

HERITAGE COMMERCE CORP
Form 10-Q
November 06, 2014

Use these links to rapidly review the document

[TABLE OF CONTENTS](#)

[Table of Contents](#)

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

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended September 30, 2014

OR

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

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

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

California
(State or Other Jurisdiction of
Incorporation or Organization)

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

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

95113
(Zip Code)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

subject to such filing requirements for the past 90 days. YES NO

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a
smaller reporting company)

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

The Registrant had 26,421,153 shares of Common Stock outstanding on October 17, 2014.

Table of Contents

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

		Page No.
	<u>Cautionary Note on Forward-Looking Statements</u>	<u>3</u>
	<u>Part I. FINANCIAL INFORMATION</u>	
<u>Item 1.</u>	<u>Consolidated Financial Statements (unaudited)</u>	<u>5</u>
	<u>Consolidated Balance Sheets</u>	<u>5</u>
	<u>Consolidated Statements of Income</u>	<u>6</u>
	<u>Consolidated Statements of Comprehensive Income (Loss)</u>	<u>7</u>
	<u>Consolidated Statements of Changes in Shareholders' Equity</u>	<u>8</u>
	<u>Consolidated Statements of Cash Flows</u>	<u>9</u>
	<u>Notes to Consolidated Financial Statements</u>	<u>10</u>
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>43</u>
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>78</u>
<u>Item 4.</u>	<u>Controls and Procedures</u>	<u>78</u>
	<u>PART II. OTHER INFORMATION</u>	
<u>Item 1.</u>	<u>Legal Proceedings</u>	<u>79</u>
<u>Item 1A.</u>	<u>Risk Factors</u>	<u>79</u>
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>79</u>
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u>	<u>79</u>
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>	<u>79</u>
<u>Item 5.</u>	<u>Other Information</u>	<u>79</u>
<u>Item 6.</u>	<u>Exhibits</u>	<u>80</u>
	<u>SIGNATURES</u>	<u>81</u>
	<u>EXHIBIT INDEX</u>	<u>82</u>

Table of Contents

Cautionary Note Regarding Forward-Looking Statements

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

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

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

Delay in the pace of economic recovery and stagnant or decreasing employment levels;

Changes in the financial performance or condition of the Company's customers, or changes in the performance or creditworthiness of our customers' suppliers or other counterparties, which could lead to decreased loan utilization rates, delinquencies, or defaults, which could negatively affect our customers' ability to meet certain credit obligations;

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

Changes in consumer spending, borrowing or saving habits;

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

The ability to increase market share and control expenses;

Risks associated with concentrations in real estate related loans;

Other-than-temporary impairment charges to our securities portfolio;

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

A prolonged slowdown in construction activity;

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

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

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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

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

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

The effect of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the rules and regulations to be promulgated by supervisory and oversight agencies implementing the legislation taking into account that the precise timing, extent and nature of such rules and regulations and the impact on the Company are uncertain;

The impact of revised capital requirements under Basel III;

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

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

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

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

Successful integration of the business, employees and operations of Bay View Funding with the Company; and

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

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

Table of Contents**Part I FINANCIAL INFORMATION****ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****HERITAGE COMMERCE CORP****CONSOLIDATED BALANCE SHEETS (Unaudited)**

	September 30, 2014	December 31, 2013
	(Dollars in thousands)	
Assets		
Cash and due from banks	\$ 23,905	\$ 20,158
Interest-bearing deposits in other financial institutions	130,170	92,447
Total cash and cash equivalents	154,075	112,605
Securities available-for-sale, at fair value	191,680	280,100
Securities held-to-maturity, at amortized cost (fair value of \$93,161 at September 30, 2014 and \$86,032 at December 31, 2013)	94,759	95,921
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	673	3,148
Loans, net of deferred fees	1,029,596	914,913
Allowance for loan losses	(18,541)	(19,164)
Loans, net	1,011,055	895,749
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	10,501	10,435
Company owned life insurance	50,853	50,012
Premises and equipment, net	7,377	7,240
Intangible assets	1,182	1,527
Accrued interest receivable and other assets	36,159	34,895
Total assets	\$ 1,558,314	\$ 1,491,632
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 488,987	\$ 431,085
Demand, interest-bearing	223,121	195,451
Savings and money market	369,378	347,052
Time deposits under \$100	20,067	21,646
Time deposits \$100 and over	197,562	195,005
Time deposits brokered	28,099	55,524
CDARS money market and time deposits	14,608	40,458
Total deposits	1,341,822	1,286,221
Accrued interest payable and other liabilities	33,576	32,015

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total liabilities	1,375,398	1,318,236
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at September 30, 2014 and December 31, 2013 (liquidation preference of \$21,004 at September 30, 2014 and December 31, 2013)	19,519	19,519
Common stock, no par value; 60,000,000 shares authorized; 26,374,980 shares issued and outstanding at September 30, 2014 and 26,350,938 shares issued and outstanding at December 31, 2013	133,195	132,561
Retained earnings	31,014	25,345
Accumulated other comprehensive loss	(812)	(4,029)
Total shareholders' equity	182,916	173,396
Total liabilities and shareholders' equity	\$ 1,558,314	\$ 1,491,632

See notes to consolidated financial statements

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
(Dollars in thousands, except per share data)				
Interest income:				
Loans, including fees	\$ 12,077	\$ 10,733	\$ 34,832	\$ 30,874
Securities, taxable	1,851	2,247	6,069	7,107
Securities, non-taxable	506	436	1,518	1,042
Interest-bearing deposits in other financial institutions	58	42	120	140
Total interest income	14,492	13,458	42,539	39,163
Interest expense:				
Deposits	500	575	1,527	1,796
Subordinated debt		51		229
Short-term borrowings		1	1	1
Total interest expense	500	627	1,528	2,026
Net interest income before provision for loan losses	13,992	12,831	41,011	37,137
Provision (credit) for loan losses	(24)	(534)	(232)	(804)
Net interest income after provision for loan losses	14,016	13,365	41,243	37,941
Noninterest income:				
Service charges and fees on deposit accounts	631	645	1,897	1,840
Increase in cash surrender value of life insurance	401	414	1,196	1,240
Servicing income	316	331	977	1,081
Gain on sales of SBA loans	259	103	858	373
Gain on sales of securities	47		97	38
Other	216	245	909	744
Total noninterest income	1,870	1,738	5,934	5,316
Noninterest expense:				
Salaries and employee benefits	6,228	5,772	19,290	17,647
Occupancy and equipment	1,055	986	2,987	3,082
Professional fees	617	602	1,329	1,984
Insurance expense	292	255	830	763
Software subscriptions	264	381	702	966

