

Table of Contents

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of September 30, 2018 and December 31, 2017. 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. The recorded investment in consumer loans collateralized by residential real estate property that are in process of foreclosure according to local requirements of the applicable jurisdiction are not material as of the periods indicated:

	September 30, 2018			December 31, 2017		
	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	\$ 6,246	\$ 6,246	\$ —	\$ 1,243	\$ 1,243	\$ —
Real estate:						
CRE	5,639	5,639	—	500	500	—
Land and construction	—	—	—	138	119	—
Home Equity	567	567	—	379	379	—
Consumer	—	—	—	1	1	—
Total with no related allowance recorded	12,452	12,452	—	2,261	2,242	—
With an allowance recorded:						
Commercial	12,597	12,597	7,089	589	532	290
Total with an allowance recorded	12,597	12,597	7,089	589	532	290
Total	\$ 25,049	\$ 25,049	\$ 7,089	\$ 2,850	\$ 2,774	\$ 290

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

	Three Months Ended September 30, 2018					
	Real Estate					
	Commercial	CRE	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	\$ 19,638	\$ 5,720	\$ —	\$ 572	\$ —	\$ 25,930
Interest income during impairment	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Cash-basis interest recognized	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —

Three Months Ended September 30, 2017

Real Estate

	Commercial CRE (Dollars in thousands)		Land and Construction	Home Equity	Consumer	Total
Average of impaired loans during the period	\$ 2,010	\$ 501	\$ 641	\$ 394	\$ 1	\$ 3,547
Interest income during impairment	\$ —	\$ —	\$ 3	\$ —	\$ —	\$ 3
Cash-basis interest recognized	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —

Nine Months Ended September 30, 2018

Real Estate

	Commercial CRE (Dollars in thousands)		Land and Construction	Home Equity	Consumer	Total
Average of impaired loans during the period	\$ 11,056	\$ 3,110	\$ 30	\$ 472	\$ —	\$ 14,668
Interest income during impairment	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Cash-basis interest recognized	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —



Table of Contents

	Nine Months Ended September 30, 2017					
	Real Estate					
	Commercial CRE (Dollars in thousands)		Land and Construction	Home Equity	Consumer	Total
Average of impaired loans during the period	\$ 2,625	\$ 583	\$ 419	\$ 326	\$ 2	\$ 3,955
Interest income during impairment	\$ —	\$ —	\$ 3	\$ —	\$ —	\$ 3
Cash-basis interest recognized	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —

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:

	September 30, 2018	September 30, 2017	December 31, 2017
	(Dollars in thousands)		
Nonaccrual loans - held-for-investment	\$ 23,342	\$ 2,560	\$ 2,250
Restructured and loans over 90 days past due and still accruing	1,373	931	235
Total nonperforming loans	24,715	3,491	2,485
Other restructured loans	334	325	289
Total impaired loans	\$ 25,049	\$ 3,816	\$ 2,774

The following table presents the nonperforming loans by class for the periods indicated:

	September 30, 2018			December 31, 2017		
	Nonaccrual (Dollars in thousands)	Restructured and Loans over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans over 90 Days Past Due and Still Accruing	Total
Commercial	\$ 17,361	\$ 1,148	\$ 18,509	\$ 1,250	\$ 235	\$ 1,485
Real estate:						
CRE	5,639	—	5,639	501	—	501
Land and construction	—	—	—	119	—	119
Home equity	342	225	567	379	—	379
Consumer	—	—	—	1	—	1

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total	\$ 23,342	\$ 1,373	\$ 24,715	\$ 2,250	\$ 235	\$ 2,485
-------	-----------	----------	-----------	----------	--------	----------

The following tables present the aging of past due loans by class for the periods indicated:

	September 30, 2018					
	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	\$ 6,430	\$ 2,098	\$ 1,456	\$ 9,984	\$ 590,610	\$ 600,594
Real estate:						
CRE	—	—	—	—	988,491	988,491
Land and construction	—	—	—	—	131,548	131,548
Home equity	967	—	—	967	115,690	116,657
Residential mortgages	—	—	—	—	52,441	52,441
Consumer	—	—	—	—	9,932	9,932
Total	\$ 7,397	\$ 2,098	\$ 1,456	\$ 10,951	\$ 1,888,712	\$ 1,899,663

Table of Contents

	December 31, 2017					
	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	\$ 4,288	\$ 1,224	\$ 589	\$ 6,101	\$ 567,195	\$ 573,296
Real estate:						
CRE	—	—	500	500	772,367	772,867
Land and construction	—	—	119	119	100,763	100,882
Home equity	223	—	—	223	78,953	79,176
Residential mortgages	—	—	—	—	44,561	44,561
Consumer	—	—	—	—	12,395	12,395
Total	\$ 4,511	\$ 1,224	\$ 1,208	\$ 6,943	\$ 1,576,234	\$ 1,583,177

Past due loans 30 days or greater totaled \$10,951,000 and \$6,943,000 at September 30, 2018 and December 31, 2017, respectively, of which \$617,000 and \$1,410,000 were on nonaccrual, respectively. At September 30, 2018, there were also \$22,725,000 of loans less than 30 days past due included in nonaccrual loans held-for-investment, which included \$21,764,000 of loans related to a single lending relationship. At December 31, 2017, there were also \$840,000 of 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 being pursued.

## Credit Quality Indicators

Concentrations of credit risk arise when a number of customers are engaged in similar business activities, or activities in the same geographic region, or have similar features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions. The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and service) and real estate lending, with the remaining 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 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, and it is probable that the Company will not receive payment of the full contractual principal and interest. Loans so classified have a well defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. In addition, the Company no longer accrues interest on the loan because of the underlying weaknesses.

Table of Contents

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

**Loss.** Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for loan losses. Therefore, there is no balance to report as of September 30, 2018 and December 31, 2017.

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

	September 30, 2018			December 31, 2017		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
Commercial	\$ 577,325	\$ 23,269	\$ 600,594	\$ 554,913	\$ 18,383	\$ 573,296
Real estate:						
CRE	982,852	5,639	988,491	766,988	5,879	772,867
Land and						
construction	131,548	—	131,548	100,763	119	100,882
Home equity	115,019	1,638	116,657	78,486	690	79,176
Residential						
mortgages	52,441	—	52,441	44,561	—	44,561
Consumer	9,932	—	9,932	12,394	1	12,395
Total	\$ 1,869,117	\$ 30,546	\$ 1,899,663	\$ 1,558,105	\$ 25,072	\$ 1,583,177

The increase in classified assets at September 30, 2018 was primarily due to seasonal advances on a line of credit associated with a single large lending relationship that was moved to classified loans in the fourth quarter of 2017, which totaled \$21,764,000 at September 30, 2018, compared to \$12,500,000 at December 31, 2017. 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 in accordance with the Company's underwriting policy.

The balance of troubled debt restructurings at September 30, 2018 was \$676,000, which are all accrual loans. The balance of troubled debt restructurings at December 31, 2017 was \$325,000, which included \$16,000 of nonaccrual loans and \$309,000 of accruing loans. Approximately \$46,000 and \$1,000 of specific reserves were established with respect to these loans as of September 30, 2018 and December 31, 2017.

The following table presents loans by class modified as troubled debt restructurings:

	During the Nine Months Ended September 30, 2018		
	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
	(Dollars in thousands)		
Commercial	2	\$ 159	\$ 159
Home equity	1	225	225
Total	3	\$ 384	\$ 384

The following table presents loans by class modified as troubled debt restructurings:

	During the Three and Nine Months Ended September 30, 2017		
	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
	(Dollars in thousands)		
Commercial	3	\$ 318	\$ 318
Total	3	\$ 318	\$ 318

## Table of Contents

During the three months ended September 30, 2018, there were no new loans modified as troubled debt restructurings in which the amount of principal or accrued interest owed from the borrower was forgiven or which resulted in a charge-off or change to the allowance for loan losses. The Company has committed to lend no additional amounts to customers with outstanding loans that are classified as troubled debt restructurings as of September 30, 2018.

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 and nine months ended September 30, 2018 and 2017.

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

## 6) Business Combinations

On April 6, 2018, the Company completed its acquisition of Tri-Valley for a transaction value of \$32,320,000. At closing the Company issued 1,889,613 shares of the Company's common stock with an aggregate market value of \$30,725,000 on the date of closing. The number of shares issued was based on a fixed exchange ratio of 0.0489 of a share of the Company's common stock for each outstanding share of Tri-Valley common stock. In addition, at closing the Company paid cash to the holder of a stock warrant and holders of outstanding stock options and related fees and fractional shares totaling \$1,595,000. The following table summarizes the consideration paid for Tri-Valley:

	(Dollars in thousands)
Cash paid for:	
Warrant	\$ 889
Options	615
Other	91
Total cash paid	1,595
Issuance of 1,889,613 shares of common stock to Tri-Valley shareholders at \$16.26 per share	30,725
Total consideration	\$ 32,320

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition.





Table of Contents

	As Recorded by Tri-Valley (Dollars in thousands)	Fair Value Adjustments		As Recorded at Acquisition
Assets acquired:				
Cash and cash equivalents	\$ 21,757	\$ 1,153	(a)	\$ 22,910
Loans	123,532	(2,563)	(b)	120,969
Allowance for loan losses	(1,969)	1,969	(c)	—
Other intangible assets	—	1,978	(d)	1,978
Other assets, net	9,939	(2,894)	(e)	7,045
Total assets acquired	\$ 153,259	\$ (357)		152,902
Liabilities assumed:				
Deposits	\$ 135,351	\$ 37	(f)	135,388
Other liabilities	608	—		608
Total liabilities assumed	\$ 135,959	\$ 37		135,996
Net assets acquired				16,906
Purchase price				30,725
Goodwill recorded in the merger				\$ 13,819

## Explanation of certain fair value related adjustments for the Tri-Valley acquisition:

(a)Represents the cash acquired in the merger, the disposition of other real estate owned of \$1,132,000, a gain on the sale of securities of \$53,000, partially offset by invoices paid after closing for services prior to closing of \$29,000, and cash paid for fractional shares in the transaction of \$3,000. The remaining \$1,592,000 of cash paid for the transaction is an adjustment to prepaid assets included in other assets, net.

(b)Represents the fair value adjustment to the net book value of loans, which includes an interest rate mark and credit mark adjustment.

(c)Represents the elimination of Tri-Valley's allowance for loan losses.

(d)Represents intangible assets recorded to reflect the fair value of core deposits and a below market lease. The core deposit asset was recorded as an identifiable intangible asset and is amortized on an accelerated basis over the estimated average life of the deposit base. The below market lease intangible assets will be amortized on the straight line method over eleven years.

(e)Represents an adjustment to net deferred tax assets resulting from the fair value adjustments related to the acquired assets, liabilities assumed and identifiable intangible assets recorded, and the disposition of other real estate owned.

(f)Represents the fair value adjustment on time deposits, which was be accreted as a reduction of interest expense.

Tri-Valley's results of operations have been included in the Company's results of operations beginning April 7, 2018.

On May 4, 2018, the Company completed its acquisition of United American for a transaction value of \$56,417,000. At closing the Company issued 2,826,032 shares of the Company's common stock with an aggregate market value of \$47,280,000 on the date of closing. The number of shares issued was based on a fixed exchange ratio of 2.1644 of a share of the Company's common stock for each outstanding share of United American common stock and each common stock equivalent underlying the United American Series D Preferred Stock and Series E Preferred Stock. The shareholders of the United American Series A Preferred Stock and Series B Preferred Stock received \$1,000 cash for each share totaling \$8,700,000 and \$435,000, respectively. In addition, the Company paid \$2,000 in cash for fractional shares, for total cash consideration of \$9,137,000. The following table summarizes the consideration paid for United American:

Table of Contents

	(Dollars in thousands)
Consideration paid:	
Cash paid for:	
Series A Preferred Stock	\$ 8,700
Series B Preferred Stock	435
Other	2
Total cash paid	9,137
Issuance of 2,826,032 shares of common stock to United American shareholders at \$16.73 per share	47,280
Total consideration	\$ 56,417

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition.

	As Recorded by United American (Dollars in thousands)	Fair Value Adjustments		As Recorded at Acquisition
Assets acquired:				
Cash and cash equivalents	\$ 45,638	\$ (32,520)	(a)	\$ 13,118
Securities available-for-sale	64,144	(421)	(b)	63,723
Loans	196,694	18,783	(c)	215,477
Allowance for loan losses	(2,952)	2,952	(d)	—
Other intangible assets	—	6,383	(e)	6,383
Other assets, net	9,119	(1,078)	(f)	8,041
Total assets acquired	\$ 312,643	\$ (5,901)		306,742
Liabilities assumed:				
Deposits	\$ 281,189	\$ 51	(g)	281,240
Other borrowings	62	—		62
Other liabilities	2,617	(188)	(h)	2,429
Total liabilities	\$ 283,868	\$ (137)		283,731
Net assets acquired				23,011
Purchase price				47,280
Goodwill recorded in the merger				\$ 24,269

Explanation of certain fair value related adjustments for the United American acquisition:

(a) Represents the cash acquired in the merger, net of cash paid for the transaction of \$9,137,000, the repurchase of \$23,732,000 loan participations from ATBancorp, and \$51,000 for invoices paid after closing for services prior to closing, partially offset by a tax refund of \$400,000.

(b)Represents the fair value adjustment on investment securities available-for-sale.

(c)Represents the repurchase of \$23,732,000 loan participations from ATBancorp, partially offset by the fair value adjustment to the net book value of loans of \$4,680,000, which includes an interest rate mark and credit mark adjustment, and net charge-offs of \$269,000 subsequent to closing.

(d)Represents the elimination of United American's allowance for loan losses.

(e)Represents intangible assets recorded to reflect the fair value of core deposits and a below market lease. The core deposit asset was recorded as an identifiable intangible asset and is amortized on an accelerated basis over the estimated average life of the deposit base. The below market lease intangible assets will be amortized on the straight line method over three years.

(f)Represents an adjustment to net deferred tax assets resulting from the fair value adjustments related to the acquired assets, liabilities assumed and identifiable intangible assets recorded.

Table of Contents

(g)Represents the fair value adjustment on time deposits, which was be accreted as a reduction of interest expense.

(h)Represents the reversal of over accrued accounts payable.

United American's results of operations have been included in the Company's results of operations beginning May 5, 2018.

The Company believes the merger provides the opportunity to combine three independent business banking franchises with similar philosophies and cultures into a combined \$3.2 billion business bank based in San Jose, California. The pooling of the three banks' resources and knowledge enhance our capabilities, operational efficiencies, and community outreach. The Company also believes the combined bank will be much better positioned to meet the needs of our customers, shareholders and the community. The one-time pre-tax acquisition and integration costs of \$16,000 and \$5,452,000 for the three months and nine months ended September 30, 2018, respectively, were included in other noninterest expense. In addition, salaries and employee benefits included severance and retention expense of \$183,000 and \$3,576,000 for the three months and nine months ended September 30, 2018, respectively, related to the Tri-Valley and United American acquisitions. Total severance, retention, acquisition and integration costs were \$199,000 and \$9,028,000 for the three months and nine months ended September 30, 2018, respectively.

The fair value of net assets acquired includes fair value adjustments to certain receivables of which some were considered impaired and some were not considered impaired as of the acquisition date. The fair value adjustments were determined using discounted contractual cash flows, adjusted for expected losses and prepayments, where appropriate. The receivables that were not considered impaired at the acquisition date were not subject to the guidance relating to purchased credit impaired loans, which have shown evidence of credit deterioration since origination.

Goodwill of \$13,819,000 arising from the Tri-Valley acquisition and \$24,269,000 from the United American acquisition is largely attributable to synergies and cost savings resulting from combining the operations of the companies. As these transactions were structured as a tax-free exchange, the goodwill will not be deductible for tax purposes. Management's preliminary valuation of the tangible and intangible assets acquired and liabilities assumed, which are based on assumptions that are subject to change, and the resulting allocation of the consideration paid for the allocation is reflected in the tables above. Prior to the end of the one-year measurement period for finalizing the consideration paid allocation, if information becomes available which would indicate adjustments are required to the allocation, such adjustments will be included in the allocation in the reporting period in which the adjustment amounts are determined. Loan valuations may be adjusted based on new information obtained by the Company in future periods that may reflect conditions or events that existed on the acquisition date. Deferred tax assets may be adjusted for purchase accounting adjustments on open areas such as loans or upon filing final "stub" period tax returns for April 6, 2018 for Tri-Valley, and May 4, 2018 for United American. The closing equity balance for Tri-Valley and United American are also subject to adjustments for invoices received after the close of the transaction that were attributable to their operations through closing.

7) Goodwill and Other Intangible Assets

Goodwill

At September 30, 2018, the carrying value of goodwill was \$83,752,000, which included \$13,045,000 of goodwill related to its acquisition of Bay View Funding, \$32,619,000 from its acquisition of Focus, \$13,819,000 from its acquisition of Tri-Valley and \$24,269,000 from its acquisition of United American.

Goodwill impairment exists when a reporting unit's carrying value exceeds its fair value, which is determined through a qualitative assessment whether it is more likely than not that the fair value of equity of the reporting unit exceeds the carrying value ("Step Zero"). If the qualitative assessment indicates it is more likely than not that the fair value of equity of a reporting unit is less than book value, then a quantitative two-step impairment test is required. Step 1 includes the determination of the carrying value of the Company's single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess.

## Table of Contents

The Company completed its annual goodwill impairment analysis as of November 30, 2017 with the assistance of an independent valuation firm. No events or circumstances since the November 30, 2017 annual impairment test were noted that would indicate it was more likely than not a goodwill impairment exists.

### Other Intangible Assets

Other intangible assets acquired in the acquisition of United American in May 2018 included a core deposit intangible asset of \$5,723,000, amortized on an accelerated method over its estimated useful life of 10 years, and a below market value lease intangible asset of \$660,000, amortized over its estimated useful life of 3 years. Accumulated amortization of the core deposit intangible and below market lease was \$469,000 at September 30, 2018.

Other intangible assets acquired in the acquisition of Tri-Valley in April 2018 include a core deposit intangible asset of \$1,768,000, amortized on an accelerated method over its estimated useful life of 10 years, and a below market value lease intangible asset of \$210,000, amortized over its estimated useful life of 11 years. Accumulated amortization of the core deposit intangible and below market lease was \$143,000 at September 30, 2018.

The core deposit intangible asset acquired in the acquisition of Focus in August 2015 was \$6,285,000. This asset is amortized on an accelerated method over its estimated useful life of 10 years. Accumulated amortization of this intangible asset was \$2,576,000 and \$1,995,000 at September 30, 2018 and December 31, 2017, respectively.

Other intangible assets acquired in the acquisition of Bay View Funding in November 2014 included: a below market value lease intangible asset of \$109,000 (amortized over 3 years), customer relationship and brokered relationship intangible assets of \$1,900,000, (amortized over the 10 year estimated useful lives), and a non-compete agreement intangible asset of \$250,000 (amortized over 3 years). Accumulated amortization of the customer relationship and brokered relationship intangible assets was \$743,000 and \$601,000 at September 30, 2018 and December 31, 2017, respectively. The below market lease and non-compete agreement intangible assets were fully amortized at December 31, 2017.

Estimated amortization expense for 2018, the next five years and thereafter is as follows:

United

United

Bay View Funding

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Year	American Core Deposit Intangible	American Below Market Lease	Tri-Valley Core Deposit Intangible	Tri-Valley Below Market Lease	Focus Core Deposit Intangible	Customer & Brokered Relationship Intangible	Total Amortization Expense
	(Dollars in thousands)						
2018	\$ 585	\$ 170	\$ 208	\$ 14	\$ 775	\$ 190	\$ 1,942
2019	777	255	240	18	734	190	2,214
2020	665	235	208	18	716	190	2,032
2021	602	—	184	18	596	190	1,590
2022	553	—	167	18	502	190	1,430
2023	521	—	158	18	420	190	1,307
Thereafter	2,020	—	603	106	549	159	3,437
	\$ 5,723	\$ 660	\$ 1,768	\$ 210	\$ 4,292	\$ 1,299	\$ 13,952

Impairment testing of the intangible assets is performed at the individual asset level. Impairment exists if the carrying amount of the asset is not recoverable and exceeds its fair value at the date of the impairment test. For intangible assets, estimates of expected future cash flows (cash inflows less cash outflows) that are directly associated with an intangible asset are used to determine the fair value of that asset. Management makes certain estimates and assumptions in determining the expected future cash flows from core deposit and customer relationship intangibles including account attrition, expected lives, discount rates, interest rates, servicing costs and other factors. Significant changes in these estimates and assumptions could adversely impact the valuation of these intangible assets. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset. Based on its assessment, management concluded that there was no impairment of intangible assets at September 30, 2018 and December 31, 2017.



Table of Contents

## 8) 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 current 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.

Under generally accepted accounting principles, a valuation allowance is required if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.

On December 22, 2017, the Tax Cuts and Jobs Act (the "Tax Act"), was signed into law, which among other items reduces the federal corporate tax rate to 21% from 35%, effective January 1, 2018.

The Company had net deferred tax assets of \$28,143,000, and \$16,247,000, at September 30, 2018, and December 31, 2017, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax assets at September 30, 2018 and December 31, 2017 will be fully realized in future years.

The following table reflects the carry amounts of the low income housing investments included in accrued interest receivable and other assets, and the future commitments included in accrued interest payable and other liabilities for the periods indicated:

	September 30, 2018	December 31, 2017
	(Dollars in thousands)	
Low income housing investments	\$ 3,139	\$ 3,411
Future commitments	\$ 287	\$ 302

The Company expects future commitments of \$15,000 to be paid in 2018, and \$272,000 in 2019 through 2023.

For tax purposes, the Company had low income housing tax credits of \$106,000 and \$110,000 for the three months ended September 30, 2018 and September 30, 2017, respectively, and low income housing investment losses of \$117,000 and \$115,000, respectively. For tax purposes, the Company had low income housing tax credits of \$319,000 and \$329,000 for the nine months ended September 30, 2018 and September 30, 2017, respectively, and low income housing investment losses of \$351,000 and \$345,000, respectively. The Company recognized low income housing investment expense as a component of income tax expense.

Table of Contents

## 9) Benefit Plans

## Supplemental Retirement Plan

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

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	2017		2017	
	(Dollars in thousands)			
Components of net periodic benefit cost:				
Service cost	\$ 62	\$ 81	\$ 186	\$ 243
Interest cost	237	259	711	777
Amortization of net actuarial loss	73	69	219	207
Net periodic benefit cost	\$ 372	\$ 409	\$ 1,116	\$ 1,227

## Split Dollar Life Insurance Benefit Plan

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

	September 30, 2018	December 31, 2017
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$ 6,711	\$ 6,301
Interest cost	170	243
Actuarial loss	—	167
Projected benefit obligation at end of period	\$ 6,881	\$ 6,711

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	December	
	September 30,	2017
	2018	2017
	(Dollars in thousands)	
Net actuarial loss	\$ 2,569	\$ 2,453
Prior transition obligation	1,171	1,238
Accumulated other comprehensive loss	\$ 3,740	\$ 3,691

	Three Months		Nine Months	
	Ended		Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
	(Dollars in thousands)			
Amortization of prior transition obligation	\$ (16)	\$ (18)	\$ (48)	\$ (53)
Interest cost	56	61	170	182
Net periodic benefit cost	\$ 40	\$ 43	\$ 122	\$ 129

10) Fair Value

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

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

## Table of Contents

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		
		Significant		
		Quoted Prices in	Other	Significant
		Active Markets for	Observable	Unobservable
		Identical Assets	Inputs	Inputs
	Balance	(Level 1)	(Level 2)	(Level 3)
	(Dollars in thousands)			
Assets at September 30, 2018				
Available-for-sale securities:				
Agency mortgage-backed securities	\$ 311,665	—	\$ 311,665	—
U.S. Government sponsored entities	7,406	—	7,406	—
I/O strip receivables	863	—	863	—
Assets at December 31, 2017				
Available-for-sale securities:				
Agency mortgage-backed securities	\$ 374,733	—	\$ 374,733	—
Trust preferred securities	17,119	—	17,119	—
I/O strip receivables	968	—	968	—

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 impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. The appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Table of Contents

Foreclosed assets are valued at the time the loan is foreclosed upon and the asset is transferred to foreclosed assets. The fair value is based primarily on third party appraisals, less costs to sell. The appraisals may utilize a single valuation approach or a combination of approaches including the comparable sales and income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

		Fair Value Measurements Using		
		Quoted Prices in	Other	Significant
		Active Markets for	Observable	Unobservable
		Identical Assets	Inputs	Inputs
	Balance	(Level 1)	(Level 2)	(Level 3)
	(Dollars in thousands)			
Assets at September 30, 2018				
Impaired loans - held-for-investment:				
Commercial	\$ 5,508	—	—	\$ 5,508
	\$ 5,508	—	—	\$ 5,508
Assets at December 31, 2017				
Impaired loans - held-for-investment:				
Commercial	\$ 242	—	—	\$ 242
Real estate:				
Land and construction	119	—	—	119
	\$ 361	—	—	\$ 361

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:

	September 30, 2018		December 31, 2017	
	(Dollars in thousands)			
Impaired loans held-for-investment:				
Book value of impaired loans held-for-investment carried at fair value	\$ 12,597		\$ 651	
Book value of impaired loans held-for-investment carried at cost	12,452		2,123	
Total impaired loans held-for-investment	\$ 25,049		\$ 2,774	
Impaired loans held-for-investment carried at fair value:				
Book value of impaired loans held-for-investment carried at fair value	\$ 12,597		\$ 651	
Specific valuation allowance	(7,089)		(290)	
Impaired loans held-for-investment carried at fair value, net	\$ 5,508		\$ 361	



Impaired loans held for investment which are measured primarily for impairment using the fair value of the collateral were \$25,049,000 at September 30, 2018. In addition, these loans had a specific valuation allowance of \$7,089,000 at September 30, 2018. Impaired loans held for investment totaling \$12,597,000 at September 30, 2018, were carried at fair value as a result of the aforementioned partial charge offs and specific valuation allowances at period end. The remaining \$12,452,000 of impaired loans were carried at cost at September 30, 2018, 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 nine months of 2018 on impaired loans held for investment carried at fair value at September 30, 2018 resulted in an additional provision for loan losses of \$7,042,000.

At September 30, 2018, there were no foreclosed assets.

Impaired loans held for investment were \$2,774,000 at December 31, 2017. There were no partial charge offs at December 31, 2017. In addition, these loans had a specific valuation allowance of \$290,000 at December 31, 2017. Impaired loans held for investment totaling \$651,000 at December 31, 2017 were carried at fair value as a result of the aforementioned partial charge offs and specific valuation allowances at year end. The remaining \$2,123,000 of impaired loans were carried at cost at December 31, 2017, 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 2017 on impaired loans

Table of Contents

held for investment carried at fair value at December 31, 2017 resulted in an additional provision for loan losses of \$254,000.

At December 31, 2017, there were no foreclosed assets

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

	September 30, 2018		Unobservable	Range
	Fair Value	Valuation Techniques	Inputs	(Weighted Average)
	(Dollars in thousands)			
Impaired loans - held-for-investment:				
Commercial	\$ 5,508	Market Approach	Discount adjustment for differences between comparable sales	Less than 1 %
	December 31, 2017		Unobservable	Range
	Fair Value	Valuation Techniques	Inputs	(Weighted Average)
	(Dollars in thousands)			
Impaired loans - held-for-investment:				
Commercial	\$ 242	Market Approach	Discount adjustment for differences between comparable sales	Less than 1 %
Real estate:				
Land and construction	119	Market Approach	Discount adjustment for differences between comparable sales	Less than 1 %

The Company obtains third party appraisals on its impaired loans held-for-investment and foreclosed assets to determine fair value. Generally, the third party appraisals apply the “market approach,” which is a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business. Adjustments are then made based on the type of property, age of appraisal, current status of property and other related factors to estimate the current value of collateral.



# Table of Contents

The carrying amounts and estimated fair values of financial instruments at September 30, 2018 are as follows:

	Carrying Amounts (Dollars in thousands)	Estimated Fair Value Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:					
Cash and cash equivalents	\$ 381,029	\$ 381,029	\$ —	\$ —	\$ 381,029
Securities available-for-sale	319,071	—	319,071	—	319,071
Securities held-to-maturity	375,732	—	359,698	—	359,698
Loans (including loans held-for-sale), net	1,878,305	—	6,344	1,840,231	1,846,575
FHLB stock, FRB stock, and other investments	25,210	—	—	—	N/A
Accrued interest receivable	9,213	—	2,327	6,886	9,213
I/O strips receivables	863	—	863	—	863
Liabilities:					
Time deposits	\$ 155,879	\$ —	\$ 156,206	\$ —	\$ 156,206
Other deposits	2,589,420	—	2,589,420	—	2,589,420
Subordinated debt	39,322	—	39,322	—	39,322
Accrued interest payable	1,026	—	1,026	—	1,026

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2017:

	Carrying Amounts (Dollars in thousands)	Estimated Fair Value Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:					
Cash and cash equivalents	\$ 316,222	\$ 316,222	\$ —	\$ —	\$ 316,222
Securities available-for-sale	391,852	—	391,852	—	391,852
Securities held-to-maturity	398,341	—	394,292	—	394,292
Loans (including loans held-for-sale), net	1,566,428	—	3,419	1,507,967	1,511,386

FHLB stock, FRB stock, and  
other

investments	17,911	—	—	—	N/A
Accrued interest receivable	7,985	—	2,423	5,562	7,985
I/O strips receivables	968	—	968	—	968
Liabilities:					
Time deposits	\$ 194,561	\$ —	\$ 194,844	\$ —	\$ 194,844
Other deposits	2,288,428	—	2,288,428	—	2,288,428
Subordinated debt	39,183	—	40,384	—	40,384
Accrued interest payable	389	—	389	—	389

The methods and assumptions, not previously discussed, used to estimate the fair value of loans, including loans held-for-sale, are described as follows:

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

The Company adopted ASU No. 2016-01, effective January 1, 2018. Adoption of the standard resulted in the use of an exit price rather than an entrance price to determine the fair value of loans, excluding loans held-for-sale, using discounted cash flow analyses as of September 30, 2018. The discount rates used to determine fair value use interest rate spreads that reflect factors such as liquidity, credit, and nonperformance risk of the loans, resulting in a level 3 classification.

Table of Contents

Fair values of loans, excluding loans held-for-sale, were estimated as follows as of December 31, 2017: 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. The methods utilized to estimate the fair value of loans as of December 31, 2017 do not necessarily represent an exit price.

Impaired loans as of September 30, 2018 and December 31, 2017 are valued at the lower of cost or fair value as described previously.

## 11) Equity Plan

The Company maintained an Amended and Restated 2004 Equity Plan (the “2004 Plan”) for directors, officers, and key employees. The 2004 Plan was terminated on May 23, 2013. On May 23, 2013, the Company’s shareholders approved the 2013 Equity Incentive Plan (the “2013 Plan”). On May 25, 2017, the shareholders approved an amendment to the Heritage Commerce Corp 2013 Equity Incentive Plan to increase the number of shares available from 1,750,000 to 3,000,000 shares. The equity plans provide for the grant of incentive and nonqualified stock options and restricted stock. The equity plans provide that the option price for both incentive and nonqualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally options vest over four years. All options expire no later than ten years from the date of grant. Restricted stock is subject to time vesting. For the nine months ended September 30, 2018, the Company granted 305,500 shares of nonqualified stock options and 97,818 shares of restricted stock. There were 1,186,800 shares available for the issuance of equity awards under the 2013 Plan as of September 30, 2018.

Stock option activity under the equity plans is as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Total Stock Options				
Outstanding at January 1, 2018	1,602,732	\$ 9.54		
Granted	305,500	\$ 16.82		
Exercised	(259,770)	\$ 9.62		
Forfeited or expired	(84,079)	\$ 14.20		
Outstanding at September 30, 2018	1,564,383	\$ 10.69	6.64	\$ 7,176,631
Vested or expected to vest	1,470,520		6.64	\$ 6,746,033

Exercisable at September 30, 2018	1,011,193	5.46	\$ 6,475,976
-----------------------------------	-----------	------	--------------

Information related to the equity plans for the periods indicated:

	Nine Months Ended September 30,	
	2018	2017
Intrinsic value of options exercised	\$ 1,767,884	\$ 1,331,528
Cash received from option exercise	\$ 2,499,481	\$ 1,352,236
Tax benefit realized from option exercises	\$ 513,901	\$ 543,654
Weighted average fair value of options granted	\$ 3.07	\$ 2.66

As of September 30, 2018, there was \$1,499,000 of total unrecognized compensation cost related to nonvested stock options granted under the equity plans. That cost is expected to be recognized over a weighted average period of approximately 2.80 years.

Table of Contents

The fair value of each option grant is estimated on the date of grant using the Black Scholes option pricing model that uses the assumptions noted in the following table, including the weighted average assumptions for the option grants for the periods indicated:

	Nine Months Ended September 30,			
	2018		2017	
Expected life in months(1)	72		72	
Volatility(1)	21	%	24	%
Weighted average risk-free interest rate(2)	2.87	%	1.94	%
Expected dividends(3)	2.62	%	2.78	%

- 
- (1) The expected life of employee stock options represents the weighted average period the stock options are expected to remain outstanding based on historical experience. Volatility is based on the historical volatility of the stock price over the same period of the expected life of the option.
- (2) Based on the U.S. Treasury constant maturity interest rate with a term consistent with the expected life of the option granted.
- (3) Each grant's dividend yield is calculated by annualizing the most recent quarterly cash dividend and dividing that amount by the market price of the Company's common stock as of the grant date
- 

Restricted stock activity under the equity plans is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
Total Restricted Stock Award		
Nonvested shares at January 1, 2018	181,185	\$ 11.66
Granted	97,818	\$ 16.83
Vested	(67,015)	\$ 16.69
Forfeited or expired	(2,440)	\$ 12.65
Nonvested shares at September 30, 2018	209,548	\$ 11.04

As of September 30, 2018, there was \$2,386,000 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the equity plans. The cost is expected to be recognized over a weighted average period of approximately 2.67 years.



12) Subordinated Debt

On May 26, 2017, the Company completed an underwritten public offering of \$40,000,000 aggregate principal amount of its fixed-to-floating rate subordinated notes (“Subordinated Debt”) due June 1, 2027. The Subordinated Debt initially bears a fixed interest rate of 5.25% per year. Commencing on June 1, 2022, the interest rate on the Subordinated Debt resets quarterly to the three-month LIBOR rate plus a spread of 336.5 basis points, payable quarterly in arrears. Interest on the Subordinated Debt is payable semi-annually on June 1st and December 1st of each year through June 1, 2022 and quarterly thereafter on March 1st, June 1st, September 1st and December 1st of each year through the maturity date or early redemption date. The Company at its option may redeem the Subordinated Debt, in whole or in part, on any interest payment date on or after June 1, 2022 without a premium.

Table of Contents

## 13) Capital Requirements

The Company and its subsidiary bank are subject to various regulatory capital requirements administered by the banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Company’s financial statements and operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and HBC must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off balance sheet items as calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. There are no conditions or events since September 30, 2018, that management believes have changed the categorization of the Company or HBC as “well-capitalized.”

As of January 1, 2015, HCC and HBC along with other community banking organizations became subject to new capital requirements and certain provisions of the new rules will be phased in from 2015 through 2019. The Federal Banking regulators approved the new rules to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of The Dodd Frank Wall Street Reform and Consumer Protection Act of 2010, as amended. The new capital rules establish a “capital conservation buffer,” which must consist entirely of common equity Tier 1 capital. The capital conservation buffer is to be phased-in over four years beginning on January 1, 2016. The buffer was 0.625% of risk-weighted assets for 2016, 1.25% for 2017, and is 1.875% for 2018, and will be 2.5% for 2019 and thereafter. The Company and HBC must maintain a capital conservation buffer above the minimum risk-based capital requirements in order to avoid certain limitations on capital distributions, stock repurchases and discretionary bonus payments to executive officers. The Company’s consolidated capital ratios and the Bank’s capital ratios exceeded the regulatory guidelines for a well-capitalized financial institution under the Basel III regulatory requirements at September 30, 2018.

Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios (set forth in the tables below) of total, Tier 1 capital, and common equity Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of September 30, 2018 and December 31, 2017, the Company and HBC met all capital adequacy guidelines to which they were subject.

The Company’s consolidated capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of September 30, 2018, and December 31, 2017.

	Required For Capital Adequacy Purposes Under Basel III
Actual	

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	Amount	Ratio		Amount	Ratio (1)	
	(Dollars in thousands)					
As of September 30, 2018						
Total Capital	\$ 334,152	14.4	%	\$ 228,973	9.875	%
(to risk-weighted assets)						
Tier 1 Capital	\$ 266,654	11.5	%	\$ 182,599	7.875	%
(to risk-weighted assets)						
Common Equity Tier 1 Capital	\$ 266,654	11.5	%	\$ 147,818	6.375	%
(to risk-weighted assets)						
Tier 1 Capital	\$ 266,654	8.6	%	\$ 124,005	4.000	%
(to average assets)						

---

(1) Includes 1.875% capital conservation buffer, effective January 1, 2018, except the Tier 1 Capital to average assets ratio.