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Data processing	238	259	741	838
FDIC deposit insurance premiums	220	200	674	666
Correspondent bank charges	174	170	539	513
Foreclosed assets, net		8	(19)	(242)
Subordinated debt redemption charges				167
Low income housing investment losses	(353)	320		930
Other	1,404	1,427	4,734	4,236

Total noninterest expense	10,139	10,380	31,807	31,550
---------------------------	--------	--------	--------	--------

Income before income taxes	5,747	4,723	15,370	11,707
Income tax expense	2,322	1,510	5,545	3,521

Net income	3,425	3,213	9,825	8,186
Dividends on preferred stock	(280)	(168)	(728)	(168)

Net income available to common shareholders	\$ 3,145	\$ 3,045	\$ 9,097	\$ 8,018
---	----------	----------	----------	----------

Earnings per common share:

Basic	\$ 0.11	\$ 0.10	\$ 0.31	\$ 0.26
Diluted	\$ 0.11	\$ 0.10	\$ 0.31	\$ 0.26

See notes to consolidated financial statements

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Net income	\$ 3,425	\$ 3,213	\$ 9,825	\$ 8,186
Other comprehensive income (loss):				
Change in net unrealized holding gains (losses) on available-for-sale securities and I/O strips	(1,166)	675	5,717	(12,033)
Deferred income taxes	487	(284)	(2,404)	5,053
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(14)	(14)	(41)	(42)
Deferred income taxes	6	6	17	18
Reclassification adjustment for gains realized in income	(47)		(97)	(38)
Deferred income taxes	20		41	16
Change in unrealized gains (losses) on securities and I/O strips, net of deferred income taxes	(714)	383	3,233	(7,026)
Change in net pension and other benefit plan liability adjustment	(9)	44	(27)	109
Deferred income taxes	3	(18)	11	(45)
Change in pension and other benefit plan liability, net of deferred income taxes	(6)	26	(16)	64
Other comprehensive income (loss)	(720)	409	3,217	(6,962)
Total comprehensive income	\$ 2,705	\$ 3,622	\$ 13,042	\$ 1,224

See notes to consolidated financial statements

[Table of Contents](#)

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

Nine Months Ended September 30, 2014 and 2013

	Preferred Stock		Common Stock		Retained	Accumulated Other Comprehensive	Total
	Shares	Amount	Shares	Amount	Earnings	Income / (Loss)	Shareholders' Equity
(Dollars in thousands, except share data)							
Balance, January 1, 2013	21,004	\$ 19,519	26,322,147	\$ 131,820	\$ 15,721	\$ 2,681	\$ 169,741
Net income					8,186		8,186
Other comprehensive loss						(6,962)	(6,962)
Issuance of restricted stock awards			10,000				
Repurchase of warrant				(140)			(140)
Amortization of restricted stock awards, net of forfeitures and taxes				153			153
Cash dividend declared \$0.03 per share					(958)		(958)
Stock option expense, net of forfeitures and taxes				430			430
Stock options exercised			8,874	35			35
Balance, September 30, 2013	21,004	\$ 19,519	26,341,021	\$ 132,298	\$ 22,949	\$ (4,281)	\$ 170,485
Balance, January 1, 2014	21,004	\$ 19,519	26,350,938	\$ 132,561	\$ 25,345	\$ (4,029)	\$ 173,396
Net income					9,825		9,825
Other comprehensive income						3,217	3,217
Issuance of restricted stock awards, net			15,000				
Amortization of restricted stock awards, net of forfeitures and taxes				(49)			(49)
Cash dividend declared \$0.13 per share					(4,156)		(4,156)
Stock option expense, net of forfeitures and taxes				641			641
Stock options exercised			9,042	42			42
Balance, September 30, 2014	21,004	\$ 19,519	26,374,980	\$ 133,195	\$ 31,014	\$ (812)	\$ 182,916

See notes to consolidated financial statements

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

	Nine Months Ended September 30,	
	2014	2013
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 9,825	\$ 8,186
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	859	1,894
Gain on sales of securities available-for-sale	(97)	(38)
Gain on sales of SBA loans	(858)	(373)
Proceeds from sale of SBA loans originated for sale	14,439	5,128
Net change in SBA loans originated for sale	(11,106)	(8,341)
Provision (credit) for loan losses	(232)	(804)
Increase in cash surrender value of life insurance	(1,196)	(1,240)
Depreciation and amortization	539	539
Amortization of intangible assets	345	355
Gains on sale of foreclosed assets, net		(231)
Stock option expense, net	641	430
Amortization of restricted stock awards, net	(49)	153
Gain on redemption of company owned life insurance	(51)	
Effect of changes in:		
Accrued interest receivable and other assets	(3,730)	999
Accrued interest payable and other liabilities	2,511	1,395
Net cash provided by operating activities	11,840	8,052
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(34,775)	(8,334)
Purchase of securities held-to-maturity	(2,347)	(43,324)
Maturities/paydowns/calls of securities available-for-sale	19,696	55,206
Maturities/paydowns/calls of securities held-to-maturity	2,345	3,310
Proceeds from sale of securities available-for-sale	108,603	26,944
Net change in loans	(115,043)	(79,633)
Change in Federal Home Loan Bank and Federal Reserve Bank stock	(66)	(64)
Purchase of premises and equipment	(676)	(460)
Proceeds from sale of foreclosed assets		809
Proceeds from redemption of company owned life insurance	406	
Net cash used in investing activities	(21,857)	(45,546)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	55,601	(283,831)
Repurchase of warrant		(140)
Payment of cash dividends	(4,156)	(958)
Redemption of subordinated debt		(9,279)
Exercise of stock options	42	35
Net cash provided by (used in) financing activities	51,487	(294,173)

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Net decrease in cash and cash equivalents	41,470	(331,667)
Cash and cash equivalents, beginning of period	112,605	373,565

Cash and cash equivalents, end of period	\$ 154,075	\$ 41,898
--	------------	-----------

Supplemental disclosures of cash flow information:

Interest paid	\$ 1,523	\$ 2,110
Income taxes paid	3,250	3,365

Supplemental schedule of non-cash investing activity:

Due to broker for securities purchased	\$	\$ 1,901
Loans transferred to foreclosed assets	31	33
Transfer of loans held-for-sale to loan portfolio		20

See notes to consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company" or "HCC") and its wholly owned subsidiary, Heritage Bank of Commerce (the "Bank" or "HBC"), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes that were included in the Company's Form 10-K for the year ended December 31, 2013. The Company also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III, which were Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities. During the third quarter of 2012, the Company dissolved the Heritage Statutory Trust I and the Heritage Capital Trust I. During the third quarter of 2013, the Company dissolved the Heritage Statutory Trust II and the Heritage Commerce Corp Statutory Trust III.

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

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

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

The results for the three and nine months ended September 30, 2014 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2014.

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 January 2014, the Financial Accounting Standards Board ("FASB") amended existing guidance clarifying that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

1) Basis of Presentation (Continued)

completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. For entities other than public business entities, the amendments in this update are effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. The Company has evaluated the adoption of the new guidance and has determined it will not have a material impact on the consolidated financial statements.

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

The Company adopted the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014. The Company quantified the impact of adopting the proportional amortization method compared to the equity method to its current year and prior period financial statements. The Company determined that the adoption of the proportional amortization method did not have a material impact to its financial statements; therefore, the Company did not adjust its prior period financial statements. As a result of the change in accounting method, the Company reclassified \$353,000 of low income housing investment losses during the third quarter of 2014 that was previously reported as noninterest expense for the first six months of 2014. The low income housing investment losses, net of the tax benefits received, are included in income tax expense on the consolidated statements of income for the three months and nine months ended September 30, 2014. The change in accounting method also resulted in an increase in the effective tax rate to 40.4% and 36.1% for the three months and nine months ended September 30, 2014, respectively, compared to 32.0% and 30.1% for the three months and nine months ended September 30, 2013. Under the equity method of accounting for the low income housing investments for the three months ended September 30, 2014, the low income housing investment losses included in noninterest expense would have been \$261,000, income tax expense would have been \$1,715,000 and the effective tax rate would

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

1) Basis of Presentation (Continued)

have been 33.4%. Under the equity method of accounting for the low income housing investments for the nine months ended September 30, 2014, the low income housing investment losses included in noninterest expense would have been \$614,000, income tax expense would have been \$4,938,000 and the effective tax rate would have been 33.5%.

In May 2014, the FASB issued an update to the guidance for accounting for revenue from contracts with customers. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. We are evaluating the impact of adopting the new guidance on the consolidated financial statements.

2) Earnings Per Share

Basic earnings per common share is computed by dividing net income, less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. The Series C Preferred Stock participates in the earnings of the Company and, therefore, the shares issued on the conversion of the Series C Preferred Stock are considered outstanding under the two class method of computing basic earnings per common share during periods of earnings. Diluted earnings per share reflect potential dilution from outstanding stock options and common stock warrants, using the treasury stock method. The common stock warrant was antidilutive for the nine months ended September 30, 2013. The Company repurchased the warrant for \$140,000 in the second quarter of 2013. A

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****2) Earnings Per Share (Continued)**

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands, except per share amounts)			
Net income available to common shareholders	\$ 3,145	\$ 3,045	\$ 9,097	\$ 8,018
Less: undistributed earnings allocated to Series C Preferred Stock	320	395	993	1,268
Distributed and undistributed earnings allocated to common shareholders	\$ 2,825	\$ 2,650	\$ 8,104	\$ 6,750
Weighted average common shares outstanding for basic earnings per common share	26,371,413	26,340,080	26,367,314	26,335,222
Dilutive effect of stock options outstanding, using the the treasury stock method	145,450	46,969	134,646	46,743
Shares used in computing diluted earnings per common share	26,516,863	26,387,049	26,501,960	26,381,965
Basic earnings per share	\$ 0.11	\$ 0.10	\$ 0.31	\$ 0.26
Diluted earnings per share	\$ 0.11	\$ 0.10	\$ 0.31	\$ 0.26

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

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

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

	For the Three Months Ended September 30, 2014 and 2013				Total(1)
	Unrealized Gains (Losses) on Available- for-Sale Securities and I/O Strips(1)	Unamortized Unrealized Gain on Available- for-Sale Securities Reclassified to Held-to- Maturity(1)	Defined Benefit Pension Plan Items(1)		
	(Dollars in thousands)				
Beginning balance July 1, 2014, net of taxes	\$ 3,533	\$ 450	\$ (4,075)	\$ (92)	
Other comprehensive income (loss) before reclassification, net of taxes	(679)		(12)	(691)	
Amounts reclassified from other comprehensive income (loss), net of taxes	(27)	(8)	6	(29)	
Net current period other comprehensive income (loss), net of taxes	(706)	(8)	(6)	(720)	
Ending balance September 30, 2014, net of taxes	\$ 2,827	\$ 442	\$ (4,081)	\$ (812)	
Beginning balance July 1, 2013, net of taxes	\$ 494	\$ 481	\$ (5,665)	\$ (4,690)	
Other comprehensive (loss) before reclassification, net of taxes	391		(6)	385	
Amounts reclassified from other comprehensive income (loss), net of taxes		(8)	32	24	
Net current period other comprehensive income (loss), net of taxes	391	(8)	26	409	
Ending balance September 30, 2013, net of taxes	\$ 885	\$ 473	\$ (5,639)	\$ (4,281)	

(1) Amounts in parenthesis indicate debits.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

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

	For the Nine Months Ended September 30, 2014 and 2013			
	Unrealized Gains (Losses) on Available- for-Sale Securities and I/O Strips(1)	Unamortized Unrealized Gain on Available- for-Sale Securities Reclassified to Held-to- Maturity(1)	Defined Benefit Pension Plan Items(1)	Total(1)
	(Dollars in thousands)			
Beginning balance January 1, 2014, net of taxes	\$ (430)	\$ 466	\$ (4,065)	(4,029)
Other comprehensive (loss) before reclassification, net of taxes	3,313		(32)	3,281
Amounts reclassified from other comprehensive income (loss), net of taxes	(56)	(24)	16	(64)
Net current period other comprehensive income (loss), net of taxes	3,257	(24)	(16)	3,217
Ending balance September 30, 2014, net of taxes	\$ 2,827	\$ 442	\$ (4,081)	\$ (812)
Beginning balance January 1, 2013, net of taxes	\$ 7,887	\$ 497	\$ (5,703)	\$ 2,681
Other comprehensive income (loss) before reclassification, net of taxes	(6,980)		(26)	(7,006)
Amounts reclassified from other comprehensive income (loss), net of taxes	(22)	(24)	90	44
Net current period other comprehensive income, net of taxes	(7,002)	(24)	64	(6,962)
Ending balance September 30, 2013, net of taxes	\$ 885	\$ 473	\$ (5,639)	\$ (4,281)

(1)

Amounts in parenthesis indicate debits.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

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

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Three Months Ended September 30,		Affected Line Item Where Net Income is Presented
	2014	2013	
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	\$ 47	\$	Realized gains on sale of securities
	(20)		Income tax expense
	27		Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	14	14	Interest income on taxable securities
	(6)	(6)	Income tax expense
	8	8	Net of tax
Amortization of defined benefit pension plan items(2)			
Prior transition obligation	25	18	
Actuarial losses	(35)	(73)	
	(10)	(55)	Income before income tax
	4	23	Income tax expense
	(6)	(32)	Net of tax
Total reclassification for the period	\$ 29	\$ (24)	

(1)

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Amounts in parenthesis indicate debits.