---

Table of Contents

	Actual Amount (Dollars in thousands)	Ratio		Required For Capital Adequacy Purposes Under Basel III Amount	Ratio (1)	
As of December 31, 2017						
Total Capital (to risk-weighted assets)	\$ 288,754	14.4	%	\$ 185,338	9.250	%
Tier 1 Capital (to risk-weighted assets)	\$ 229,258	11.4	%	\$ 145,265	7.250	%
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 229,258	11.4	%	\$ 115,210	5.750	%
Tier 1 Capital (to average assets)	\$ 229,258	8.0	%	\$ 114,959	4.000	%

(1) Includes 1.25% capital conservation buffer, effective January 1, 2017, except the Tier 1 Capital to average assets ratio.

HBC's actual capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of September 30, 2018, and December 31, 2017.

	Actual Amount (Dollars in thousands)	Ratio		To Be Well-Capitalized Under Basel III Regulatory Requirements Amount	Ratio		Required For Capital Adequacy Purposes Under Basel III Amount	Ratio (1)	
As of September 30, 2018									
Total Capital (to risk-weighted assets)	\$ 310,636	13.4	%	\$ 231,696	10.0	%	\$ 228,800	9.875	%
Tier 1 Capital (to risk-weighted assets)	\$ 282,460	12.2	%	\$ 185,357	8.0	%	\$ 182,461	7.875	%
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 282,460	12.2	%	\$ 150,602	6.5	%	\$ 147,706	6.375	%
Tier 1 Capital (to average assets)	\$ 282,460	9.1	%	\$ 154,920	5.0	%	\$ 123,936	4.000	%

- (1) Includes 1.875% capital conservation buffer, effective January 1, 2018, except the Tier 1 Capital to average assets ratio.
-

Table of Contents

	Actual			To Be Well-Capitalized Under Basel III Regulatory Requirements			Required For Capital Adequacy  Purposes Under Basel III		
	Amount	Ratio		Amount	Ratio		Amount	Ratio (1)	
	(Dollars in thousands)								
As of December 31, 2017									
Total Capital (to risk-weighted assets)	\$ 265,102	13.2	%	\$ 200,274	10.0	%	\$ 185,253	9.250	%
Tier 1 Capital (to risk-weighted assets)	\$ 244,790	12.2	%	\$ 160,219	8.0	%	\$ 145,198	7.250	%
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 244,790	12.2	%	\$ 130,178	6.5	%	\$ 115,157	5.750	%
Tier 1 Capital (to average assets)	\$ 244,790	8.5	%	\$ 143,655	5.0	%	\$ 114,924	4.000	%

(1) Includes 1.25% capital conservation buffer, effective January 1, 2017, except the Tier 1 Capital to average assets ratio.

The Subordinated Debt, net of unamortized issuance costs, totaled \$39,322,000 at September 30, 2018, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank.

Under California General Corporation Law, the holders of common stock are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available. The California Financial Code provides that a state licensed bank may not make a cash distribution to its shareholders in excess of the lesser of the following: (i) the bank's retained earnings; or (ii) the bank's net income for its last three fiscal years, less the amount of any distributions made by the bank to its shareholders during such period. However, a bank, with the prior approval of the Commissioner of the California Department of Business Oversight—Division of Financial Institutions ("DBO") may make a distribution to its shareholders of an amount not to exceed the greater of (i) a bank's retained earnings; (ii) its net income for its last fiscal year; or (iii) its net income for the current fiscal year. Also with the prior approval of the Commissioner of the DBO and the shareholders of the bank, the bank may make a distribution to its shareholders, as a reduction in capital of the bank. In the event that the Commissioner determines that the shareholders' equity of a bank is inadequate or that the making of a distribution by a bank would be unsafe or unsound, the Commissioner may order a bank to refrain from making such a proposed distribution. As of September 30, 2018, HBC would not be required to obtain regulatory approval, and the amount available for cash dividends is \$26,057,000. Similar restrictions applied to the amount and sum of loan advances and other transfers of funds from HBC to the parent company. During the third quarter of 2018, HBC distributed dividends of \$5,000,000 for a total of \$13,000,000 for the first nine months of 2018.

#### 14) Loss Contingencies

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.

#### 15) Revenue Recognition

On January 1, 2018, the Company adopted ASU No. 2014-09 (Topic 606) and all subsequent ASUs that modified Topic 606. As stated in Note 1 Basis of Presentation, the implementation of the new standard did not have a material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts were not adjusted and continue to be reported in accordance with our historic accounting under Topic 606.

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as fees associated with mortgage servicing rights, financial guarantees, gain on sale of securities, bank-owned life insurance, gain on sales of SBA loans, and certain credit card fees

## Table of Contents

are also not in scope of the new guidance. Topic 606 is applicable to noninterest revenue streams such as deposit related fees, interchange fees, and merchant income. However, the recognition of these revenue streams did not change significantly upon adoption of Topic 606. Substantially all of the Company's revenue is generated from contracts with customers. The following noninterest income revenue streams are in-scope of Topic 606:

### Service Charges on Deposit Accounts

Service charges on deposit accounts consist of account analysis fees (i.e., net fees earned on analyzed business and public checking accounts), monthly service fees, check orders, and other deposit account related fees. We sometimes charge customers fees that are not specifically related to the customer accessing its funds, such as account maintenance or dormancy fees. The amount of deposit fees assessed varies based on a number of factors, such as the type of customer and account, the quantity of transactions, and the size of the deposit balance. We charge, and in some circumstances do not charge, fees to earn additional revenue and influence certain customer behavior. An example would be where we do not charge a monthly service fee, or do not charge for certain transactions, for customers that have a high deposit balance. Deposit fees are considered either transactional in nature (such as wire transfers, nonsufficient fund fees, and stop payment orders) or non-transactional (such as account maintenance and dormancy fees). These fees are recognized as earned or as transactions occur and services are provided. Check orders and other deposit account related fees are largely transactional based and, therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers' accounts.

### Interchange Revenue

Interchange revenue primarily consists of interchange fees, volume-related incentives and ATM charges. As the card-issuing bank, interchange fees represent our portion of discount fees paid by merchants for credit / debit card transactions processed through the interchange network. The levels and structure of interchange rates are set by the credit card companies and are based on cardholder purchase volumes. The Company earns interchange income as cardholder transactions occur and interchange fees are settled on a daily basis. Since interchange fees are settled on a daily basis, the Company believes the application of Topic 606 to interchange fees would likely not lead to significantly different recognition and measurement outcomes when compared to our current accounting practice. In addition, the Company will continue to consider any constraint on the variability of consideration due to returns, refunds and chargebacks. ATM charges consist of fees received from non-customers using a bank-owned ATM and fees received for customers using a nonbank-owned ATM. These fees are earned when these types of ATM transactions occur.

### Merchant Services Revenue



Revenue from the Company's merchant services business consists principally of transaction and account management fees charged to merchants for the electronic processing of transactions. These fees are net of interchange fees paid to the credit card issuing bank, card company assessments, and revenue sharing amounts.

Based on the insignificant level of merchant services revenue, the Company has concluded that the application of Topic 606 to merchant services account management fees would likely not lead to significantly different recognition and measurement outcomes when compared to our current accounting practice. As a result, revenue from account management fees will continue to be recognized by the Company at the end of each month since the end of this measurement period allows us to reliably measure our progress towards completion of our performance obligation.

#### Other

Noninterest miscellaneous fees consist of charges for various other services including safe deposit box rentals, wire transfers, check cashing, telephone transfers, and online business banking. Given the insignificance of these amounts individually and in total, further consideration of these revenue streams under Topic 606 is not considered necessary.

Table of Contents

The following presents noninterest income, segregated by revenue streams in-scope and out-of-scope of Topic 606, for the periods indicated:

	Three Months Ended September 30, 2018          2017 (Dollars in thousands)	
Noninterest Income In-scope of Topic 606:		
Service charges and fees on deposit accounts	\$ 551	\$ 510
Interchange fees	83	75
Merchant services revenue	39	44
Other	179	166
Total noninterest income in-scope of Topic 606	852	795
Noninterest Income Out-of-scope of Topic 606	1,354	1,665
Total noninterest income	\$ 2,206	\$ 2,460

	Nine Months Ended September 30, 2018          2017 (Dollars in thousands)	
Noninterest Income In-scope of Topic 606:		
Service charges and fees on deposit accounts	\$ 1,524	\$ 1,449
Interchange fees	239	208
Merchant services revenue	122	129
Other	479	498
Total noninterest income in-scope of Topic 606	2,364	2,284
Noninterest Income Out-of-scope of Topic 606	4,817	4,764
Total noninterest income	\$ 7,181	\$ 7,048

## 16) Noninterest Expense

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

Three Months Ended September 30, 2018          2017		Nine Months Ended September 30, 2018          2017	
---	--	--	--

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	(Dollars in thousands)			
Salaries and employee benefits (1)	\$ 10,719	\$ 9,071	\$ 35,302	\$ 27,766
Occupancy and equipment	1,559	1,142	3,927	3,426
Professional fees	721	695	1,116	2,439
Amortization of intangible assets	631	296	1,336	1,083
Software subscriptions	555	475	1,747	1,333
Data processing	525	411	1,501	1,080
Insurance expense	430	401	1,236	1,123
Acquisition and integration related costs	16	—	5,452	—
Other	2,572	2,343	6,963	7,166
Total	\$ 17,728	\$ 14,834	\$ 58,580	\$ 45,416

---

(1) Includes severance and retention retention expense related to the Tri-Valley and United American acquisitions of \$183,000 and \$3,576,000 for third quarter of 2018 and the first nine months of 2018, respectively

---



Table of Contents

## 17) Business Segment Information

The following presents the Company's operating segments. The Company operates through two business segments: Banking segment and Factoring segment. Transactions between segments consist primarily of borrowed funds. Intersegment interest expense is allocated to the Factoring segment based on the Company's prime rate and funding costs. The provision for loan loss is allocated based on the segment's allowance for loan loss determination which considers the effects of charge-offs. Noninterest income and expense directly attributable to a segment are assigned to it. Taxes are paid on a consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring originated by Bay View Funding.

	Three Months Ended September 30, 2018		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 30,425	4,185	\$ 34,610
Intersegment interest allocations	601	(601)	—
Total interest expense	2,159	—	2,159
Net interest income	28,867	3,584	32,451
Provision (credit) for loan losses	(671)	246	(425)
Net interest income after provision	29,538	3,338	32,876
Noninterest income	2,011	195	2,206
Noninterest expense (2)	16,045	1,683	17,728
Intersegment expense allocations	172	(172)	—
Income before income taxes	15,676	1,678	17,354
Income tax (benefit) expense	4,483	496	4,979
Net income	\$ 11,193	\$ 1,182	\$ 12,375
Total assets	\$ 3,107,897	\$ 85,013	\$ 3,192,910
Loans, net of deferred fees	\$ 1,828,379	\$ 71,008	\$ 1,899,387
Goodwill	\$ 70,708	\$ 13,044	\$ 83,752

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

(2) The banking segment's noninterest expense includes acquisition cost of \$199,000

	Three Months Ended September 30, 2017		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 24,805	\$ 3,150	\$ 27,955
Intersegment interest allocations	284	(284)	—
Total interest expense	1,634	—	1,634
Net interest income	23,455	2,866	26,321
Provision for loan losses	107	8	115
Net interest income after provision	23,348	2,858	26,206

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Noninterest income	2,101	359	2,460
Noninterest expense	13,149	1,685	14,834
Intersegment expense allocations	130	(130)	—
Income before income taxes	12,430	1,402	13,832
Income tax expense	4,660	589	5,249
Net income	\$ 7,770	\$ 813	\$ 8,583
<hr/>			
Total assets	\$ 2,776,262	\$ 67,686	\$ 2,843,948
Loans, net of deferred fees	\$ 1,517,186	\$ 48,764	\$ 1,565,950
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

---

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

---

Table of Contents

	Nine Months Ended September 30, 2018		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 83,781	\$ 10,686	\$ 94,467
Intersegment interest allocations	1,304	(1,304)	—
Total interest expense	5,504	—	5,504
Net interest income	79,581	9,382	88,963
Provision for loan losses	6,958	321	7,279
Net interest income after provision	72,623	9,061	81,684
Noninterest income	6,628	553	7,181
Noninterest expense (2)	53,813	4,767	58,580
Intersegment expense allocations	574	(574)	—
Income before income taxes	26,012	4,273	30,285
Income tax expense	6,923	1,263	8,186
Net income	\$ 19,089	\$ 3,010	\$ 22,099
<hr/>			
Total assets	\$ 3,107,897	85,013	\$ 3,192,910
Loans, net of deferred fees	\$ 1,828,379	71,008	\$ 1,899,387
Goodwill	\$ 70,708	13,044	\$ 83,752

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

(2) The banking segment's noninterest expense includes acquisition costs of \$9,028,000

	Nine Months Ended September 30, 2017		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 70,146	\$ 8,613	\$ 78,759
Intersegment interest allocations	786	(786)	—
Total interest expense	3,679	—	3,679
Net interest income	67,253	7,827	75,080
Provision for loan losses	372	18	390
Net interest income after provision	66,881	7,809	74,690
Noninterest income	6,153	895	7,048
Noninterest expense	40,152	5,264	45,416
Intersegment expense allocations	392	(392)	—
Income before income taxes	33,274	3,048	36,322
Income tax expense	12,472	1,280	13,752
Net income	\$ 20,802	\$ 1,768	\$ 22,570
<hr/>			
Total assets	\$ 2,776,262	\$ 67,686	\$ 2,843,948
Loans, net of deferred fees	\$ 1,517,186	\$ 48,764	\$ 1,565,950
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

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

18) Subsequent Events

On October 25, 2018, the Company announced that its Board of Directors declared a \$0.11 per share quarterly cash dividend to holders of common stock. The dividend will be paid on November 20, 2018 to shareholders of record on November 6, 2018.



## Table of Contents

### ITEM 2—MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources of Heritage Commerce Corp (the “Company” or “HCC”), its wholly owned subsidiary, Heritage Bank of Commerce (“HBC”), and HBC’s wholly owned subsidiary, CSNK Working Capital Finance Corp., a California Corporation, dba Bay View Funding (“Bay View Funding”). This information is intended to facilitate the understanding and assessment of significant changes and trends related to our financial condition and the results of operations. This discussion and analysis should be read in conjunction with our consolidated financial statements and the accompanying notes presented elsewhere in this report. Unless we state otherwise or the context indicates otherwise, references to the “Company,” “Heritage,” “we,” “us,” and “our,” in this Report on Form 10 Q refer to Heritage Commerce Co and its subsidiaries.

### CRITICAL ACCOUNTING POLICIES

Critical accounting policies are discussed in our Form 10 K for the year ended December 31, 2017. There are no changes to these policies as of September 30, 2018.

### EXECUTIVE SUMMARY

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

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

### Performance Overview

For the three months ended September 30, 2018, net income was \$12.4 million, or \$0.28 per average diluted common share, compared to \$8.6 million, or \$0.22 per average diluted common share, for the three months ended September

30, 2017. The Company's annualized return on average tangible assets was 1.54% and annualized return on average tangible equity was 19.36% for the three months ended September 30, 2018, compared to 1.22% and 15.41%, respectively, for the three months ended September 30, 2017.

For the nine months ended September 30, 2018, net income was \$22.1 million, or \$0.53 per average diluted common share, compared to \$22.6 million, or \$0.59 per average diluted common share, for the nine months ended September 30, 2017. The Company's annualized return on average tangible assets was 1.01% and annualized return on average tangible equity was 12.33% for the nine months ended September 30, 2018 compared to 1.14% and 14.11%, respectively, for the nine months ended September 30, 2017.

#### Tri-Valley Bank and United American Bank Mergers

The Company completed the merger of its wholly-owned bank subsidiary Heritage Bank of Commerce with Tri-Valley Bank ("Tri-Valley") effective as of the close on April 6, 2018. Tri-Valley's results of operations have been included in the Company's results of operations beginning April 7, 2018.

Tri-Valley was a full-service California state-chartered commercial bank with branches in San Ramon and Livermore, California and served businesses and individuals primarily in Contra Costa and Alameda counties in Northern California. The Company closed the San Ramon office on July 13, 2018.

## Table of Contents

The Company completed the merger of its wholly-owned bank subsidiary Heritage Bank of Commerce with United American Bank (“United American”) effective as of the close on May 4, 2018. United American’s results of operations have been included in the Company’s results of operations beginning May 5, 2018.

United American was a full-service commercial bank located in San Mateo County with full-service branches located in San Mateo, Redwood City and Half Moon Bay, California and serviced businesses, professionals and individuals. The Company closed the Half Moon Bay office on August 10, 2018.

Tri-Valley added \$115.2 million in loans, at fair value, and \$91.4 million in deposits, at fair value, at September 30, 2018. United American added \$208.8 million in loans, at fair value, and \$266.6 million in deposits, at fair value, at September 30, 2018. Severance, retention, acquisition, and integration costs related to the two mergers totaled \$199,000 for the third quarter of 2018, and \$9.0 million for the first nine months of 2018.

### Factoring Activities - Bay View Funding

Based in Santa Clara, California, Bay View Funding provides business-essential working capital factoring financing to various industries throughout the United States. The following table reflects selected financial information for Bay View Funding for the periods indicated:

	September 30, 2018	September 30, 2017
	(Dollars in thousands)	
Total factored receivables	\$ 71,008	\$ 48,764
Average factored receivables		
For the three months ended	\$ 69,740	\$ 45,323
for the nine months ended	\$ 57,096	\$ 44,097
Total full time equivalent employees	37	40

### Third Quarter 2018 Highlights

The following are important factors that impacted the Company’s results of operations:

- Net interest income, before provision for loan losses, increased 23% to \$32.5 million for the third quarter of 2018, compared to \$26.3 million for the third quarter of 2017. For the first nine months of 2018, net interest income increased 18% to \$89.0 million, compared to \$75.1 million for the first nine months of 2017. Net interest income increased for the third quarter of 2018 and the first nine months of 2018, compared to the respective periods in 2017, primarily due to the impact of the increase in loans and deposits from the Tri-Valley and United American acquisitions, in addition to organic loan growth and the positive impact of rising interest rates.

For the third quarter of 2018, the fully tax equivalent (“FTE”) net interest margin increased 38 basis points to 4.36% from 3.98% for the third quarter of 2017. The improvement was primarily due to a higher average balance of loans, an increase in the accretion of the loan purchase discount into loan interest income from the Tri-Valley and the United American acquisitions in the second quarter of 2018, the impact of increases in the prime rate, and the rate on overnight funds.

- For the first nine months of 2018, the net interest margin increased 24 basis points to 4.27%, compared to 4.03% for the first nine months of 2017, primarily due to a higher average balance of loans and securities, an increase in the accretion of the loan purchase discount into loan interest income from the acquisitions, the impact of increases in the prime rate, and the rate on overnight funds.
- The average yield on the loan portfolio increased to 5.92% for the third quarter of 2018, compared to 5.72% for the third quarter of 2017, primarily due to an increase in the accretion of the loan purchase discount into loan interest income from the acquisitions, and increases in the prime rate. The average yield on the Company’s legacy loan portfolio (excluding the purchased residential loans, purchased commercial real estate (“CRE”) loans, factored receivables portfolio, and accretion of the loan purchase discount from the acquisitions) increased 10 basis points for the third quarter of 2018, compared to the third quarter of 2017.

## Table of Contents

The average yield on the purchased residential loans was 2.68% for the third quarter of 2018, compared to 2.67% for the third quarter of 2017. The average yield on the purchased CRE loans was 3.24% for the third quarter of 2018, compared to 3.52% the third quarter of 2017.

- The yield on the loan portfolio increased to 5.82% for the first nine months of 2018, compared to 5.63% for the first nine months of 2017, primarily due to an increase in accretion of the loan purchase discount into loan interest income from the acquisitions and increases in the prime rate. The yield on the Company's legacy loan portfolio (excluding the purchased residential loans, purchased CRE loans, factored receivables portfolio, and accretion of the loan purchase discount from the acquisitions) increased 9 basis points for the first nine months of 2018, compared to the first nine months of 2017. The yield on the purchased residential loans was 2.71% for the first nine months of 2018, compared to 2.67% for the first nine months of 2017. The yield on the purchased CRE loans was 3.45% for the first nine months of 2018, compared to 3.51% for the first nine months of 2017.
- The accretion of the loan purchase discount into loan interest income from the three acquisitions was \$506,000 for the third quarter of 2018, compared to \$270,000 for the third quarter of 2017. The accretion of the loan purchase discount into loan interest income from the three acquisitions was \$1.2 million for the first nine months of 2018, compared to \$741,000 for the first nine months of 2017. The total purchase discount on loans from Focus Business Bank ("Focus") loan portfolio was \$5.4 million on the acquisition date of August 20, 2015, of which \$790,000 remains outstanding as of September 30, 2018. The total purchase discount on loans from Tri-Valley loan portfolio was \$2.6 million on the acquisition date of April 6, 2018, of which \$2.4 million remains outstanding as of September 30, 2018. The total purchase discount on loans from United American loan portfolio was \$4.7 million on the acquisition date of May 4, 2018, of which \$4.0 million remains outstanding as of September 30, 2018.
- There was a (\$425,000) credit to the provision for loan losses for the third quarter of 2018, compared to a \$115,000 provision for loan losses for the third quarter of 2017. The credit to the provision for loan losses for the third quarter of 2018 was primarily due to net recoveries of \$1.2 million. For the nine months ended September 30, 2018, there was a \$7.3 million provision for loan losses, compared to a \$390,000 provision for loan loan losses for the nine months ended September 30, 2017. The increase in the provision for loan losses for the first nine months of 2018 compared to the first nine months of 2017 was primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018.
- Total noninterest income was \$2.2 million for the third quarter of 2018, compared to \$2.5 million for the third quarter of 2017. For the nine months ended September 30, 2018, total noninterest income was \$7.2 million, compared to \$7.0 million for the nine months ended September 30, 2017. The increase in noninterest income for first nine months of 2018, compared to the first nine months of 2017, was primarily due to proceeds from a legal settlement during the second quarter of 2018, higher service charges and fees on deposit accounts and gain on sales of securities for the first nine months of 2018, partially offset by a lower increase in cash surrender value of life insurance proceeds, servicing income, and gain on sale of SBA loans for the first nine months of 2018. The first nine months of 2017 also included a higher fee income from Bay View Funding compared to the first nine months of 2018, which was included in other noninterest income.
- Total noninterest expense for the third quarter of 2018 was \$17.7 million, compared to \$14.8 million for the third quarter of 2017. Noninterest expense for the nine months ended September 30, 2018 was \$58.6 million, compared to \$45.4 million for the nine months ended September 30, 2017. The increase in noninterest expense in the first nine months of 2018, compared to first nine months of 2017, was primarily due to costs related to the merger transactions and higher salaries and employee benefits as a result of annual salary increases, and additional operating costs of

Tri-Valley and United American, partially offset by lower professional fees.

- The efficiency ratio for the third quarter of 2018 was 51.15%, compared to 51.54% for the third quarter of 2017. The efficiency ratio for the nine months ended September 30, 2018 was 60.93%, compared to 55.30% for the nine months ended September 30, 2017.

## Table of Contents

- The income tax expense for the third quarter of 2018 was \$5.0 million, compared income tax expense of \$5.2 million for the third quarter of 2017. The effective tax rate for the third quarter of 2018 decreased to 28.7%, compared to 37.9% for the third quarter of 2017, primarily due to a lower federal corporate tax rate for the third quarter of 2018. On December 22, 2017 the Tax Cuts and Jobs Act (the “Tax Act”), was signed into law, which among other items reduced the federal corporate tax rate to 21% from 35%, effective January 1, 2018. Income tax expense for the nine months ended September 30, 2018 was \$8.2 million, compared to \$13.8 million for the nine months ended September 30, 2017. The effective tax rate for the nine months ended September 30, 2018 was 27.0%, compared to 37.9% for the nine months ended September 30, 2017.

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

- Cash, other investments and interest bearing deposits in other financial institutions and securities available for sale, at fair value, decreased (5%) to \$700.1 million at September 30, 2018, from \$736.2 million at September 30, 2017, and decreased (1%) from \$708.1 million at December 31, 2017.
- At September 30, 2018, securities held to maturity, at amortized cost, totaled \$375.7 million, compared to \$379.5 million at September 30, 2017, and \$398.3 million at December 31, 2017.
- Loans, excluding loans held-for-sale, increased \$333.4 million, or 21%, to \$1.90 billion at September 30, 2018, compared to \$1.57 billion at September 30, 2017, which included \$208.8 million in loans from United American, \$115.2 million in loans from Tri-Valley, and an increase of \$20.3 million, or 1% in the Company’s legacy portfolio, partially offset by a decrease of \$7.5 million in purchased residential mortgage loans, and a decrease of \$3.4 million of purchased CRE loans. Loans increased \$316.7 million, or 20%, to \$1.90 billion at September 30, 2018, compared to \$1.58 billion at December 31, 2017, which included \$208.8 million in loans from United American, \$115.2 million in loans from Tri-Valley, and an increase of \$1.4 million in the Company’s legacy portfolio, and partially offset by a decrease of \$5.6 million in purchased residential mortgage loans, and \$3.1 million in purchased CRE loans.
- Nonperforming assets (“NPAs”) increased to \$24.7 million, or 0.77% of total assets, at September 30, 2018, compared to \$3.5 million, or 0.12% of total assets, at September 30, 2017, and \$2.5 million, or 0.09% of total assets, at December 31, 2017, primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018.
- Classified assets increased to \$30.5 million, at September 30, 2018, compared to \$10.9 million, at September 30, 2017, primarily due to a single large lending relationship that was moved to classified assets during the fourth quarter of 2017. Classified assets were \$25.1 million at December 31, 2017. There were no foreclosed assets at September 30, 2018, September 30, 2017, and December 31, 2017.
- Net recoveries totaled \$1.2 million for the third quarter of 2018, compared to net recoveries of \$236,000 for the third quarter of 2017, and net recoveries of \$201,000 for the fourth quarter of 2017.

- The allowance for loan losses (“ALLL”) at September 30, 2018 was \$27.4 million, or 1.44% of total loans, representing 110.97% of total nonperforming loans. The allowance for loan losses at September 30, 2017 was \$19.7 million, or 1.26% of total loans, representing 565.68% of total nonperforming loans. The allowance for loan losses at December 31, 2017 was \$19.7 million, or 1.24% of total loans, representing 791.07% of total nonperforming loans. The ALLL to total nonperforming loans decreased at September 30, 2018, compared to September 30, 2017 and December 31, 2017, primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018.
- Total deposits increased \$264.7 million, or 11%, to \$2.75 billion at September 30, 2018, compared to \$2.48 billion at September 30, 2017, which included \$266.6 million, at fair value, in deposits from United American, \$91.4 million, at fair value, in deposits from Tri-Valley, partially offset by decrease of \$28.2 million, or (1%), in the Company’s legacy deposits. Total deposits increased \$262.3 million or 11% from \$2.48 billion at December 31, 2017, which included \$266.6 million, at fair value, in deposits from United American, \$91.4 million, at fair value, in deposits from Tri-Valley, partially offset by the maturity of \$65.1



Table of Contents

million State of California certificates of deposits, and a decrease of \$30.6 million in the Company's legacy deposits.

- Deposits, excluding all time deposits and CDARS deposits, increased \$318.1 million, or 14%, to \$2.58 billion at September 30, 2018, compared to \$2.26 billion at September 30, 2017, which included \$231.9 million of deposits added from United American, \$83.0 million of deposits added from Tri-Valley, and an increase of \$3.1 million in the Company's legacy deposits. Deposits, excluding all time deposits and CDARS deposits, increased \$305.0 million, or 13%, compared to \$2.28 billion at December 31, 2017, which included \$231.9 million of deposits added from United American, \$83.0 million of deposits added from Tri-Valley, partially offset by a decrease of \$10.0 million, in the Company's legacy deposits.
- The ratio of noncore funding (which consists of time deposits of \$250,000 and over, CDARS deposits, brokered deposits, securities under an agreement to repurchase, subordinated debt, and short term borrowings) to total assets was 4.25% at September 30, 2018, compared to 7.16% at September 30, 2017, and 6.85% at December 31, 2017.
- The loan to deposit ratio was 69.19% at September 30, 2018, compared to 63.13% at September 30, 2017, and 63.74% at December 31, 2017.
- The Company's consolidated capital ratios exceeded regulatory guidelines and the Bank's capital ratios exceeded the regulatory guidelines for a well capitalized financial institution under the Basel III regulatory requirements at September 30, 2018.

	Heritage	Heritage	Well-capitalized	Fully Phased-in
	Commerce	Bank of	Financial	Basel III
Capital Ratios	Corp	Commerce	Institution	Minimum
Total Risk-Based	14.4 %	13.4 %	Basel III	Requirement(1)
Tier 1 Risk-Based	11.5 %	12.2 %	Regulatory	Effective
Common Equity Tier 1 Risk-based	11.5 %	12.2 %	Guidelines	January 1, 2019
Leverage	8.6 %	9.1 %		

(1) Fully phased in Basel III requirements for both HCC and HBC include a 2.5% capital conservation buffer, except the leverage ratio.

## 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. The Company's depositors are generally located in its primary market area. Depending on loan demand and other funding requirements, the Company also obtains deposits from wholesale sources including deposit brokers. HBC is a member of the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program allows customers with deposits in excess of FDIC insured limits to obtain coverage on time deposits through a network of banks within the CDARS program. The Company has a policy to monitor all deposits that may be sensitive to interest rate changes to help assure that liquidity risk does not become excessive due to concentrations.

Total deposits increased \$264.7 million, or 11%, to \$2.75 billion at September 30, 2018, compared to \$2.48 billion at September 30, 2017, which included \$266.6 million, at fair value, in deposits from United American, \$91.4 million, at fair value, in deposits from Tri-Valley, partially offset by decrease of \$28.2 million, or (1%), in the Company's legacy deposits balances. Total deposits increased \$262.3 million or 11% from \$2.48 billion at December 31, 2017, which included \$266.6 million in deposits from United American, \$91.4 million in deposits from Tri-Valley, partially offset by the maturity of \$65.1 million State of California certificates of deposits, and a decrease of \$30.6 million in the Company's legacy deposits.

Deposits, excluding all time deposits and CDARS deposits, increased \$318.1 million, or 14%, to \$2.58 billion at September 30, 2018, compared to \$2.26 billion at September 30, 2017, which included \$231.9 million of deposits added

## Table of Contents

from United American, \$83.0 million of deposits added from Tri-Valley, and an increase of \$3.1 million in the Company's legacy deposits. Deposits, excluding all time deposits and CDARS deposits, increased \$305.0 million, or 13%, compared to \$2.28 billion at December 31, 2017, which included \$231.9 million of deposits added from United American, \$83.0 million of deposits added from Tri-Valley, partially offset by a decrease of \$10.0 million, in the Company's legacy deposits.

## 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. 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. At September 30, 2018, we had \$381.0 million in cash and cash equivalents and approximately \$635.9 million in available borrowing capacity from various sources including the Federal Home Loan Bank ("FHLB"), the Federal Reserve Bank of San Francisco ("FRB"), Federal funds facilities with several financial institutions, and line of credit with a correspondent bank. The Company also had \$636.6 million at fair value in unpledged securities available at September 30, 2018. Our loan to deposit ratio was 69.19% at September 30, 2018, compared to 63.13% at September 30, 2017, and 63.74% at December 31, 2017.

## Lending

Our lending business originates principally through our branch offices located in our primary markets. In addition, Bay View Funding provides factoring financing throughout the United States. Total loans, excluding loans held-for-sale, increased \$333.4 million, or 21%, to \$1.90 billion at September 30, 2018, compared to \$1.57 billion at September 30, 2017, which included \$208.8 million in loans from United American, \$115.2 million in loans from Tri-Valley, and an increase of \$20.3 million, or 1% in the Company's legacy portfolio, partially offset by a decrease of \$7.5 million in purchased residential mortgage loans, and a decrease of \$3.4 million of purchased CRE loans. Loans increased \$316.7 million, or 20%, to \$1.90 billion at September 30, 2018, compared to \$1.58 billion at December 31, 2017, which included \$208.8 million in loans from United American, \$115.2 million in loans from Tri-Valley, and an increase of \$1.4 million, or 1%, in the Company's legacy portfolio, partially offset by a decrease of \$5.6 million in purchased residential mortgage loans, and \$3.1 million in purchased CRE loans. The loan portfolio remains well-diversified with commercial and industrial ("C&I") loans accounting for 31% of the loan portfolio at September 30, 2018, which included \$71.0 million of factored receivables. CRE loans accounted for 52% of the total loan portfolio, of which 39% were occupied by businesses that own them. Land and construction loans accounted for 7% of total loans, consumer and home equity loans accounted for 7% of total loans, and residential mortgage loans accounted for the remaining 3% of total loans at September 30, 2018.

## Net Interest Income

The management of interest income and expense is fundamental to the performance of the Company. Net interest income, the difference between interest income and interest expense, is the largest component of the Company's total revenue. Management closely monitors both total net interest income and the net interest margin (net interest income divided by average earning assets). Net interest income before provision for loan losses increased 23% to \$32.5 million for the third quarter of 2018, compared to \$26.3 million for the third quarter of 2017. For the first nine months of 2018, net interest income increased 18% to \$89.0 million, compared to \$75.1 million for the first nine months of 2017. Net interest income increased for the first nine months of 2018, compared to the first nine months of 2017, primarily due to the impact of the increase in loans and deposits from the Tri-Valley and United American acquisitions, in addition to organic loan growth and the positive impact of rising interest rates.

The Company through its asset and liability policies and practices seeks to maximize net interest income without exposing the Company to an excessive level of interest rate risk. Interest rate risk is managed by monitoring the pricing, maturity and repricing options of all classes of interest bearing assets and liabilities. This is discussed in more detail under "Liquidity and Asset/Liability Management." In addition, we believe there are measures and initiatives we can take to improve the net interest margin, including increasing loan rates, adding floors on floating rate loans, reducing nonperforming assets, managing deposit interest rates, and reducing higher cost deposits.

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

## Table of Contents

### Management of Credit Risk

We continue to 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 will deteriorate, some of which could occur in an accelerated time frame. As a result, future additions to the allowance for loan losses may be necessary. Because the loan portfolio contains a number of commercial loans, commercial real estate, construction and land development loans with relatively large balances, deterioration in the credit quality of one or more of these loans may require a significant increase to the allowance for loan losses. Future additions to the allowance may also be required based on changes in the financial condition of borrowers. Additionally, Federal and state banking regulators, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to recognize further loan loss provisions or charge offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses would have an adverse effect, which may be material, on our financial condition and results of operation. Further discussion of the management of credit risk appears under “Provision for Loan Losses” and “Allowance for Loan Losses.”

In June 2016, the FASB issued new guidance on measurement of credit losses on financial instruments, which is the final guidance on the new current expected credit loss (“CECL”) model. The new guidance will replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to estimate future credit loss estimates. Management is currently evaluating the impact of adopting CECL, which becomes effective for the Company on January 1, 2020. The effect of the adoption of CECL is currently unknown and could result in an increase to the allowance for loan losses and a charge to equity. Further discussion of the adoption of CECL appears in Note 1 – Basis of Presentation – Newly Issued, but not yet Effective Accounting Standards in the financial statements in this Form 10-Q.

### 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. Total noninterest expense for the third quarter of 2018 was \$17.7 million, compared to \$14.8 million for the third quarter of 2017. Noninterest expense for the nine months ended September 30, 2018 was \$58.5 million, compared to \$45.4 million for the nine months ended September 30, 2017. The increase in noninterest expense in the first nine months of 2018, compared to first nine months of 2017, was primarily due to costs related to the merger transactions and higher salaries and employee benefits as a result of annual salary increases, and additional operating costs of Tri-Valley and United American, partially offset by lower professional fees.

## 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.

Table of Contents

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 and lending services to our customers.

Net Interest Income and Net Interest Margin

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

The following Distribution, Rate and Yield table presents the average amounts outstanding for the major categories of the Company's balance sheet, the average interest rates earned or paid thereon, and the resulting net interest margin on average interest earning assets for the periods indicated. Average balances are based on daily averages.