(2)

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

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

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Nine Months Ended September 30,		Affected Line Item Where Net Income is Presented
	2014	2013	
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	\$ 97	\$ 38	Realized gains on sale of securities
	(41)	(16)	Income tax expense
	56	22	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	41	42	Interest income on taxable securities
	(17)	(18)	Income tax expense
	24	24	Net of tax
Amortization of defined benefit pension plan items(2)			
Prior transition obligation	77	63	
Actuarial losses	(105)	(219)	
	(28)	(156)	Income before income tax
	12	66	Income tax expense
	(16)	(90)	Net of tax
Total reclassification for the period	\$ 64	\$ (44)	

(1)

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Amounts in parenthesis indicate debits.

(2)

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

[Table of Contents](#)**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****4) Securities**

The amortized cost and estimated fair value of securities at September 30, 2014 and December 31, 2013 were as follows:

September 30, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(Dollars in thousands)				
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 137,450	\$ 3,125	\$ (798)	\$ 139,777
Corporate bonds	35,963	636	(183)	36,416
Trust preferred securities	15,000	487		15,487
Total	\$ 188,413	\$ 4,248	\$ (981)	\$ 191,680

Securities held-to-maturity:

Agency mortgage-backed securities	\$ 14,851	\$ 6	\$ (222)	\$ 14,635
Municipals tax exempt	79,908	742	(2,124)	78,526
Total	\$ 94,759	\$ 748	\$ (2,346)	\$ 93,161

December 31, 2013	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
(Dollars in thousands)				
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 208,644	\$ 2,465	\$ (3,465)	\$ 207,644
Corporate bonds	53,002	527	(1,483)	52,046
Trust preferred securities	20,849		(439)	20,410
Total	\$ 282,495	\$ 2,992	\$ (5,387)	\$ 280,100

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Securities held-to-maturity:

Agency mortgage-backed securities	\$	15,932	\$		\$	(470)	\$	15,462
Municipals tax exempt		79,989		54		(9,473)		70,570

Total	\$	95,921	\$	54	\$	(9,943)	\$	86,032
--------------	-----------	---------------	-----------	-----------	-----------	----------------	-----------	---------------

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****4) Securities (Continued)**

Securities with unrealized losses at September 30, 2014 and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

September 30, 2014	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	\$	\$	\$ 38,542	\$ (798)	\$ 38,542	\$ (798)
Corporate bonds	16,071	(106)	5,099	(77)	21,170	(183)
Total	\$ 16,071	\$ (106)	\$ 43,641	\$ (875)	\$ 59,712	\$ (981)

Securities held-to-maturity:						
Agency mortgage-backed securities	\$ 4,166	\$ (43)	\$ 7,124	\$ (179)	\$ 11,290	\$ (222)
Municipals Tax Exempt	1,606	(2)	54,706	(2,122)	56,312	(2,124)
Total	\$ 5,772	\$ (45)	\$ 61,830	\$ (2,301)	\$ 67,602	\$ (2,346)

December 31, 2013	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 87,798	\$ (2,869)	\$ 8,920	\$ (596)	\$ 96,718	\$ (3,465)
Corporate bonds	38,092	(1,322)	1,860	(161)	39,952	(1,483)
Trust preferred securities	20,410	(439)			20,410	(439)
Total	\$ 146,300	\$ (4,630)	\$ 10,780	\$ (757)	\$ 157,080	\$ (5,387)

Securities held-to-maturity:

Agency mortgage-backed securities	\$	5,978	\$	(101)	\$	9,134	\$	(369)	\$	15,112	\$	(470)
Municipals Tax Exempt		38,177		(4,421)		25,520		(5,052)		63,697		(9,473)
Total	\$	44,155	\$	(4,522)	\$	34,654	\$	(5,421)	\$	78,809	\$	(9,943)

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, 2014, the Company held 351 securities (121 available-for-sale and 230 held-to-maturity), of which 188 had fair values below amortized cost. At September 30, 2014, there were \$38,542,000 of agency mortgage-backed securities available-for-sale, \$5,099,000 of corporate bonds available-for-sale, \$7,124,000 of agency mortgage-backed securities held-to-maturity and \$54,706,000 of municipals bonds held-to-maturity carried with an unrealized loss for over 12 months. The total unrealized loss for securities over 12 months was \$3,176,000 at September 30, 2014. 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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****4) Securities (Continued)**

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, 2014.

At December 31, 2013, the Company held 392 securities (163 available-for-sale and 229 held-to-maturity), of which 275 had fair values below amortized cost. At December 31, 2013, there were \$8,920,000 of agency mortgage-backed securities available-for-sale, \$1,860,000 of corporate bonds available-for-sale, \$9,134,000 of agency mortgage-backed securities held-to-maturity, and \$25,520,000 of municipal bonds held-to-maturity carried with an unrealized loss for over 12 months. The total unrealized loss for securities over 12 months was \$6,178,000 at December 31, 2013. The unrealized losses were due to higher interest rates. The issuers were of high credit quality and all principal amounts were expected to be paid when securities mature. The fair value was expected to recover as the securities approach their maturity date and/or market rates decline. The Company did not believe that it is more likely than not that the Company would be required to sell a security in an unrealized loss position prior to recovery in value. The Company did not consider these securities to be other than temporarily impaired at December 31, 2013.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Proceeds	\$ 58,592	\$	\$ 108,603	\$ 26,944
Gross gains	288		1,008	310
Gross losses	(241)		(911)	(272)

The amortized cost and estimated fair values of securities as of September 30, 2014, are shown by contractual maturity below. The expected maturities will differ from contractual maturities if borrowers have the right to call or pre-pay obligations with or without call or pre-payment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after one through five years	\$ 6,315	\$ 6,685
Due after five through ten years	29,648	29,731
Due after ten years	15,000	15,487
Asset-backed securities and agency mortgage-backed securities	137,450	139,777
Total	\$ 188,413	\$ 191,680

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****4) Securities (Continued)**

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after five through ten years	\$ 5,721	\$ 5,875
Due after ten years	74,187	72,651
Agency mortgage-backed securities	14,851	14,635
Total	\$ 94,759	\$ 93,161

5) Loans

Loans were as follows:

	September 30, 2014	December 31, 2013
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	\$ 436,481	\$ 393,074
Real estate:		
Commercial and residential	464,991	423,288
Land and construction	53,064	31,443
Home equity	61,079	51,815
Consumer	14,609	15,677
Loans	1,030,224	915,297
Deferred loan origination fees, net	(628)	(384)
Loans, net of deferred fees	1,029,596	914,913
Allowance for loan losses	(18,541)	(19,164)
Loans, net	\$ 1,011,055	\$ 895,749