Table of Contents

## Distribution, Rate and Yield

	Three Months Ended September 30, 2018				Three Months Ended September 30, 2017			
	Average Balance	Interest Income / Expense	Average Yield / Rate		Average Balance	Interest Income / Expense	Average Yield / Rate	
	(Dollars in thousands)							
Assets:								
Loans, gross (1)(2)	\$ 1,918,791	28,632	5.92	%	\$ 1,560,421	22,507	5.72	%
Securities — taxable	624,352	3,483	2.21	%	671,528	3,596	2.12	%
Securities — exempt from Federal tax (3)	87,410	702	3.19	%	89,426	866	3.84	%
Other investments, interest-bearing deposits in other financial institutions and Federal funds sold	335,373	1,940	2.29	%	335,706	1,289	1.52	%
Total interest earning assets (3)	2,965,926	34,757	4.65	%	2,657,081	28,258	4.22	%
Cash and due from banks	40,704				35,173			
Premises and equipment, net	7,320				7,609			
Goodwill and other intangible assets	96,436				51,715			
Other assets	82,753				85,229			
Total assets	\$ 3,193,139				\$ 2,836,807			
Liabilities and shareholders' equity:								
Deposits:								
Demand, noninterest-bearing	\$ 1,071,638				\$ 980,554			
Demand, interest-bearing	682,694	551	0.32	%	583,363	290	0.20	%
Savings and money market	823,762	761	0.37	%	686,511	429	0.25	%
Time deposits — under \$100	23,699	23	0.39	%	19,770	14	0.28	%
Time deposits — \$100 and over	131,262	237	0.72	%	181,167	317	0.69	%
CDARS — interest-bearing demand, money								
market and time deposits	15,971	3	0.07	%	18,650	1	0.02	%
Total interest-bearing deposits	1,677,388	1,575	0.37	%	1,489,461	1,051	0.28	%
Total deposits	2,749,026	1,575	0.23	%	2,470,015	1,051	0.17	%
	39,292	583	5.89	%	39,120	583	5.91	%



Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Subordinated debt, net of issuance costs								
Short-term borrowings	133	1	2.98	%	84	—	0.00	%
Total interest-bearing liabilities	1,716,813	2,159	0.50	%	1,528,665	1,634	0.42	%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	2,788,451	2,159	0.31	%	2,509,219	1,634	0.26	%
Other liabilities	54,717				54,922			
Total liabilities	2,843,168				2,564,141			
Shareholders' equity	349,971				272,666			
Total liabilities and shareholders' equity	\$ 3,193,139				\$ 2,836,807			
Net interest income (3) / margin		32,598	4.36	%		26,624	3.98	%
Less tax equivalent adjustment (3)		(147)				(303)		
Net interest income		\$ 32,451				\$ 26,321		

(1) Includes loans held for sale. Nonaccrual loans are included in average balance.

(2) Yield amounts earned on loans include fees and costs. The accretion (amortization) of deferred loan fees (costs) into loan interest income was \$73,000 for the third quarter of 2018, compared to \$200,000 for the third quarter of 2017.

(3) Reflects tax equivalent adjustment for Federal tax exempt income based on a 21% tax rate for the third quarter of 2018, and a 35% tax rate for the third quarter of 2017.



Table of Contents

	Nine Months Ended September 30, 2018				Nine Months Ended September 30, 2017			
	Average Balance	Interest Income / Expense	Average Yield / Rate		Average Balance	Interest Income / Expense	Average Yield / Rate	
Assets:								
Loans, gross (1)(2)	\$ 1,776,546	77,272	5.82	%	\$ 1,521,447	\$ 64,112	5.63	%
Securities — taxable	662,274	11,112	2.24	%	616,648	9,916	2.15	%
Securities — exempt from Federal tax (3)	87,990	2,120	3.22	%	89,991	2,606	3.87	%
Other investments, interest-bearing deposits in other financial institutions and Federal funds sold	271,757	4,408	2.17	%	291,222	3,037	1.39	%
Total interest earning assets (3)	2,798,567	94,912	4.53	%	2,519,308	79,671	4.23	%
Cash and due from banks	37,890				33,656			
Premises and equipment, net	7,330				7,581			
Goodwill and other intangible assets	77,777				52,103			
Other assets	82,666				85,901			
Total assets	\$ 3,004,230				\$ 2,698,549			
Liabilities and shareholders' equity:								
Deposits:								
Demand, noninterest-bearing	\$ 1,003,590				\$ 924,841			
Demand, interest-bearing	651,445	1,319	0.27	%	574,966	880	0.20	%
Savings and money market	769,448	1,823	0.32	%	632,907	1,081	0.23	%
Time deposits — under \$100	21,235	58	0.37	%	20,141	44	0.29	%
Time deposits — \$100 and over	131,436	564	0.57	%	191,301	859	0.60	%
CDARS — interest-bearing demand, money market and time deposits	16,086	8	0.07	%	13,061	3	0.03	%
Total interest-bearing deposits	1,589,650	3,772	0.32	%	1,432,376	2,867	0.27	%
Total deposits	2,593,240	3,772	0.19	%	2,357,217	2,867	0.16	%
Subordinated debt, net of issuance costs	39,246	1,731	5.90	%	17,912	811	6.05	%
Short-term borrowings	76	1	1.76	%	68	1	1.97	%
Total interest-bearing liabilities	1,628,972	5,504	0.45	%	1,450,356	3,679	0.34	%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	2,632,562	5,504	0.28	%	2,375,197	3,679	0.21	%
Other liabilities	54,204				57,377			
Total liabilities	2,686,766				2,432,574			

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Shareholders' equity	317,464				265,975			
Total liabilities and shareholders' equity	\$ 3,004,230				\$ 2,698,549			
Net interest income (3) / margin		89,408	4.27	%		75,992	4.03	%
Less tax equivalent adjustment (3)		(445)				(912)		
Net interest income		\$ 88,963				\$ 75,080		

---

(1) Includes loans held for sale. Nonaccrual loans are included in average balance.

(2) Yield amounts earned on loans include fees and costs. The accretion (amortization) of deferred loan fees (costs) into loan interest income was \$322,000 for the nine months ended September 30, 2018, compared to \$370,000 for the nine months ended September 30, 2017.

(3) Reflects tax equivalent adjustment for Federal tax exempt income based on a 21% tax rate for 2018, and a 35% tax rate for 2017.

---

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 September 30, 2018 vs. 2017 Increase (Decrease) Due to Change in: Average      Average      Net Volume      Rate      Change (Dollars in thousands)		
Income from the interest earning assets:			
Loans, gross	\$ 5,348	\$ 777	\$ 6,125
Securities — taxable	(258)	145	(113)
Securities — exempt from Federal tax (1)	(17)	(147)	(164)
Other investments, interest-bearing deposits in other financial institutions and Federal funds sold	2	649	651
Total interest income on interest earning assets (1)	5,075	1,424	6,499
Expense from the interest-bearing liabilities:			
Demand, interest-bearing	80	181	261
Savings and money market	121	211	332
Time deposits — under \$100	4	5	9
Time deposits — \$100 and over	(92)	12	(80)
CDARS — interest-bearing demand, money market and time deposits	—	2	2
Subordinated debt, net of issuance costs	2	(2)	—
Short-term borrowings	1	—	1
Total interest expense on interest-bearing liabilities	116	409	525
Net interest income (1)	\$ 4,959	\$ 1,015	5,974
Less tax equivalent adjustment (1)			156
Net interest income			\$ 6,130

---

(1) Reflects tax equivalent adjustment for Federal tax exempt income based on a 21% tax rate for the third quarter of 2018, and a 35% tax rate for the third quarter of 2017.

---



Table of Contents

	Nine Months Ended September 30, 2018 vs. 2017		
	Increase (Decrease)		
	Due to Change in:		
	Average	Average	Net
	Volume	Rate	Change
	(Dollars in thousands)		
Income from the interest earning assets:			
Loans, gross	\$ 11,042	\$ 2,117	\$ 13,159
Securities — taxable	781	415	1,196
Securities — exempt from Federal tax (1)	(47)	(439)	(486)
Other investments, interest-bearing deposits in other financial institutions and Federal funds sold	(318)	1,690	1,372
Total interest income on interest-earning assets (1)	11,458	3,783	15,241
Expense from the interest-bearing liabilities:			
Demand, interest-bearing	158	281	439
Savings and money market	308	434	742
Time deposits — under \$100	2	12	14
Time deposits — \$100 and over	(252)	(43)	(295)
CDARS — interest-bearing demand, money market and time deposits	1	4	5
Subordinated debt, net of issuance costs	941	(21)	920
Short-term borrowings	—	—	—
Total interest expense on interest-bearing liabilities	1,158	667	1,825
Net interest income (1)	\$ 10,300	\$ 3,116	13,416
Less tax equivalent adjustment (1)			467
Net interest income			\$ 13,883

---

(1) Reflects tax equivalent adjustment for Federal tax exempt income based on a 21% tax rate for 2018, and a 35% tax rate for 2017.

---

The Company's net interest margin (FTE), expressed as a percentage of average earning assets, increased 38 basis points to 4.36% for the third quarter of 2018, from 3.98% for the third quarter of 2017. The improvement was primarily due to a higher average balance of loans, an increase in the accretion of the loan purchase discount into loan interest income from the Tri-Valley Bank and the United American Bank acquisitions in the second quarter of 2018, the impact of increases in the prime rate, and the rate on overnight funds.

For the first nine months of 2018, the net interest margin increased 24 basis points to 4.27%, compared to 4.03% for the first nine months of 2017, primarily due to a higher average balance of loans and securities, an increase in the

accretion of the loan purchase discount into loan interest income from the Tri-Valley and United American acquisitions in the second quarter of 2018, the impact of increases in the prime rate, and the rate on overnight funds.

The average yield on the loan portfolio increased to 5.92% for the third quarter of 2018, compared to 5.72% for the third quarter of 2017, primarily due to an increase in the accretion of the loan purchase discount into loan interest income from the acquisitions, and increases in the prime rate. The average yield on the Company's legacy loan portfolio (excluding the purchased residential loans, purchased CRE loans, factored receivables portfolio, and accretion of the loan purchase discount from the acquisitions) increased 10 basis points for the third quarter of 2018, compared to the third quarter of 2017. The average yield on the purchased residential loans was 2.68% for the third quarter of 2018, compared to 2.67% for the third quarter of 2017. The average yield on the purchased CRE loans was 3.24% for the third quarter of 2018, compared to 3.52% the third quarter of 2017.

The yield on the loan portfolio increased to 5.82% for the first nine months of 2018, compared to 5.63% for the first nine months of 2017, primarily due to to an increase in accretion of the loan purchase discount into loan interest income from the acquisitions and increases in the prime rate. The yield on the Company's legacy loan portfolio (excluding the purchased residential loans, purchased CRE loans, factored receivables portfolio, and accretion of the loan



## Table of Contents

purchase discount from the acquisitions) increased 9 basis points for the first nine months of 2018, compared to the first nine months of 2017. The yield on the purchased residential loans was 2.71% for the first nine months of 2018, compared to 2.67% for the first nine months of 2017. The yield on the purchased CRE loans was 3.45% for the first nine months of 2018, compared to 3.51% for the first nine months of 2017.

Net interest income, before the provision for loan losses, increased 23% to \$32.5 million for the third quarter of 2018, compared to \$26.3 million for the third quarter of 2017. Net interest income increased 18% to \$89.0 million for the nine months ended September 30, 2018, compared to \$75.1 million for the nine months ended September 30, 2017. Net interest income increased for the third quarter of 2018 and the first nine months of 2018, compared to the respective periods in 2017, primarily due to the impact of the increase in loans and deposits from the Tri-Valley and United American acquisitions, in addition to organic loan growth and the positive impact of rising interest rates.

### Provision for Loan Losses

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

There was a (\$425,000) credit to the provision for loan losses for the third quarter of 2018, compared to a provision for loan losses of \$115,000 for the third quarter of 2017. The credit to the provision for loan losses for the third quarter of 2018 was primarily due to net recoveries of \$1.2 million. For the nine months ended September 30, 2018, there was a \$7.3 million provision for loan losses compared to a \$390,000 provision for loan losses for the nine months ended September 30, 2017. The increase in the provision for loan losses for the first nine months of 2018 compared to the first nine months of 2017 was primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018. At September 30, 2018, the recorded investment of this lending relationship was \$21.8 million, and the Company had a \$7.0 million specific loan loss reserve allocated for this lending relationship. Additionally, subsequent to the end of the third quarter of 2018, the recorded investment of this lending relationship was reduced to \$17.4 million. 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".

The allowance for loan losses totaled \$27.4 million, or 1.44% of total loans at September 30, 2018, compared to \$19.7 million, or 1.26% of total loans at September 30, 2017, and \$19.7 million, or 1.24% of total loans at

December 31, 2017. Net recoveries totaled \$1.2 million for the third quarter of 2018, compared to net recoveries of \$236,000 for the third quarter of 2017, and net recoveries of \$201,000 for the fourth quarter of 2017. The allowance for loan losses to total nonperforming loans decreased to 110.97% at September 30, 2018, compared to 565.68% at September 30, 2017, and 791.07% at December 31, 2017, primarily due to the single lending relationship that was placed on nonaccrual during the second quarter of 2018. The loans acquired from Tri-Valley and United American are included in total loans; however, there was minimal allowance for loan losses attributed to these loans at September 30, 2018 because upon acquisition they were marked to fair value.

Table of Contents

Noninterest Income	Three Months Ended		Increase (decrease) 2018 versus 2017		
	September 30, 2018	2017	Amount	Percent	
(Dollars in thousands)					
Service charges and fees on deposit accounts	\$ 1,107	\$ 869	\$ 238	27	%
Gain on sales of SBA loans	236	147	89	61	%
Increase in cash surrender value of life insurance	216	417	(201)	(48)	%
Servicing income	163	246	(83)	(34)	%
Other	484	781	(297)	(38)	%
Total	\$ 2,206	\$ 2,460	\$ (254)	(10)	%

	Nine Months Ended		Increase (decrease) 2018 versus 2017		
	September 30, 2018	2017	Amount	Percent	
(Dollars in thousands)					
Service charges and fees on deposit accounts	\$ 2,981	\$ 2,410	\$ 571	24	%
Gain on sales of SBA loans	551	635	(84)	(13)	%
Increase in cash surrender value of life insurance	816	1,259	(443)	(35)	%
Servicing income	533	736	(203)	(28)	%
Gain (loss) on sales of securities	266	(6)	272	4,533	%
Other	2,034	2,014	20	1	%
Total	\$ 7,181	\$ 7,048	\$ 133	2	%

Total noninterest income decreased to \$2.2 million for the third quarter of 2018, compared to \$2.5 million for the third quarter of 2017. For the nine months ended September 30, 2018, noninterest income increased to \$7.2 million, compared to \$7.0 million for the nine months ended September 30, 2017, primarily due to proceeds from a legal settlement during the second quarter of 2018, higher service charges and fees on deposit accounts and gain on sales of securities for the first nine months of 2018, partially offset by a lower increase in cash surrender value of life insurance proceeds, servicing income, and gain on sale of SBA loans for the first nine months of 2018. The first nine months of 2017 also included a higher fee income from Bay View Funding which was included in other noninterest income. The Company received \$1.3 million in proceeds from a legal settlement during the second quarter of 2018, of which \$377,000 was recorded in other noninterest income, and \$922,000 was credited to professional fees for recaptured legal fees previously paid by the Company.

Historically, a portion of the Company's noninterest income has been associated with its SBA lending activity, as gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. For the three months ended September 30, 2018, SBA loan sales resulted in a \$236,000 gain, compared to a \$147,000 gain on sales of SBA loans for the three months ended September 30, 2017. For the nine months ended September 30, 2018, SBA loan sales resulted in a \$551,000 gain, compared to a \$635,000 gain on sale of SBA loans for the nine months ended September 30, 2017.

The servicing assets that result from the sales of SBA loans with servicing retained are amortized over the expected term of the loans using a method approximating the interest method. Servicing income generally declines as the respective loans are repaid.

Table of Contents

## Noninterest Expense

	Three Months Ended September 30,		Increase (Decrease) 2018 versus 2017		
	2018	2017	Amount	Percent	
	(Dollars in thousands)				
Salaries and employee benefits (1)	\$ 10,719	\$ 9,071	\$ 1,648	18	%
Occupancy and equipment	1,559	1,142	417	37	%
Professional fees	721	695	26	4	%
Amortization of intangible assets	631	296	335	113	%
Software subscriptions	555	475	80	17	%
Data processing	525	411	114	28	%
Insurance expense	430	401	29	7	%
Acquisition and integration related costs	16	—	16	N	/A
Other	2,572	2,343	229	10	%
Total	\$ 17,728	\$ 14,834	\$ 2,894	20	%

---

(1) Salaries and employee benefits included severance and retention expense of \$183,000 related to the Tri-Valley and United American acquisitions for the third quarter 2018.

---

	Nine Months Ended September 30,		Increase (Decrease) 2018 versus 2017		
	2018	2017	Amount	Percent	
	(Dollars in thousands)				
Salaries and employee benefits (1)	\$ 35,302	\$ 27,766	\$ 7,536	27	%
Occupancy and equipment	3,927	3,426	501	15	%
Professional fees	1,116	2,439	(1,323)	(54)	%
Amortization of intangible assets	1,336	1,083	253	23	%
Software subscriptions	1,747	1,333	414	31	%
Data processing	1,501	1,080	421	39	%
Insurance expense	1,236	1,123	113	10	%
Acquisition and integration related costs	5,452	—	5,452	N	/A
Other	6,963	7,166	(203)	(3)	%
Total	\$ 58,580	\$ 45,416	\$ 13,164	29	%

---

(1)

Salaries and employee benefits included severance and retention expense of \$3.6 million related to the Tri-Valley and United American acquisitions for the nine months of 2018.

---

Table of Contents

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

## Noninterest Expense by Category

	Three Months Ended September 30,					
	2018	Percent of Total		2017	Percent of Total	
	(Dollars in thousands)					
Salaries and employee benefits (1)	\$ 10,719	60	%	\$ 9,071	61	%
Occupancy and equipment	1,559	9	%	1,142	8	%
Professional fees	721	4	%	695	4	%
Amortization of intangible assets	631	4	%	296	2	%
Software subscriptions	555	3	%	475	3	%
Data processing	525	3	%	411	3	%
Insurance expense	430	2	%	401	3	%
Acquisition and integration related costs	16	0	%	—	0	%
Other	2,572	15	%	2,343	16	%
Total	\$ 17,728	100	%	\$ 14,834	100	%

---

(1) Salaries and employee benefits included severance and retention expense of \$183,000 related to the Tri-Valley and United American acquisitions for the third quarter of 2018.

---

	Nine Months Ended September 30,					
	2018			2017		
	Amount	Percent		Amount	Percent	
	(Dollars in thousands)	of Total			of Total	
Salaries and employee benefits (1)	\$ 35,302	60	%	\$ 27,766	61	%
Occupancy and equipment	3,927	7	%	3,426	8	%
Professional fees	1,116	2	%	2,439	5	%
Amortization of intangible assets	1,336	2	%	1,083	2	%
Software subscriptions	1,747	3	%	1,333	3	%
Data processing	1,501	3	%	1,080	2	%
Insurance expense	1,236	2	%	1,123	3	%
Acquisition and integration related costs	5,452	9	%	—	0	%
Other	6,963	12	%	7,166	16	%
Total	\$ 58,580	100	%	\$ 45,416	100	%

---

(1) Salaries and employee benefits included severance and retention expense of \$3.6 million related to the Tri-Valley and United American acquisitions for the nine months of 2018.