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

	Three Months Ended September 30, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 11,454	\$ 7,069	\$ 69	\$ 18,592
Charge-offs	(132)		(25)	(157)
Recoveries	123	7		130
Net (charge-offs) recoveries	(9)	7	(25)	(27)
Provision (credit) for loan losses	163	(205)	18	(24)
Balance, end of period	\$ 11,608	\$ 6,871	\$ 62	\$ 18,541

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****5) Loans (Continued)****Three Months Ended September 30, 2013**

	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 12,811	\$ 6,388	\$ 143	\$ 19,342
Charge-offs	(254)	(40)		(294)
Recoveries	820	7	1	828
Net recoveries	566	(33)	1	534
Provision (credit) for loan losses	(10)	(461)	(63)	(534)
Balance, end of period	\$ 13,367	\$ 5,894	\$ 81	\$ 19,342

Nine Months Ended September 30, 2014

	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 12,533	\$ 6,548	\$ 83	\$ 19,164
Charge-offs	(726)		(25)	(751)
Recoveries	309	51		360
Net (charge-offs) recoveries	(417)	51	(25)	(391)
Provision (credit) for loan losses	(508)	272	4	(232)
Balance, end of period	\$ 11,608	\$ 6,871	\$ 62	\$ 18,541

Nine Months Ended September 30, 2013

Commercial	Real Estate	Consumer	Total
-------------------	--------------------	-----------------	--------------

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

(Dollars in thousands)

Balance, beginning of period	\$	12,866	\$	6,034	\$	127	\$	19,027
Charge-offs		(1,213)		(96)				(1,309)
Recoveries		2,158		269		1		2,428
Net recoveries		945		173		1		1,119
Provision (credit) for loan losses		(444)		(313)		(47)		(804)
Balance, end of period	\$	13,367	\$	5,894	\$	81	\$	19,342

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****5) Loans (Continued)**

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

	September 30, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 606	\$ 124	\$ 62	\$ 730
Collectively evaluated for impairment	11,002	6,747	62	17,811
Total allowance balance	\$ 11,608	\$ 6,871	\$ 62	\$ 18,541

Loans:

Individually evaluated for impairment	\$ 3,398	\$ 3,806	\$ 6	\$ 7,210
Collectively evaluated for impairment	433,083	575,328	14,603	1,023,014
Total loan balance	\$ 436,481	\$ 579,134	\$ 14,609	\$ 1,030,224

	December 31, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 1,694	\$ 741	\$ 21	\$ 2,456
Collectively evaluated for impairment	10,839	5,807	62	16,708
Total allowance balance	\$ 12,533	\$ 6,548	\$ 83	\$ 19,164

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Loans:

Individually evaluated for impairment	\$	4,906	\$	6,790	\$	122	\$	11,818
Collectively evaluated for impairment		388,168		499,756		15,555		903,479

Total loan balance	\$	393,074	\$	506,546	\$	15,677	\$	915,297
--------------------	----	---------	----	---------	----	--------	----	---------

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****5) Loans (Continued)**

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of September 30, 2014 and December 31, 2013. 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.

	September 30, 2014			December 31, 2013		
	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	\$ 2,923	\$ 2,361	\$	\$ 1,999	\$ 1,915	\$
Real estate:						
Commercial and residential	2,531	1,672		2,831	2,831	
Land and construction	2,144	1,655		1,761	1,761	
Home Equity	355	355		377	377	
Consumer	6	6				
Total with no related allowance recorded	7,959	6,049		6,968	6,884	
With an allowance recorded:						
Commercial	1,037	1,037	\$ 606	3,225	2,991	1,694
Real estate:						
Commercial and residential				1,531	1,531	451
Home Equity	124	124	124	290	290	290
Consumer				122	122	21
Total with an allowance recorded	1,161	1,161	730	5,168	4,934	2,456
Total	\$ 9,120	\$ 7,210	\$ 730	\$ 12,136	\$ 11,818	\$ 2,456

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

Three Months Ended September 30, 2014

	Commercial	Real Estate	Consumer	Total
--	------------	-------------	----------	-------

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Commercial and Residential Land and Construction Home Equity

(Dollars in thousands)

Average of impaired loans during the period	\$ 3,790	\$ 2,273	\$ 1,672	\$ 513	\$ 19	\$ 8,267
Interest income during impairment	\$	\$	\$	\$	\$	\$
Cash-basis interest earned	\$	\$	\$	\$	\$	\$

24

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

5) Loans (Continued)

Three Months Ended September 30, 2013

	Real Estate						Total
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer		
	(Dollars in thousands)						
Average of impaired loans during the period	\$ 5,539	\$ 5,032	\$ 1,989	\$ 2,393	\$ 133	\$ 15,086	
Interest income during impairment	\$	\$	\$	\$	\$	\$	
Cash-basis interest earned	\$	\$	\$	\$	\$	\$	

Nine Months Ended September 30, 2014

	Real Estate						Total
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer		
	(Dollars in thousands)						
Average of impaired loans during the period	\$ 4,411	\$ 3,034	\$ 1,705	\$ 575	\$ 69	\$ 9,794	
Interest income during impairment	\$ 56	\$	\$	\$	\$	\$ 56	
Cash-basis interest earned	\$	\$	\$	\$	\$	\$	

Nine Months Ended September 30, 2013

	Real Estate						Total
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer		
	(Dollars in thousands)						
Average of impaired loans during the period	\$ 7,342	\$ 5,061	\$ 2,095	\$ 2,414	\$ 138	\$ 17,050	
Interest income during impairment	\$	\$	\$	\$	\$	\$	
Cash-basis interest earned	\$	\$	\$	\$	\$	\$	

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

September 30, 2014	September 30, 2013	December 31, 2013
-----------------------	-----------------------	----------------------

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

(Dollars in thousands)

Nonaccrual loans held-for-investment	\$ 7,010	\$ 14,615	\$ 11,326
Restructured and loans over 90 days past due and still accruing	200	502	492

Total nonperforming loans	\$ 7,210	\$ 15,117	\$ 11,818
---------------------------	----------	-----------	-----------

Other restructured loans	\$	\$ 10	\$
Impaired loans, excluding loans held-for-sale	\$ 7,210	\$ 15,127	\$ 11,818
	25		

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****5) Loans (Continued)**

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

	September 30, 2014			December 31, 2013		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	\$ 3,198	\$ 200	\$ 3,398	\$ 4,414	\$ 492	\$ 4,906
Real estate:						
Commercial and residential	1,672		1,672	4,363		4,363
Land and construction	1,655		1,655	1,761		1,761
Home equity	479		479	666		666
Consumer	6		6	122		122
Total	\$ 7,010	\$ 200	\$ 7,210	\$ 11,326	\$ 492	\$ 11,818

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

	September 30, 2014					
	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	\$ 344	\$ 131	\$ 2,197	\$ 2,672	\$ 433,809	\$ 436,481
Real estate:						
Commercial and residential			1,065	1,065	463,926	464,991
Land and construction	308			308	52,756	53,064
Home equity			124	124	60,955	61,079
Consumer					14,609	14,609
Total	\$ 652	\$ 131	\$ 3,386	\$ 4,169	\$ 1,026,055	\$ 1,030,224

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	December 31, 2013					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	\$ 3,314	\$ 428	\$ 2,865	\$ 6,607	\$ 386,467	\$ 393,074
Real estate:						
Commercial and residential	1,559		1,065	2,624	420,664	423,288
Land and construction					31,443	31,443
Home equity	28		290	318	51,497	51,815
Consumer			89	89	15,588	15,677
Total	\$ 4,901	\$ 428	\$ 4,309	\$ 9,638	\$ 905,659	\$ 915,297

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

5) Loans (Continued)

Past due loans 30 days or greater totaled \$4,169,000 and \$9,638,000 at September 30, 2014 and December 31, 2013, respectively, of which \$3,809,000 and \$5,900,000 were on nonaccrual. At September 30, 2014, there were also \$3,201,000 loans less than 30 days past due included in nonaccrual loans held for investment. At December 31, 2013, there were also \$5,426,000 loans less than 30 days past due included in nonaccrual loans held for investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

Credit Quality Indicators

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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****5) Loans (Continued)**

deficiencies are not corrected. In addition, the Company no longer accrues interest on the loan because of the underlying weaknesses.

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

Loss. Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for loan losses. Therefore, there is no balance to report at September 30, 2014 or December 31, 2013.

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

	September 30, 2014			December 31, 2013		
	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total
	(Dollars in thousands)					
Commercial	\$ 428,372	\$ 8,109	\$ 436,481	\$ 380,806	\$ 12,268	\$ 393,074
Real estate:						
Commercial and residential	458,671	6,320	464,991	416,992	6,296	423,288
Land and construction	51,408	1,656	53,064	29,682	1,761	31,443
Home equity	59,945	1,134	61,079	48,818	2,997	51,815
Consumer	14,252	357	14,609	15,336	341	15,677
Total	\$ 1,012,648	\$ 17,576	\$ 1,030,224	\$ 891,634	\$ 23,663	\$ 915,297

* Classified loans in the table above include Small Business Administration ("SBA") guarantees.

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

The recorded investment of troubled debt restructurings at September 30, 2014 was \$1,638,000, which included \$1,438,000 of nonaccrual loans and \$200,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2013 was \$3,722,000, which included \$3,230,000 of nonaccrual loans and \$492,000 of accruing loans. Approximately \$147,000 and \$1,186,000 in specific reserves were established with respect to these loans as of September 30, 2014 and December 31, 2013, respectively. As of September 30, 2014 and December 31, 2013, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

There were no new loans modified as troubled debt restructurings during the three and nine month periods ended September 30, 2014 and 2013.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

5) Loans (Continued)

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the three and nine month periods ended September 30, 2014 and 2013.

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

6) Income Taxes

Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles, leading to timing differences between the Company's actual 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.

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

The Company had net deferred tax assets of \$18,741,000, and \$23,326,000, at September 30, 2014, and December 31, 2013, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at September 30, 2014 and December 31, 2013 will be fully realized in future years.

The Company adopted the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014. The adoption did not have a material impact on the Company's financial condition or results of operations during the current year or on the prior period financial statements. As a result of the change in accounting method, the Company reclassified \$353,000 of low income housing investment losses during the third quarter of 2014 that was previously reported as noninterest expense for the first six months of 2014. The low income housing investment losses, net of the tax benefits received, are included in income tax expense on the consolidated statements of income for the three months and nine months ended September 30, 2014. The change in accounting method also resulted in an increase in the effective tax rate to 40.4% and 36.1% for the three months and nine months ended September 30, 2014, respectively, compared to 32.0% and 30.1% for the three months and nine months ended September 30, 2013. Under the equity method of accounting for the low income housing investments for the three months ended September 30, 2014,

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****6) Income Taxes (Continued)**

the low income housing investment losses included in noninterest expense would have been \$261,000, income tax expense would have been \$1,715,000 and the effective tax rate would have been 33.4%. Under the equity method of accounting for the low income housing investments for the nine months ended September 30, 2014, the low income housing investment losses included in noninterest expense would have been \$614,000, income tax expense would have been \$4,938,000 and the effective tax rate would have been 33.5%.

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands)		(Dollars in thousands)	
Components of net periodic benefit cost:				
Service cost	\$ 179	\$ 303	\$ 537	\$ 909
Interest cost	228	196	684	588
Amortization of net actuarial loss	35	73	105	219
Net periodic benefit cost	\$ 442	\$ 572	\$ 1,326	\$ 1,716

Split-Dollar Life Insurance Benefit Plan

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

	September 30, 2014		December 31, 2013	
	(Dollars in thousands)			
Change in projected benefit obligation:				
Projected benefit obligation at beginning of year	\$	4,353	\$	4,717
Interest cost		147		177
Actuarial gain				(541)
Projected benefit obligation at end of period	\$	4,500	\$	4,353

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****7) Benefit Plans (Continued)**

	September 30, 2014	December 31, 2013
	(Dollars in thousands)	
Net actuarial loss	\$ 400	\$ 256
Prior transition obligation	1,530	1,597
Accumulated other comprehensive loss	\$ 1,930	\$ 1,853

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands)		(Dollars in thousands)	
Amortization of prior transition obligation	\$ (25)	\$ (18)	\$ (77)	\$ (63)
Interest cost	49	44	147	132
Net periodic benefit cost	\$ 24	\$ 26	\$ 70	\$ 69

8) Equity***Series C Preferred Stock***

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. The 21,004 shares of Series C Preferred Stock are convertible into 5,601,000 shares of common stock. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. The holders of Series C Preferred Stock receive dividends on an as converted basis when dividends are also declared for holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

9) Fair Value

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

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

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

9) Fair Value (Continued)

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).