---

Total noninterest expense for the third quarter of 2018 was \$17.7 million, compared to \$14.8 million for the third quarter of 2017. Noninterest expense for the nine months ended September 30, 2018 was \$58.5 million, compared to \$45.4 million for the nine months ended September 30, 2017. The increase in noninterest expense in the first nine months of 2018, compared to first nine months of 2017, was primarily due to costs related to the merger transactions and higher salaries and employee benefits as a result of annual salary increases, and additional operating costs of Tri-Valley and United American, partially offset by lower professional fees. Other noninterest expense included pre-tax acquisition and integration costs of \$16,000 and \$5.5 million for the third quarter of 2018, and the first nine months of 2018, respectively. In addition, salaries and employee benefits included severance and retention expense of \$183,000, and \$3.6 million for the third quarter of 2018, and the first nine months of 2018, respectively, related to the Tri-Valley and United American acquisitions. Total severance, retention, acquisition and integration costs were \$199,000 and \$9.0 million for the third quarter of 2018, and the first nine months of 2018, respectively. Professional fees totaled \$1.1 million for the first nine months of 2018, compared to \$2.4 million for the first nine months of 2017, primarily due to the recovery of \$922,000 of professional fees from a legal settlement in the second quarter of 2018. Full time equivalent employees were 296, 282, and 278 at September 30, 2018, September 30, 2017, and December 31, 2017, respectively



Table of Contents

## Income Tax Expense

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

The following table shows the Company's effective income tax rates for the periods indicated:

	Three Months Ended September 30, 2018		2017		Nine Months Ended September 30, 2018		2017	
Effective income tax rate	28.7	%	37.9	%	27.0	%	37.9	%

The Company's income tax expense for the third quarter of 2018 was \$5.0 million, compared to income tax expense of \$5.2 million for the third quarter of 2017. The effective tax rate for the third quarter of 2018 decreased compared to the third quarter of 2017, primarily due to lower federal corporate tax rate for the third quarter of 2018. On December 22, 2017, the Tax Act, was signed into law, which among other things reduced the federal corporate tax rate to 21% from 35%, effective January 1, 2018. Income tax expense for the nine months ended September 30, 2018 was \$8.2 million, compared to \$13.8 million for the nine months ended September 30, 2017.

The difference in the effective tax rate for the periods reported compared to the combined Federal and state statutory tax rate of 29.6% for the third quarter of 2018 and the first nine months of 2018, and 42% for the the third quarter of 2017 and first nine months of 2017, is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes, tax credits related to investments in low income housing limited partnerships (net of low income housing investment losses), and tax-exempt interest income earned on municipal bonds.

In March 2016, the FASB issued new guidance intended to simplify several areas of accounting for share-based compensation programs, including the income tax impact, classification on the statement of cash flows, and forfeitures. The Company adopted the new guidance on share-based compensation during the first quarter of 2017. All excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) are recognized as income tax expense or benefit on the income statement. The tax effects of exercised or vested awards are treated as discrete items in the reporting period in which they occur. The adoption of this guidance resulted in a reduction to income tax expense of (\$58,000) for the third quarter of 2018, compared to a reduction of (\$106,000) for the third quarter of 2017, and a reduction to income tax expense of (\$351,000) for the first nine months of 2018, compared to a reduction of (\$158,000) for the first nine months of 2017.

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

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

The Company had net deferred tax assets of \$28.1 million at September 30, 2018, \$22.4 million at September 30, 2017, and \$16.2 million at December 31, 2017. After consideration of the matters in the preceding paragraph, the

Table of Contents

Company determined that it is more likely than not that the net deferred tax assets September 30, 2018, September 30, 2017, and December 31, 2017 will be fully realized in future years.

## Business Segment Information

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

	Three Months Ended September 30, 2018		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 30,425	\$ 4,185	\$ 34,610
Intersegment interest allocations	601	(601)	—
Total interest expense	2,159	—	2,159
Net interest income	28,867	3,584	32,451
Provision (credit) for loan losses	(671)	246	(425)
Net interest income after provision	29,538	3,338	32,876
Noninterest income	2,011	195	2,206
Noninterest expense (2)	16,045	1,683	17,728
Intersegment expense allocations	172	(172)	—
Income before income taxes	15,676	1,678	17,354
Income tax expense	4,483	496	4,979
Net income	\$ 11,193	\$ 1,182	\$ 12,375
Total assets	\$ 3,107,897	\$ 85,013	\$ 3,192,910
Loans, net of deferred fees	\$ 1,828,379	\$ 71,008	\$ 1,899,387
Goodwill	\$ 70,708	\$ 13,044	\$ 83,752

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

(2) The banking segment's noninterest expense includes acquisition costs of \$199,000

Three Months Ended September 30, 2017  
Banking(1) Factoring Consolidated  
(Dollars in thousands)

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Interest income	\$ 24,805	\$ 3,150	\$ 27,955
Intersegment interest allocations	284	(284)	—
Total interest expense	1,634	—	1,634
Net interest income	23,455	2,866	26,321
Provision for loan losses	107	8	115
Net interest income after provision	23,348	2,858	26,206
Noninterest income	2,101	359	2,460
Noninterest expense	13,149	1,685	14,834
Intersegment expense allocations	130	(130)	—
Income before income taxes	12,430	1,402	13,832
Income tax expense	4,660	589	5,249
Net income	\$ 7,770	\$ 813	\$ 8,583
<hr/>			
Total assets	\$ 2,776,262	\$ 67,686	\$ 2,843,948
Loans, net of deferred fees	\$ 1,517,186	\$ 48,764	\$ 1,565,950
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

---

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

---

Table of Contents

	Nine Months Ended September 30, 2018		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 83,781	\$ 10,686	\$ 94,467
Intersegment interest allocations	1,304	(1,304)	—
Total interest expense	5,504	—	5,504
Net interest income	79,581	9,382	88,963
Provision for loan losses	6,958	321	7,279
Net interest income after provision	72,623	9,061	81,684
Noninterest income	6,628	553	7,181
Noninterest expense (2)	53,813	4,767	58,580
Intersegment expense allocations	574	(574)	—
Income before income taxes	26,012	4,273	30,285
Income tax expense	6,923	1,263	8,186
Net income	\$ 19,089	\$ 3,010	\$ 22,099
<hr/>			
Total assets	\$ 3,107,897	\$ 85,013	\$ 3,192,910
Loans, net of deferred fees	\$ 1,828,379	\$ 71,008	\$ 1,899,387
Goodwill	\$ 70,708	\$ 13,044	\$ 83,752

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

(2) The banking segment's noninterest expense includes acquisition costs of \$9.0 million

	Nine Months Ended September 30, 2017		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 70,146	\$ 8,613	\$ 78,759
Intersegment interest allocations	786	(786)	—
Total interest expense	3,679	—	3,679
Net interest income	67,253	7,827	75,080
Provision for loan losses	372	18	390
Net interest income after provision	66,881	7,809	74,690
Noninterest income	6,153	895	7,048
Noninterest expense	40,152	5,264	45,416
Intersegment expense allocations	392	(392)	—
Income before income taxes	33,274	3,048	36,322
Income tax expense	12,472	1,280	13,752
Net income	\$ 20,802	\$ 1,768	\$ 22,570
<hr/>			
Total assets	\$ 2,776,262	\$ 67,686	\$ 2,843,948
Loans, net of deferred fees	\$ 1,517,186	\$ 48,764	\$ 1,565,950
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

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

Banking. Our banking segment's net income was \$11.2 million for the three months ended September 30, 2018, compared to net income of \$7.8 million for the three months ended September 30, 2017. The banking segment's earnings for the first nine months of 2018 was \$19.1 million, compared to \$20.8 million for the first nine months of 2017. Net interest income increased to \$28.9 million for the three months ended September 30, 2018, compared to \$23.5 million for the three months ended September 30, 2017. For the nine months ended September 30, 2018, net interest income increased to \$79.6 million, compared to \$67.3 million for the nine months ended September 30, 2017. The increase in net interest income for the three and nine months ended September 30, 2018, compared to the comparable periods in 2017, was primarily due to the impact of the increase in loans and deposits from the Tri-Valley and United American acquisitions, in addition to organic loan growth and the positive impact of rising interest rates. The credit to the provision for loan losses was (\$671,000) for the three months ended September 30, 2018, compared to a provision for loan losses of \$107,000 for the three months ended September 30, 2017. The credit to the provision for loan losses for the third quarter

## Table of Contents

of 2018 was primarily due to net recoveries of \$1.2 million. For the nine months ended September 30, 2018, the provision for loan losses was \$7.0 million, compared to a provision for loan losses of \$372,000 for the nine months ended September 30, 2017. The increase in the provision for loan losses for the first nine months of 2018 compared to the first nine months of 2017 was primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of 2018. Noninterest income was \$2.0 million for the three months ended September 30, 2018, compared to \$2.1 million for the three months ended September 30, 2017. Noninterest income increased to \$6.6 million for the nine months ended September 30, 2018, compared to \$6.2 million for the nine months ended September 30, 2017, primarily due to proceeds from a legal settlement during the second quarter of 2018, higher service charges and fees on deposit accounts and gain on sales of securities for the first nine months of 2018. Noninterest expense increased to \$16.0 million for the three months ended September 30, 2018, compared to \$13.1 million for the three months ended September 30, 2017. For the nine months ended September 30, 2018, noninterest expense was \$53.8 million, compared to \$40.2 million for the nine months ended September 30, 2017. The increase in noninterest expense in the first nine months of 2018, compared to first nine months of 2017, was primarily due to costs related to the merger transactions and higher salaries and employee benefits as a result of annual salary increases, and additional operating costs of Tri-Valley and United American, partially offset by lower professional fees.

**Factoring.** Bay View Funding's primary business operation is purchasing and collecting factored receivables. Factored receivables are receivables that have been transferred by the originating organization and typically have not been subject to previous collection efforts. In a factoring transaction Bay View Funding directly purchases the receivables generated by its clients at a discount to their face value. The transactions are structured to provide the clients with immediate working capital when there is a mismatch between payments to the client for a good and service and the payment of operating costs incurred to provide such good or service. The average life of the factored receivables was 35 days for the nine months ended September 30, 2018, compared to 36 days for the nine months ended September 30, 2017. Net interest income for the three months and nine months ended September 30, 2018, increased compared to the three months and nine months ended September 30, 2017, primarily due to an increase in the average balance of factored receivables outstanding, partially offset by a decrease in the average yield on the factored receivables portfolio.

## FINANCIAL CONDITION

As of September 30, 2018, total assets increased to \$3.19 billion, compared to \$2.84 billion at September 30, 2017, and December 31, 2017. The increase in total assets at September 30, 2018 was primarily due to the Tri-Valley and United American acquisitions. Tri-Valley added \$115.2 million in loans, at fair value, and \$91.4 million in deposits, at fair value at September 30, 2018. United American added \$208.8 million in loans, at fair value, and \$266.6 million in deposits, at fair value, at September 30, 2018.

Securities available for sale, at fair value, were \$319.1 million at September 30, 2018, a decrease of (18%) from \$390.1 million at September 30, 2017, and a decrease of (19%) from \$391.9 million at December 31, 2017. Securities held to maturity, at amortized cost, were \$375.7 million at September 30, 2018, a decrease of (1%) from \$379.5 million at September 30, 2017, and a decrease of (6%) from \$398.3 million at December 31, 2017. Total loans, excluding

loans held for sale, increased \$333.4 million, or 21%, to \$1.90 billion at September 30, 2018, compared to \$1.57 billion at September 30, 2017, which included \$208.8 million in loans from United American, \$115.2 million in loans from Tri-Valley, and an increase of \$20.3 million, or 1% in the Company's legacy portfolio, partially offset by a decrease of \$7.5 million in purchased residential mortgage loans and a decrease of \$3.4 million in purchased CRE loans. Loans increased 20% at September 30, 2018, compared to \$1.58 billion at December 31, 2017, which included \$208.8 million in loans from United American, \$115.2 million in loans from Tri-Valley, and an increase of \$1.4 million in the Company's legacy portfolio, partially offset by a decrease of \$5.6 million in purchased residential mortgages, and a decrease of \$3.1 million in purchased CRE loans.

Total deposits increased \$264.7 million, or 11%, to \$2.75 billion at September 30, 2018, compared to \$2.48 billion at September 30, 2017, which included \$266.6 million in deposits from United American, \$91.4 million in deposits from Tri-Valley, a decrease of \$65.1 million in State of California certificates of deposits due to maturity, and a decrease of \$28.2 million, or (1%), in the Company's legacy deposits. Total deposits increased \$262.3 million, or 11%, at September 30, 2018 from \$2.48 billion at December 31, 2017, which included \$266.6 million in deposits from United American, \$91.4 million in deposits from Tri-Valley, the maturity of \$65.1 million in State of California certificates of deposits, and a decrease of \$30.6 million in the Company's legacy deposits.



## Table of Contents

Deposits, excluding all time deposits and CDARS deposits, increased \$318.1 million, or 14%, to \$2.58 billion at September 30, 2018, compared to \$2.26 billion at September 30, 2017, which included \$231.9 million of deposits added from United American, \$83.0 million of deposits added from Tri-Valley, and an increase of \$3.1 million in the Company's legacy deposits. Deposits, excluding all time deposits and CDARS deposits, increased \$305.0 million, or 13%, compared to \$2.28 billion at December 31, 2017, which included \$231.9 million of deposits added from United American, \$83.0 million of deposits added from Tri-Valley, partially offset by a decrease of \$10.0 million in the Company's legacy deposits.

## Securities Portfolio

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

	September 30, 2018	September 30, 2017	December 31, 2017
	(Dollars in thousands)		
Securities available-for-sale (at fair value):			
Agency mortgage-backed securities	\$ 311,665	\$ 373,167	\$ 374,733
U.S. Government sponsored entities	7,406	—	—
Trust preferred securities	—	16,940	17,119
Total	\$ 319,071	\$ 390,107	\$ 391,852
Securities held-to-maturity (at amortized cost):			
Agency mortgage-backed securities	\$ 288,594	\$ 290,418	\$ 309,616
Municipals — exempt from Federal tax	87,138	89,132	88,725
	\$ 375,732	\$ 379,550	\$ 398,341

The following table summarizes the weighted average life and weighted average yields of securities at September 30, 2018:

	Weighted Average Life										Total Amount					
	Within One		After One and		After Five and		After Ten									
	Year or Less		Within Five		Within Ten		Years									
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield								
	(Dollars in thousands)															
Available-for-sale (at fair value):																
Mortgage-backed securities	\$	—		\$	238,391	2.22	%	\$	73,274	2.52	%	\$	—	—	\$	311,665
Government sponsored entities		—			7,406	2.65	%		—				—	—		7,406
	\$	—		\$	245,797	2.24	%	\$	73,274	2.52	%	\$	—	—	\$	319,071

o-maturity (at amortized cost):

ge-backed securities	\$	—		\$	204,487	2.04	%	\$	43,486	2.43	%	\$	40,621	3.17	%	\$	288,5	
xempt from Federal tax (1)		4,297	3.22	%	21,107	3.38	%		12,289	3.04	%		49,445	3.20	%		87,13	
	\$	4,297	3.22	%	\$	225,594	2.16	%	\$	55,775	2.56	%	\$	90,066	3.19	%	\$	375,7

(1) Reflects tax equivalent adjustment for Federal tax exempt income based on a 21% tax rate.

The securities portfolio is the second largest component of the Company's interest earning assets, and the structure and composition of this portfolio is important to an analysis of the financial condition of the Company. The portfolio serves the following purposes: (i) it provides a source of pledged assets for securing certain deposits and borrowed funds, as may be required by law or by specific agreement with a depositor or lender; (ii) it provides liquidity to even out cash flows from the loan and deposit activities of customers; (iii) it can be used as an interest rate risk management tool, since it provides a large base of assets, the maturity and interest rate characteristics of which can be changed more readily than the loan portfolio to better match changes in the deposit base and other funding sources of the Company; and (iv) it is an alternative interest earning use of funds when loan demand is weak or when deposits grow more rapidly than loans.

The Company's portfolio may include: (i) U.S. Treasury securities and U.S. Government sponsored entities' debt securities for liquidity and pledging; (ii) mortgage backed securities, which in many instances can also be used for pledging, and which generally enhance the yield of the portfolio; (iii) municipal obligations, which provide tax free

## Table of Contents

income and limited pledging potential; (iv) single entity issue trust preferred securities, which generally enhance the yield on the portfolio; (v) corporate bonds, which also enhance the yield on the portfolio; (vi) money market mutual funds; (vii) certificates of deposit; (viii) commercial paper; (ix) bankers acceptances; (x) repurchase agreements; (xi) collateralized mortgage obligations; and (xii) asset-backed securities.

The Company classifies its securities as either available for sale or held to maturity at the time of purchase. Accounting guidance requires available for sale securities to be marked to fair value with an offset to accumulated other comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available for sale securities.

The investment securities available for sale portfolio, at fair value, totaled \$319.1 million at September 30, 2018, a decrease of (18%) from \$390.1 million at September 30, 2017, and a decrease of (19%) from \$391.9 million at December 31, 2017. At September 30, 2018, the Company's securities available-for-sale portfolio was comprised of \$311.7 million agency mortgage-backed securities (all issued by U.S. Government sponsored entities) and \$7.4 million U.S. Government sponsored entities debt securities. The pre-tax unrealized loss on securities available-for-sale at September 30, 2018 was (\$12.7) million, compared to a pre-tax unrealized gain on securities available-for-sale of \$1.0 million at September 30, 2017, and a pre-tax unrealized loss on securities available-for-sale of (\$1.5) million at December 31, 2017. All other factors remaining the same, when market interest rates are rising, the Company will experience a lower unrealized gain (or a higher unrealized loss) on the securities portfolio. Investment securities available-for-sale acquired from United American totaled \$63.7 million, at fair value, on May 4, 2018. Subsequent to closing, the Company sold \$55.4 million of these securities, for a gain on sale of securities of \$179,000 in the second quarter of 2018.

At September 30, 2018, investment securities held to maturity, at amortized cost, totaled \$375.7 million, a decrease of (1%) from \$379.5 million at September 30, 2017, and a decrease of (6%) from \$398.3 million at December 31, 2017. At September 30, 2018, the Company's securities held-to-maturity portfolio was comprised of \$288.6 million agency mortgage-backed securities, and \$87.1 million tax-exempt municipal bonds.

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

## 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 59% of total assets at September 30, 2018, represented 55% at September 30, 2017, and represented 56% at December 31, 2017. The ratio of loans to deposits was 69.19% at September 30, 2018, compared to 63.13% at September 30, 2017, and 63.74% at

December 31, 2017.