	Balance	Fair Value Measurements Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
(Dollars in thousands)			
Assets at September 30, 2014:			
Available-for-sale securities:			
Agency mortgage-backed securities	\$ 139,777		\$ 139,777
Corporate bonds	\$ 36,416		\$ 36,416
Trust preferred securities	\$ 15,487		\$ 15,487
I/O strip receivables	\$ 1,605		\$ 1,605
Assets at December 31, 2013:			
Available-for-sale securities:			
Agency mortgage-backed securities	\$ 207,644		\$ 207,644
Corporate bonds	\$ 52,046		\$ 52,046
Trust preferred securities	\$ 20,410		\$ 20,410
I/O strip receivables	\$ 1,647		\$ 1,647

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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****9) Fair Value (Continued)**

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

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

	Balance	Fair Value Measurements Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
(Dollars in thousands)			
<u>Assets at September 30, 2014:</u>			
Impaired loans held-for-investment:			
Commercial	\$ 1,095		\$ 1,095
Real estate:			
Commercial and residential	607		607
Land and construction	1,207		1,207
	\$ 2,909		\$ 2,909

Foreclosed assets:			
Commercial	\$ 31		\$ 31
	\$ 31		\$ 31

<u>Assets at December 31, 2013:</u>			
Impaired loans held-for-investment:			
Commercial	\$ 1,780		\$ 1,780
Real estate:			
Commercial and residential	2,846		2,846
Land and construction	1,290		1,290
Consumer	100		100

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

\$ 6,016

\$ 6,016

Foreclosed assets:

Land and construction

\$ 575

\$ 575

\$ 575

\$ 575

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****9) Fair Value (Continued)**

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

	September 30, 2014	December 31, 2013
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	\$ 3,639	\$ 8,472
Book value of impaired loans held-for-investment carried at cost	3,571	3,346
Total impaired loans held-for-investment	\$ 7,210	\$ 11,818
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	\$ 3,639	\$ 8,472
Specific valuation allowance	(730)	(2,456)
Impaired loans held-for-investment carried at fair value, net	\$ 2,909	\$ 6,016

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were \$7,210,000 at September 30, 2014, after partial charge-offs of \$97,000 in the first nine months of 2014. In addition, these loans had a specific valuation allowance of \$730,000 at September 30, 2014. Impaired loans held-for-investment totaling \$3,639,000 at September 30, 2014, were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining \$3,571,000 of impaired loans were carried at cost at September 30, 2014, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during the first nine months of 2014 on impaired loans held-for-investment carried at fair value at September 30, 2014 resulted in a credit to the provision for loan losses of \$185,000.

At September 30, 2014, foreclosed assets had a carrying amount of \$31,000, with no valuation allowance at September 30, 2014.

Impaired loans held for investment of \$11,818,000 at December 31, 2013, after partial charge offs of \$318,000 in 2013, were analyzed for additional impairment primarily using the fair value of collateral. In addition, these loans had a specific valuation allowance of \$2,456,000 at December 31, 2013. Impaired loans held for investment totaling \$8,472,000 at December 31, 2013, were carried at fair value as a result of the aforementioned partial charge offs and specific valuation allowances at year end. The remaining \$3,346,000 of impaired loans were carried at cost at December 31, 2013, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge offs and changes in specific valuation allowances during 2013 on impaired loans held for investment carried at fair value at December 31, 2013 resulted in an additional provision for loan losses of \$508,000.

[Table of Contents](#)**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****9) Fair Value (Continued)**

At December 31, 2013, foreclosed assets had a carrying amount of \$575,000, with no valuation allowance at December 31, 2013.

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, 2014			Range (Weighted Average)
	Fair Value	Valuation Techniques	Unobservable Inputs	
	(Dollars in thousands)			
Impaired loans held-for-investment:				
Commercial	\$ 1,095	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)
Real estate:				
Commercial and residential	\$ 607	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)
Land and construction	\$ 1,207	Market Approach	Discount adjustment for differences between comparable sales	1% to 2% (2%)

	December 31, 2013			Range (Weighted Average)
	Fair Value	Valuation Techniques	Unobservable Inputs	
	(Dollars in thousands)			
Impaired loans held-for-investment:				
Commercial	\$ 1,780	Market Approach	Discount adjustment for differences between comparable sales	2% to 3% (2%)
Real estate:				
Commercial and residential	\$ 2,846	Market Approach	Discount adjustment for differences between	1% to 15% (2%)

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Land and construction	\$ 1,290	Market Approach	comparable sales Discount adjustment for differences between comparable sales	1% to 2% (2%)
Foreclosed assets:				
Land and construction	\$ 575	Market Approach	Discount adjustment for differences between comparable sales	1% to 16% (7%)

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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****9) Fair Value (Continued)**

market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business. Adjustments are then made based on the type of property, age of appraisal, current status of property and other related factors to estimate the current value of collateral.

The carrying amounts and estimated fair values of financial instruments at September 30, 2014 are as follows:

	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Estimated Fair Value		Total
			Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
(Dollars in thousands)					
Assets:					
Cash and cash equivalents	\$ 154,075	\$ 154,075			\$ 154,075
Securities available-for-sale	\$ 191,680		\$ 191,680		\$ 191,680
Securities held-to-maturity	\$ 94,759		\$ 93,161		\$ 93,161
Loans (including loans held-for-sale), net	\$ 1,011,728		\$ 673	\$ 1,002,129	\$ 1,002,802
FHLB and FRB stock	\$ 10,501				N/A
Accrued interest receivable	\$ 4,286		\$ 1,623	\$ 2,663	\$ 4,286
Loan servicing rights and I/O strips receivables	\$ 2,204		\$ 4,174		\$ 4,174
Liabilities:					
Time deposits	\$ 260,336		\$ 252,854		\$ 252,854
Other deposits	\$ 1,081,486		\$ 1,081,486		\$ 1,081,486
Accrued interest payable	\$ 197		\$ 197		\$ 197

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****9) Fair Value (Continued)**

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2013:

	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Estimated Fair Value		Total
			Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
(Dollars in thousands)					
Assets:					
Cash and cash equivalents	\$ 112,605	\$ 112,605			\$ 112,605
Securities available-for-sale	\$ 280,100		\$ 280,100		\$ 280,100
Securities held-to-maturity	\$ 95,921		\$ 86,032		\$ 86,032
Loans (including loans held-for-sale), net	\$ 898,897		\$ 3,148	\$ 890,368	\$ 893,516
FHLB and FRB stock	\$ 10,435				N/A
Accrued interest receivable	\$ 4,085		\$ 1,729	\$ 2,356	\$ 4,085
Loan servicing rights and I/O strips receivables	\$ 2,172		\$ 4,203		\$ 4,203
Liabilities:					
Time deposits	\$ 277,844		\$ 278,239		\$ 278,239
Other deposits	\$ 1,008,377		\$ 1,008,377		\$ 1,008,377
Accrued interest payable	\$ 192		\$ 192		\$ 192

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

Cash and Cash Equivalents

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

Loans

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

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

9) Fair Value (Continued)

FHLB and FRB Stock

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

Accrued Interest Receivable/Payable

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

Deposits

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

Off-balance Sheet Instruments

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

Limitations

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

10) Equity Plan

The Company maintained an Amended and Restated 2004 Equity Plan (the "2004 Plan") for directors, officers, and key employees. The 2004 Plan was terminated on May 23, 2013. On May 23, 2013, the Company's shareholders approved the 2013 Equity Incentive Plan (the "2013 Plan"). The equity plans provide for the grant of incentive and nonqualified stock options and restricted stock. The equity plans provide that the option price for both incentive and nonqualified stock options will be

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****10) Equity Plan (Continued)**

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. As of September 30, 2014, the Company granted 312,050 shares of nonqualified stock options and 15,000 shares of restricted stock subject to time vesting requirements. There were 1,417,875 shares available for the issuance of equity awards under the 2013 Plan as of September 30, 2014.