## 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:

	September 30, 2018			September 30, 2017			December 31, 2017		
	Balance	% to Total		Balance	% to Total		Balance	% to Total	
	(Dollars in thousands)								
Commercial	\$ 600,594	31	%	\$ 587,276	38	%	\$ 573,296	36	%
Real estate:									
CRE	988,491	52	%	754,856	48	%	772,867	49	%
Land and									
construction	131,548	7	%	92,310	6	%	100,882	6	%
Home equity	116,657	6	%	74,171	4	%	79,176	5	%
Residential									
mortgages	52,441	3	%	46,489	3	%	44,561	3	%
Consumer	9,932	1	%	11,749	1	%	12,395	1	%
Total Loans	1,899,663	100	%	1,566,851	100	%	1,583,177	100	%
Deferred									
loan fees, net	(276)	—		(901)	—		(510)	—	
Loans, net of									
deferred									
fees	1,899,387	100	%	1,565,950	100	%	1,582,667	100	%
Allowance									
for loan									
losses	(27,426)			(19,748)			(19,658)		
Loans, net	\$ 1,871,961			\$ 1,546,202			\$ 1,563,009		

Table of Contents

The Company's loan portfolio is concentrated in commercial loans, (primarily manufacturing, wholesale, and services oriented entities), and commercial real estate, with the remaining balance in land development and construction, home equity, purchased residential mortgages, and consumer loans. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 68% of its gross loans were secured by real property at September 30, 2018, compared to 60% at September 30, 2017 and 63% at December 31, 2017. While no specific industry concentration is considered significant, the Company's bank lending operations are substantially located in areas that are dependent on the technology and real estate industries and their supporting companies.

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

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

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such 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 third quarter and nine months ended September 30, 2018, loans were sold resulting in a gain on sales of SBA loans of \$236,000, and \$551,000, respectively.

The Company's factoring receivables are from the operations of Bay View Funding whose primary business is purchasing and collecting factored receivables. Factored receivables are receivables that have been transferred by the originating organization and typically have not been subject to previous collection efforts. These receivables are acquired from a variety of companies, including but not limited to service providers, transportation companies, manufacturers, distributors, wholesalers, apparel companies, advertisers, and temporary staffing companies. The portfolio of factored receivables is included in the Company's commercial loan portfolio. The average life of the factored receivables was 35 days for the first nine months of 2018, compared to 36 days for the first nine months of 2017. The average life of the factored receivables was 36 days for the year ended December 31, 2017. The balance of the purchased receivables was \$71.0 million at September 30, 2018, compared to \$48.8 million at both September 30, 2017 and at December 31, 2017.

The commercial loan portfolio increased \$13.3 million to \$600.6 million at September 30, 2018, from \$587.3 million at September 30, 2017, which included \$21.7 million of loans added from United American, and \$10.2 million of loans added from Tri-Valley, partially offset by a decrease of \$18.6 million, or (3%), the Company's legacy portfolio. The commercial loan portfolio increased \$27.3 million from \$573.3 million at December 31, 2017, which included \$21.7 million of loans added from United American, \$10.2 million of loans added from Tri-Valley, partially offset by a decrease of \$4.6 million, or (1%), in the Company's legacy portfolio. C&I usage was 36% at September 30, 2018, compared to 37% at September 30, 2017 and December 31, 2017.

The Company's CRE loans consist primarily of loans based on the borrower's cash flow and are secured by deeds of trust on commercial 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 depending on the type of property and its utilization. The Company offers both fixed and floating rate loans. Maturities CRE loans are generally between five and ten years (with amortization ranging from fifteen to twenty five years and a balloon payment due at maturity), however, SBA and certain other real estate loans that can be sold in the secondary market may be granted for longer maturities.

The CRE loan portfolio increased \$233.6 million, or 31%, to \$988.5 million at September 30, 2018, compared to \$754.9 million at September 30, 2017, which included \$135.9 million of loans added from United American, \$93.7 million of loans added from Tri-Valley, and an increase of \$7.3 million, or 1%, in the Company's legacy portfolio, partially offset by a decrease of \$3.3 million in purchased CRE loans. The CRE loan portfolio increased \$215.6, or 28%,

Table of Contents

from \$772.9 million at December 31, 2017, which included \$135.9 million of loans added from United American, \$93.7 million of loans added from Tri-Valley, partially offset by a decrease of \$11.0 million, or (1%) in the Company's legacy portfolio, and \$3.1 million in purchased CRE loans.

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Construction loans are provided only in our market area, and the Company has extensive controls for the disbursement process. Land and construction loans increased \$39.2 million, or 43%, to \$131.5 million at September 30, 2018, compared to \$92.3 million at September 30, 2017, and increased \$30.7 million, or 30%, from \$100.9 million at December 31, 2017, primarily due to organic growth of \$26.6 million and \$4.1 million of loans added from United American.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 75% loan to value ratio. Home equity lines of credit increased \$42.5 million, or 57%, to \$116.7 million at September 30, 2018, compared to \$74.2 million at September 30, 2017, which included \$32.9 million of loans added from United American, and \$11.4 million of loans added from Tri-Valley, partially offset by a decrease of \$1.8 million in the Company's legacy portfolio. Home equity lines of credit increased \$37.5 million, or 47%, compared to \$79.2 million at December 31, 2017, which included \$32.9 million of loans added from United American, and \$11.4 million of loans added from Tri-Valley, partially offset by a decrease of \$6.8 million in the Company's legacy portfolio.

Residential mortgage loans increased \$5.9 million, 13%, to \$52.4 million at September 30, 2018, compared to \$46.5 million at September 30, 2017, primarily due to \$13.4 million of loans added from United American, partially offset by a \$7.5 million decrease in purchased residential mortgage loans. Residential mortgage loans increased \$7.8 million, from \$44.6 million at December 31, 2017 primarily due to \$13.4 million of loans added from United American, partially offset by a \$5.6 million decrease in purchased residential mortgage loans.

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 \$59.5 million and \$99.2 million at September 30, 2018, respectively.





Table of Contents

## Loan Maturities

The following table presents the maturity distribution of the Company's loans (excluding loans held for sale) as of September 30, 2018. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall Street Journal. As of September 30, 2018, approximately 52% of the Company's loan portfolio consisted of floating interest rate loans.

	Due in One Year or Less (Dollars in thousands)	Over One Year But Less than Five Years	Over Five Years	Total
Commercial	\$ 478,040	100,660	21,894	\$ 600,594
Real estate:				
CRE	115,730	443,557	429,204	988,491
Land and construction	128,571	1,705	1,272	131,548
Home equity	107,716	4,361	4,580	116,657
Residential mortgages	1,460	5,764	45,217	52,441
Consumer	9,729	199	4	9,932
Loans	\$ 841,246	\$ 556,246	\$ 502,171	\$ 1,899,663
Loans with variable interest rates	\$ 749,126	169,428	77,556	\$ 996,110
Loans with fixed interest rates	92,120	386,819	424,614	903,553
Loans	\$ 841,246	\$ 556,247	\$ 502,170	\$ 1,899,663

## Loan Servicing

As of September 30, 2018 and 2017, \$113.1 million and \$141.9 million, respectively, in SBA loans were serviced by the Company for others. Activity for loan servicing rights was as follows:

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	2017		2017	
	(Dollars in thousands)			
Beginning of period balance	\$ 1,065	\$ 1,554	\$ 1,373	\$ 1,854
Additions	84	40	160	158
Amortization	(170)	(175)	(554)	(593)

End of period balance	\$ 979	\$ 1,419	\$ 979	\$ 1,419
-----------------------	--------	----------	--------	----------

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 September 30, 2018 and 2017, as the fair value of the assets was greater than the carrying value.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(Dollars in thousands)			
Beginning of period balance	\$ 919	\$ 1,028	\$ 968	\$ 1,067
Unrealized holding loss	(56)	(39)	(105)	(78)
End of period balance	\$ 863	\$ 989	\$ 863	\$ 989

## Credit Quality

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

## Table of Contents

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 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. Past due loans 30 days or greater totaled \$10.9 million and \$6.9 million at September 30, 2018 and December 31, 2017, respectively, of which \$617,000 and \$1.4 million were on nonaccrual. At September 30, 2018, there were also \$22.7 million loans less than 30 days past due included in nonaccrual loans held for investment. At December 31, 2017, there were also \$840,000 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. 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.

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

	September 30, 2018		2017		December 31, 2017	
	(Dollars in thousands)					
Nonaccrual loans — held-for-investment	\$	23,342	\$	2,560	\$	2,250
Restructured and loans 90 days past due and still accruing		1,373		931		235
Total nonperforming loans		24,715		3,491		2,485
Foreclosed assets		—		—		—
Total nonperforming assets	\$	24,715	\$	3,491	\$	2,485
Nonperforming assets as a percentage of loans						
plus foreclosed assets		1.30	%	0.22	%	0.16
Nonperforming assets as a percentage of total assets		0.77	%	0.12	%	0.09

Nonperforming assets were \$24.7 million, or 0.77% of total assets, at September 30, 2018, compared to \$3.5 million, or 0.12% of total assets, at September 30, 2017, and \$2.5 million, or 0.09% of total assets, at December 31, 2017. The increase in nonperforming assets at September 30, 2018, compared to September 30, 2017 and December 31, 2017, was primarily due to a single large lending relationship that was placed on nonaccrual during the second quarter of

Table of Contents

2018. At September 30, 2018, the recorded investment of this lending relationship was \$21.8 million, and the Company had a \$7.0 million specific loan loss reserve allocated for this lending relationship. Additionally, subsequent to the end of the third quarter of 2018, the recorded investment of this lending relationship was reduced to \$17.4 million.

The following table presents nonperforming loans by class at the dates indicated:

	September 30, 2018			December 31, 2017		
	Nonaccrual (Dollars in thousands)	Restructured and Loans over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans over 90 Days Past Due and Still Accruing	Total
Commercial	\$ 17,361	\$ 1,148	\$ 18,509	\$ 1,250	\$ 235	\$ 1,485
Real estate:						
CRE	5,639	—	5,639	501	—	501
Land and construction	—	—	—	119	—	119
Home equity	342	225	567	379	—	379
Consumer	—	—	—	1	—	1
Total	\$ 23,342	\$ 1,373	\$ 24,715	\$ 2,250	\$ 235	\$ 2,485

Loans with a well defined weakness, which are characterized by the distinct possibility that the Company will sustain a loss if the deficiencies are not corrected, are categorized as “classified.” Classified loans 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). The principal balance of classified loans, was \$30.5 million at September 30, 2018, \$10.9 million at September 30, 2017, and \$25.1 million at December 31, 2017. The increase in classified loans at September 30, 2018 was primarily due to loans associated with the lending relationship discussed above that was moved to classified loans, which totaled \$21.8 million at September 30, 2018, compared to \$12.5 million at December 31, 2017. Loans held for sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses.

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

September 30, 2018

September 30, 2017

December 31, 2017

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	Nonclassified (Dollars in thousands)	Classified	Total	Nonclassified	Classified	Total	Nonclassified	Classified	Total
ial e:	\$ 577,325	\$ 23,269	\$ 600,594	\$ 578,867	\$ 8,409	\$ 587,276	\$ 554,913	\$ 18,383	\$ 573,296
	982,852	5,639	988,491	754,152	704	754,856	766,988	5,879	772,867
on	131,548	—	131,548	91,217	1,093	92,310	100,763	119	100,882
ity	115,019	1,638	116,657	73,469	702	74,171	78,486	690	79,176
al	52,441	—	52,441	46,489	—	46,489	44,561	—	44,561
s	9,932	—	9,932	11,748	1	11,749	12,394	1	12,395
r	\$ 1,869,117	\$ 30,546	\$ 1,899,663	\$ 1,555,942	\$ 10,909	\$ 1,566,851	\$ 1,558,105	\$ 25,072	\$ 1,583,177

Classified assets were \$30.5 million, or 0.95% of total assets, at September 30, 2018, compared to \$10.9 million, or 0.38% of total assets, at September 30, 2017 and \$25.1 million, or 0.88% of total assests at December 31, 2017. The increase in classified assets at September 30, 2018 was primarily due to seasonal advances on lines of credit associated with a single large lending relationship that was moved to classified loans in the fourth quarter of 2017, which totaled \$21.8 million at September 30, 2018, compared to \$12.5 million at December 31, 2017. 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 in accordance with the Company's underwriting policy.

Table of Contents

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

	Nine Months Ended September 30, 2018		
	Performing TDRs	Nonperforming TDRs	Total
	(Dollars in thousands)		
Balance at January 1, 2018	\$ 309	\$ 16	\$ 325
Additions	384	—	384
Principal repayments	(17)	(16)	(33)
Balance at September 30, 2018	\$ 676	\$ —	\$ 676

	Nine Months Ended September 30, 2017		
	Performing TDRs	Nonperforming TDRs	Total
	(Dollars in thousands)		
Balance at January 1, 2017	\$ 131	\$ 2	\$ 133
Additions	228	90	318
Principal repayments	(16)	(1)	(17)
Balance at September 30, 2017	\$ 343	\$ 91	\$ 434

### 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 collectability as of the evaluation date. The Company's historical delinquency experience and loss experience are utilized to determine the probability of default and loss given default for segments of the portfolio where the Company has experienced losses in the past. For segments of the portfolio where the Company has no significant prior loss experience, the Company uses quantifiable observable industry data to determine the probability of default and loss given default.

The following provides a summary of the risks associated with various segments of the Company's loan portfolio, which are factors management regularly considers when evaluating the adequacy of the allowance:

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



## Table of Contents

Should the overall aging for the portfolio increase, this structure will by formula increase the allowance to reflect the increasing risk. Should the portfolio turn more quickly, it would reduce the associated allowance to reflect the reducing risk.

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

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

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

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

Three Months Ended September 30, 2018			
	Real		
Commercial	Estate	Consumer	Total

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

(Dollars in thousands)

Beginning of period balance	\$ 17,522	\$ 9,020	\$ 122	\$ 26,664
Charge-offs	(719)	—	(25)	(744)
Recoveries	1,897	34	—	1,931
Net (charge-offs) recoveries	1,178	34	(25)	1,187
Provision (credit) for loan losses	(1,427)	1,022	(20)	(425)
End of period balance	\$ 17,273	\$ 10,076	\$ 77	\$ 27,426

RATIOS:

Annualized net charge-offs (recoveries) to average loans (1)	(0.24) %	(0.01) %	0.01 %	(0.24) %
Allowance for loan losses to total loans (1)	0.91 %	0.53 %	0.00 %	1.44 %
Allowance for loan losses to nonperforming loans	69.89 %	40.77 %	0.31 %	110.97 %

---

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

---

Table of Contents

## Three Months Ended September 30, 2017

	Real			
	Commercial	Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 11,259	\$ 7,982	\$ 156	\$ 19,397
Charge-offs	(111)	—	—	(111)
Recoveries	281	66	—	347
Net recoveries	170	66	—	236
Provision (credit) for loan losses	(441)	592	(36)	115
End of period balance	\$ 10,988	\$ 8,640	\$ 120	\$ 19,748
RATIOS:				
Annualized net charge-offs (recoveries) to average loans (1)	(0.04) %	(0.02) %	0.00 %	(0.06) %
Allowance for loan losses to total loans (1)	0.70 %	0.55 %	0.01 %	1.26 %
Allowance for loan losses to nonperforming loans	314.75 %	247.49 %	3.44 %	565.68 %

## Nine Months Ended September 30, 2018

	Real			
	Commercial	Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 10,608	\$ 8,950	\$ 100	\$ 19,658
Charge-offs	(1,835)	—	(25)	(1,860)
Recoveries	2,229	120	—	2,349
Net (charge-offs) recoveries	394	120	(25)	489
Provision for loan losses	6,271	1,006	2	7,279
End of period balance	\$ 17,273	\$ 10,076	\$ 77	\$ 27,426
RATIOS:				
Annualized net charge-offs (recoveries) to average loans (1)	(0.03) %	(0.01) %	0.00 %	(0.04) %
Allowance for loan losses to total loans (1)	0.91 %	0.53 %	0.00 %	1.44 %
Allowance for loan losses to nonperforming loans	69.89 %	40.77 %	0.31 %	110.97 %

## Nine Months Ended September 30, 2017

	Real			
	Commercial	Estate	Consumer	Total

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	(Dollars in thousands)			
Beginning of period balance	\$ 10,656	\$ 8,327	\$ 106	\$ 19,089
Charge-offs	(2,179)	—	—	(2,179)
Recoveries	1,453	995	—	2,448
Net (charge-offs) recoveries	(726)	995	—	269
Provision (credit) for loan losses	1,058	(682)	14	390
End of period balance	\$ 10,988	\$ 8,640	\$ 120	\$ 19,748
RATIOS:				
Annualized net charge-offs (recoveries) to average loans (1)	0.07 %	(0.09) %	0.00 %	(0.02) %
Allowance for loan losses to total loans (1)	0.70 %	0.55 %	0.01 %	1.26 %
Allowance for loan losses to nonperforming loans	314.75 %	247.49 %	3.44 %	565.68 %

---

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

---

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

	September 30, 2018			2017			December 31, 2017		
	Allowance (Dollars in thousands)	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	
Commercial	\$ 17,273	31	%	\$ 10,988	38	%	\$ 10,608	36	%
Real estate:									
CRE	6,053	52	%	5,598	48	%	5,909	49	%
Land and construction	1,987	7	%	1,381	6	%	1,441	6	%
Home equity	1,826	6	%	1,435	4	%	1,390	5	%
Residential mortgages	210	3	%	226	3	%	210	3	%
Consumer	77	1	%	120	1	%	100	1	%
Total	\$ 27,426	100	%	\$ 19,748	100	%	\$ 19,658	100	%

The allowance for loan losses totaled \$27.4 million, or 1.44% of total loans at September 30, 2018, compared to \$19.7 million, or 1.26% of total loans at September 30, 2017, and \$19.7 million, or 1.24% of total loans at December 31, 2017. The Company had net recoveries of \$1.2 million, or (0.24%) of average loans, for the third quarter of 2018, compared to net recoveries of (\$236,000), or (0.06%) of average loans, for the third quarter of 2017, and net recoveries of (\$201,000), or (0.05)% of average loans, for the fourth quarter of 2017.

The allowance for loan losses related to the commercial portfolio increased \$6.7 million, at September 30, 2018 from December 31, 2017, primarily due to a provision for loan losses of \$6.3 million resulting from the \$7.0 million specific loan loss reserve allocated for the single large lending relationship discussed above, and net recoveries of \$394,000. The allowance for loan losses related to the real estate portfolio increased \$1.1 million at September 30, 2018 from December 31, 2017, primarily due to increasing market risk associated with risk factors for real estate loans, resulting in a \$1.0 million provision for loan losses and net recoveries of \$120,000.

## Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate a more accurate or appropriate value for an asset or liability. Total goodwill was \$83.7 million at September 30, 2018, which

consisted of, \$13.0 million related to the Bay View Funding acquisition, \$32.6 million related to the Focus acquisition, \$13.8 million related to the Tri-Valley acquisition, and \$24.3 million related to the United American acquisition. Total goodwill was \$45.6 million at December 31, 2017, which consisted of \$13.0 million related to the Bay View Funding acquisition, and \$32.6 million related to the Focus acquisition.

On April 6, 2018, the Company completed its acquisition of Tri-Valley for a transaction value of \$32.3 million. At closing the Company issued 1,889,613 shares of the Company's common stock with an aggregate market value of \$30.7 million on the date of closing. The number of shares issued was based on a fixed exchange ratio of 0.0489 of a share of the Company's common stock for each outstanding share of Tri-Valley common stock. In addition, at closing the Company paid cash to the holder of a stock warrant and holders of outstanding stock options and related fees and fractional shares totaling \$1.6 million. The Company recorded goodwill of \$13.8 million for the Tri-Valley acquisition.

On May 4, 2018, the Company completed its acquisition of United American for a transaction value of \$56.4 million. At closing the Company issued 2,826,032 shares of the Company's common stock with an aggregate market value of \$47.3 million on the date of closing. The number of shares issued was based on a fixed exchange ratio of 2.1644 of a share of the Company's common stock for each outstanding share of United American common stock and each common stock equivalent underlying the United American Series D Preferred Stock and Series E Preferred Stock. The shareholders of the United American Series A Preferred Stock and the Series B Preferred Stock received \$1,000 cash for each share totaling \$8.7 million and \$435,000, respectively. In addition, the Company paid \$2,000 in cash for fractional

Table of Contents

shares, for total cash consideration of \$9.1 million. The Company recorded goodwill of \$24.3 million for the United American acquisition.

The Company completed its annual goodwill impairment analysis as of November 30, 2017 with the assistance of an independent valuation firm. No events or circumstances since the November 30, 2017 annual impairment test were noted that would indicate it was more likely than not a goodwill impairment exists.

Other intangible assets were \$12.6 million at September 30, 2018, compared to \$5.6 million at December 31, 2017. A customer relationship and brokered relationship, and intangible assets arising from the acquisition of Bay View Funding were \$1.2 million at September 30, 2018 and \$1.3 million at December 31, 2017, net of accumulated amortization. The below market lease and non-compete intangible assets were fully amortized at December 31, 2017. The core deposit intangible assets arising from the acquisition of Focus was \$3.7 million at September 30, 2018 and \$4.3 million at December 31, 2017, net of accumulated amortization. The core deposit intangible and below market lease intangible assets arising from the Tri-Valley acquisition were \$1.8 million at September 30, 2018, net of accumulated amortization. The core deposit intangible and below market lease intangible assets arising from the United American acquisition were \$5.9 million at September 30, 2018, net of accumulated amortization.

## Deposits

The composition and cost of the Company's deposit base are important components in analyzing the Company's net interest margin and balance sheet liquidity characteristics, both of which are discussed in greater detail in other sections herein. The Company's liquidity is impacted by the volatility of deposits from the propensity of that money to leave the institution for rate related or other reasons. Deposits can be adversely affected if economic conditions weaken in California, and the Company's market area in particular. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed \$250,000, as customers with balances of that magnitude are typically more rate sensitive than customers with smaller balances.

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

	September 30, 2018			September 30, 2017			December 31, 2017		
	Balance	% to Total		Balance	% to Total		Balance	% to Total	
	(Dollars in thousands)								
Demand, noninterest-bearing	\$ 1,081,846	39	%	\$ 943,723	38	%	\$ 989,753	40	%
Demand, interest-bearing	670,624	24	%	605,301	24	%	601,929	24	%
Savings and money market	828,297	30	%	713,693	29	%	684,131	27	%
	68,194	3	%	53,479	2	%	51,710	2	%

Time deposits — under \$250									
Time deposits — \$250 and over	84,763	3	%	147,422	6	%	138,634	6	%
CDARS — interest-bearing demand, money market and time deposits	11,575	1	%	16,986	1	%	16,832	1	%
Total deposits	\$ 2,745,299	100	%	\$ 2,480,604	100	%	\$ 2,482,989	100	%

The Company obtains deposits from a cross section of the communities it serves. The Company's business is not generally seasonal in nature. Public funds were less than 1% of deposits at September 30, 2018, and 3% at September 30, 2017, and December 31, 2017.

Total deposits increased \$264.7 million, or 11%, to \$2.75 billion at September 30, 2018, compared to \$2.48 billion at September 30, 2017, which included \$266.6 million, at fair value, in deposits from United American, \$91.4 million, at fair value, in deposits from Tri-Valley, partially offset by decrease of \$28.2 million, or (1%), in the Company's legacy deposits. Total deposits increased \$262.3 million or 11% from \$2.48 billion at December 31, 2017, which included \$266.6 million in deposits from United American, \$91.4 million in deposits from Tri-Valley, partially offset by the maturity of \$65.1 million State of California certificates of deposits, and a decrease of \$30.6 million, or (1%), in the Company's legacy deposits.

Deposits, excluding all time deposits and CDARS deposits, increased \$318.1 million, or 14%, to \$2.58 billion at September 30, 2018, compared to \$2.26 billion at September 30, 2017, which included \$231.9 million of deposits added from United American, \$83.0 million of deposits added from Tri-Valley, and an increase of \$3.1 million in the Company's legacy deposits. Deposits, excluding all time deposits and CDARS deposits, increased \$305.0 million, or



Table of Contents

13%, compared to \$2.28 billion at December 31, 2017, which included \$231.9 million of deposits added from United American, \$83.0 million of deposits added from Tri-Valley, partially offset by a decrease of \$10.0 million in the Company's legacy deposits.

Time deposits of \$250,000 and over decreased \$62.7 million, or (43%), to \$84.8 million at September 30, 2018, compared to \$147.4 million at September 30, 2017, which included the maturity of \$65.1 million State of California certificates of deposits, and a decrease of \$17.6 million, or (21%), in the Company's legacy deposits, partially offset by \$16.2 million of deposits added from United American, and \$3.8 million of deposits added from Tri-Valley. Time deposits of \$250,000 and over decreased \$53.9 million, or (39%), compared to \$138.6 million at December 31, 2017, which included the maturity of \$65.1 million State of California certificates of deposits, and a decrease of \$8.8 million, or (12%), in the Company's legacy deposits, partially offset by \$16.2 million of deposits added from United American, and \$3.8 million of deposits added from Tri-Valley.

At September 30, 2018, the Company had no certificates of deposits from the State of California. At September 30, 2017, the Company had \$71.5 million, at fair value, of securities pledged for \$65.1 million in certificates of deposits from the State of California. At December 31, 2017, the Company had \$72.5 million, at fair value, of securities pledged for \$65.1 million in certificates of deposits from the State of California.

At September 30, 2018, the \$11.6 million CDARS deposits were comprised of \$7.3 million of interest-bearing demand deposits, \$1.4 million of money market accounts and \$2.9 million of time deposits. At September 30, 2017, the \$17.0 million CDARS deposits were comprised of \$11.8 million of interest-bearing demand deposits, \$1.8 million of money market accounts and \$3.4 million of time deposits. At December 31, 2017, the \$16.8 million CDARS deposits were comprised of \$10.9 million of interest-bearing demand deposits, \$1.7 million of money market accounts and \$4.2 million of time deposits.

The following table indicates the contractual maturity schedule of the Company's time deposits of \$250,000 and over, and all CDARS time deposits as of September 30, 2018:

	Balance	% of Total	
	(Dollars in thousands)		
Three months or less	\$ 35,717	41	%
Over three months through six months	11,413	13	%
Over six months through twelve months	32,457	37	%
Over twelve months	8,098	9	%
Total	\$ 87,685	100	%

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

## Return on Equity and Assets

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

	Three Months Ended September 30, 2018				Nine Months Ended September 30, 2018			
Return on average assets	1.54	%	1.20	%	0.98	%	1.12	%
Return on average tangible assets	1.59	%	1.22	%	1.01	%	1.14	%
Return on average equity	14.03	%	12.49	%	9.31	%	11.35	%
Return on average tangible equity	19.36	%	15.41	%	12.33	%	14.11	%
Average equity to average assets ratio	10.96	%	9.61	%	10.57	%	9.86	%

Table of Contents

## Off Balance Sheet Arrangements

In the normal course of business the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in the contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, but are not reflected on the Company's consolidated balance sheets. Total unused commitments to extend credit were \$721.0 million at September 30, 2018, compared to \$684.0 million at September 30, 2017, and \$687.4 million at December 31, 2017. Unused commitments represented 38% outstanding gross loans at September 30, 2018, 44% at September 30, 2017, and 43% at December 31, 2017.

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:

	September 30, 2018		2017		December 31, 2017	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)					
Unused lines of credit and commitments to make loans	\$ 120,286	\$ 584,141	\$ 17,024	\$ 652,105	\$ 102,505	\$ 570,190
Standby letters of credit	4,125	12,468	4,400	10,492	3,972	10,715
	\$ 124,411	\$ 596,609	\$ 21,424	\$ 662,597	\$ 106,477	\$ 580,905

## 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 cash inflows must be properly 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 of liquidity is our loan to deposit ratio. Our loan to deposit ratio was 69.19% at September 30, 2018, compared to 63.13% at September 30, 2017, and 63.74% at December 31, 2017.

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

HBC has off balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. HBC can borrow from the FHLB on a short term (typically overnight) or long term (over one year) basis. HBC had no overnight borrowings from the FHLB at September 30, 2018, September 30, 2017, and December 31, 2017. HBC had \$233.0 million of loans pledged to the FHLB as collateral on an available line of credit of \$183.2 million at September 30, 2018, none of which was outstanding.

HBC can also borrow from the FRB's discount window. HBC had \$660.4 million of loans pledged to the FRB as collateral on an available line of credit of \$392.7 million at September 30, 2018, none of which was outstanding.

At September 30, 2018, HBC had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at September 30, 2018, September 30, 2017, and December 31, 2017.

Table of Contents

The Company has a \$5.0 million line of credit with a correspondent bank, of which none was outstanding at September 30, 2018.

HBC may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase at September 30, 2018, September 30, 2017, and December 31, 2017.

## Subordinated Debt

On May 26, 2017, the Company completed an underwritten public offering of \$40.0 million aggregate principal amount of its fixed-to-floating rate subordinated notes (“Subordinated Debt”) due June 1, 2027. The Subordinated Debt initially bears a fixed interest rate of 5.25% per year. Commencing on June 1, 2022, the interest rate on the Subordinated Debt resets quarterly to the three-month LIBOR rate plus a spread of 336.5 basis points. Interest on the Subordinated Debt is payable semi-annually on June 1st and December 1st of each year through June 1, 2022 and quarterly thereafter on March 1st, June 1st, September 1st and December 1st of each year through the maturity date or early redemption date. The Company, at its option, may redeem the Subordinated Debt, in whole or in part, on any interest payment date on or after June 1, 2022 without a premium. The Subordinated Debt, net of unamortized costs totaled \$39.3 million at September 30, 2018 and \$39.2 million at December 31, 2017, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank. The Company down streamed \$20.0 million of the proceeds to HBC during the second quarter of 2017.

## Capital Resources

The Company uses a variety of measures to evaluate capital adequacy. Management reviews various capital measurements on a regular basis and takes appropriate action to ensure that such measurements are within established internal and external guidelines. The external guidelines, which are issued by the Federal Reserve and the FDIC, establish a risk adjusted ratio relating capital to different categories of assets and off balance sheet exposures.

The following table summarizes risk based capital, risk weighted assets, and risk based capital ratios of the consolidated Company under the Basel III requirements for the periods indicated:

	September 30, 2018	September 30, 2017	December 31, 2017
	(Dollars in thousands)		
Capital components:			
Common equity Tier 1 capital	\$ 266,654	\$ 229,656	\$ 229,258
Additional Tier 1 capital	—	—	—
Tier 1 Capital	266,654	229,656	229,258
Tier 2 Capital	67,498	59,575	59,496

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total risk-based capital	\$ 334,152	\$ 289,231	\$ 288,754
Risk-weighted assets	\$ 2,318,713	\$ 1,986,488	\$ 2,003,652
Average assets for capital purposes	\$ 3,100,135	\$ 2,783,219	\$ 2,873,978

Capital ratios:

Total risk-based capital	14.4	%	14.6	%	14.4	%
Tier 1 risk-based capital	11.5	%	11.6	%	11.4	%
Common equity Tier 1 risk-based capital	11.5	%	11.6	%	11.4	%
Leverage(1)	8.6	%	8.3	%	8.0	%

---

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

---

Table of Contents

The following table summarizes risk based capital, risk-weighted assets, and risk-based capital ratios of HBC under the Basel III requirements for the periods indicated:

	September 30, 2018	September 30, 2017	December 31, 2017
	(Dollars in thousands)		
Capital components:			
Common equity Tier 1 capital	\$ 282,460	\$ 244,831	\$ 244,790
Additional Tier 1 capital	—	—	—
Tier 1 Capital	282,460	244,831	244,790
Tier 2 Capital	28,176	20,438	20,312
Total risk-based capital	\$ 310,636	\$ 265,269	\$ 265,102
Risk-weighted assets	\$ 2,316,959	\$ 1,985,132	\$ 2,002,736
Average assets for capital purposes	\$ 3,098,391	\$ 2,782,021	\$ 2,873,102
Capital ratios:			
Total risk-based capital	13.4	%	13.4 %
Tier 1 risk-based capital	12.2	%	12.3 %
Common equity Tier 1 risk-based capital	12.2	%	12.3 %
Leverage(1)	9.1	%	8.8 %

---

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

---

The following table presents the applicable well capitalized regulatory guidelines and the standards for minimum capital adequacy requirements under Basel III:

	Transitional Minimum Regulatory Requirement(1) Effective January 1, 2018	Fully Phased-in Minimum Regulatory Requirement(2) Effective January 1, 2019	Well-capitalized Financial Institution Regulatory Guidelines
Capital ratios:			
Total risk-based capital	9.875	%	10.5 %
Tier 1 risk-based capital	7.875	%	8.5 %
Common equity Tier 1 risk-based capital	6.375	%	7.0 %
Leverage	4.000	%	4.0 %

- (1) Includes 1.875% capital conservation buffer, except the leverage capital ratio.
  - (2) Includes 2.5% capital conservation buffer, except the leverage capital ratio.
- 

The Basel III capital rules introduce a new “capital conservation buffer,” for banking organizations to maintain a common equity Tier 1 ratio more than 2.5% above these minimum risk weighted asset ratios. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk weighted assets above the minimum but below the capital conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The implementation of the capital conservation buffer was phased in beginning on January 1, 2016 at 0.625% and will be phased in over a four year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The capital conservation buffer increased to 1.875% beginning on January 1, 2018.

At September 30, 2018, the Company’s consolidated capital ratio exceeded regulatory guidelines and HBC’s capital ratios exceed the highest regulatory capital requirement of “well capitalized” under Basel III prompt corrective action provisions. Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios of total risk based capital, Tier 1 capital, and common equity Tier 1



## Table of Contents

(as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of September 30, 2018, September 30, 2017, and December 31, 2017, the Company and HBC met all capital adequacy guidelines to which they were subject. There are no conditions or events since September 30, 2018, that management believes have changed the categorization of the Company or HBC as well capitalized.

At September 30, 2018, the Company had total shareholders' equity of \$353.5 million, compared to \$275.4 million at September 30, 2017, and \$271.2 million at December 31, 2017. At September 30, 2018, total shareholders' equity included \$300.2 million in common stock, \$70.5 million in retained earnings, and (\$17.2) million of accumulated other comprehensive loss.

The accumulated other comprehensive loss was (\$17.2) million at September 30, 2018, compared to (\$6.1) million at September 30, 2017, and (\$9.3) million at December 31, 2017. The unrealized gain loss on securities available for sale, net of taxes, included in accumulated other comprehensive loss was an unrealized loss of (\$9.0) million at September 30, 2018, compared to an unrealized gain of \$614,000 at September 30, 2017, and an unrealized loss (\$1.1) million at December 31, 2017. The components of accumulated other comprehensive loss, net of taxes, at September 30, 2018 include the following: an unrealized loss on available for sale securities of (\$9.0) million; the remaining unamortized unrealized gain on securities available for sale transferred to held to maturity of \$351,000; a split dollar insurance contracts liability of (\$3.7) million; a supplemental executive retirement plan liability of (\$5.4) million; and an unrealized gain on interest only strip from SBA loans of \$613,000.

The book value per share was \$8.17 at September 30, 2018, compared to \$7.21 at September 30, 2017, and \$7.10 at December 31, 2017. The tangible book value per share was \$5.94 at September 30, 2018, compared to \$5.86 at September 30, 2017, and \$5.76 at December 31, 2017.

## 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 Management's Asset/Liability Committee and the Director's Finance and Investment Committee. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximizing income. Management realizes certain risks are inherent, and that the goal is to identify and manage the risks. Management uses two methodologies to manage interest rate risk: (i) a standard GAP analysis; and (ii) an interest rate shock simulation model.

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

Table of Contents

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 September 30, 2018. 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.

Change in Interest Rates (basis points)	Increase/(Decrease) in Estimated Net Interest Income		
	Amount	Percent	
	(Dollars in thousands)		
+400	\$ 29,678	22.8	%
+300	\$ 22,441	17.3	%
+200	\$ 15,244	11.7	%
+100	\$ 7,836	6.0	%
0	\$ —	—	%
-100	\$ (12,013)	(9.2)	%
-200	\$ (25,463)	(19.6)	%

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

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

Table of Contents

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 September 30, 2018. 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 at September 30, 2018, the period covered by this report on Form 10-Q.

During the three and nine months ended September 30, 2018, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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 other factors discussed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017, which could materially affect our business, financial condition and/or operating results. There were no material changes from risk factors previously disclosed in our 2017 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 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

82

---

Table of Contents

ITEM 6—EXHIBITS

Exhibit	Description
3.1	<u>Heritage Commerce Corp Restated Articles of Incorporation, (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 16, 2009)</u>
3.2	<u>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 3.2 to the Registrant's Registration Statement on Form S-1 filed July 23, 2010).</u>
3.3	<u>Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 28, 2013)</u>
31.1	<u>Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002</u>
31.2	<u>Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002</u>
32.1	<u>Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350</u>
32.2	<u>Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350</u>
101.INS	XBRL Instance Document, filed herewith
101.SCH	XBRL Taxonomy Extension Schema Document, filed herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, filed herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, filed herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, filed herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, filed 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.

Heritage Commerce Corp (Registrant)

Date: November 6, 2018 /s/ WALTER T. KACZMAREK  
Walter T. Kaczmarek  
Chief Executive Officer

Date: November 6, 2018 /s/ Lawrence D. McGovern  
Lawrence D. McGovern  
Chief Financial Officer