Stock option activity under the equity plans is as follows:

Total Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2014	1,506,504	\$ 11.80		
Granted	312,050	\$ 8.07		
Exercised	(9,042)	\$ 4.63		
Forfeited or expired	(74,495)	\$ 10.98		
Outstanding at September 30, 2014	1,735,017	\$ 11.21	5.9	\$ 1,990,300
Vested or expected to vest	1,648,266		5.9	\$ 1,890,785
Exercisable at September 30, 2014	1,195,994		4.6	\$ 1,458,800

As of September 30, 2014, there was \$2,043,000 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 2.75 years.

Restricted stock activity under the equity plans is as follows:

Total Restricted Stock Award	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested shares at January 1, 2014	58,000	\$ 6.28
Granted	15,000	\$ 8.23

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Exercised	(48,000)	\$	6.23
Nonvested shares at September 30, 2014	25,000	\$	7.54

As of September 30, 2014, there was \$114,000 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 3.04 years.

[Table of Contents](#)**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****11) 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.

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 table below) of total and 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, 2014 and December 31, 2013, 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.

	Actual		To Be Well-Capitalized Under Regulatory Requirements		Required For Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
As of September 30, 2014:						
Total Capital (to risk-weighted assets)	\$ 195,606	15.3%	\$ 128,033	10.0%	\$ 102,427	8.0%
Tier 1 Capital (to risk-weighted assets)	\$ 179,563	14.0%	\$ 76,820	6.0%	\$ 51,213	4.0%
Tier 1 Capital (to average assets)	\$ 179,563	11.7%	N/A	N/A	\$ 61,407	4.0%
As of December 31, 2013:						
Total Capital (to risk-weighted assets)	\$ 179,916	15.3%	\$ 117,581	10.0%	\$ 94,065	8.0%
Tier 1 Capital (to risk-weighted assets)	\$ 165,612	14.0%	\$ 70,549	6.0%	\$ 47,032	4.0%
Tier 1 Capital (to average assets)	\$ 165,612	11.2%	N/A	N/A	\$ 59,083	4.0%

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2014****(Unaudited)****11) Capital Requirements (Continued)**

HBC's actual capital and required amounts and ratios are presented in the following table.

	Actual		To Be Well-Capitalized Under Prompt Corrective Action Provisions		Required For Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
As of September 30, 2014:						
Total Capital (to risk-weighted assets)	\$ 183,501	14.3%	\$ 128,216	10.0%	\$ 102,573	8.0%
Tier 1 Capital (to risk-weighted assets)	\$ 167,436	13.1%	\$ 76,930	6.0%	\$ 51,286	4.0%
Tier 1 Capital (to average assets)	\$ 167,436	10.9%	\$ 76,841	5.0%	\$ 61,473	4.0%
As of December 31, 2013:						
Total Capital (to risk-weighted assets)	\$ 163,827	13.9%	\$ 117,872	10.0%	\$ 94,297	8.0%
Tier 1 Capital (to risk-weighted assets)	\$ 149,037	12.6%	\$ 70,723	6.0%	\$ 47,148	4.0%
Tier 1 Capital (to average assets)	\$ 149,037	10.1%	\$ 73,858	5.0%	\$ 59,086	4.0%

As of September 30, 2014 the Company's and HBC's capital ratios exceed the highest regulatory capital requirement of prompt corrective provisions. There are no conditions or events since September 30, 2014 that management believes have changed the categorization of the Company or HBC as well capitalized.

HCC is dependent upon dividends from HBC. Under California General Corporation Law, the holders of common stock are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available. The California Financial Code provides that a state licensed bank may not make a cash distribution to its shareholders in excess of the lesser of the following: (i) the bank's retained earnings; or (ii) the bank's net income for its last three fiscal years, less the amount of any distributions made by the bank to its shareholders during such period. However, a bank, with the prior approval of the Commissioner of the California Department of Business Oversight Division of Financial Institutions ("DBO") may make a distribution to its shareholders of an amount not to exceed the greater of (i) a bank's retained earnings; (ii) its net income for its last fiscal year; or (iii) its net income for the current fiscal year. Also with the prior approval of the Commissioner of the DBO and the shareholders of the bank, the bank may make a distribution to its shareholders, as a reduction in capital of the bank. In the event that the Commissioner determines that the shareholders' equity of a bank is inadequate or that the making of a distribution by a bank would be unsafe or unsound, the Commissioner may order a bank to refrain from making such a proposed distribution. As of September 30, 2014, HBC would be required to obtain regulatory approval from the DBO for a

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

11) Capital Requirements (Continued)

dividend or other distribution to HCC. Similar restrictions applied to the amount and sum of loan advances and other transfers of funds from HBC to the parent company.

12) Loss Contingencies

The Company's policy is to accrue for legal costs associated with both asserted and unasserted claims when it is probable that such costs will be incurred and such costs can be reasonably estimated. A number of parties have filed complaints in the Superior Court of California for the County of Santa Clara asserting certain claims against the Company arising from the transfer of funds. The litigation is in the early stages and it is not possible to determine the amount of the loss, if any, arising from the claim in excess of the legal expenses expected to be incurred in defense of the litigation. The Company intends to vigorously defend the litigation.

13) Subsequent Events

On October 9, 2014, the Company announced that Heritage Bank of Commerce entered into a Stock Purchase Agreement ("Purchase Agreement") with BVF/CSNK Acquisition Corp., a Delaware corporation ("BVF") and its stockholders, pursuant to which HBC agreed to acquire all of the outstanding common stock from the stockholders of BVF for an aggregate purchase price of \$22,520,000. The acquisition was completed on November 1, 2014 and BVF became a wholly-owned subsidiary of HBC. At the Closing HBC delivered as payment on account of the purchase price \$20,268,000 of the total purchase price, and \$2,252,000, or 10%, was deposited into an escrow account with an independent escrow agent to support the payment of indemnification claims, if any, by HBC against BVF stockholders pursuant to the Purchase Agreement. The escrow account will be released to the stockholders 18 months from the closing date, net of any payments made to HBC or amounts received for unresolved claims submitted by HBC. Based in Santa Clara, California, BVF is the parent company of CSNK Working Capital Finance Corp. dba Bay View Funding, which provides business-essential working capital factoring financing to various industries throughout the United States. Combining BVF's staff and national reach with Heritage Bank of Commerce's funding further diversifies the Company's commercial product offerings. The platform is scalable and is aligned with recent key product initiatives designed to deliver a full spectrum of commercial lending products to our markets. BVF had total assets of \$40,600,000 as of September 30, 2014. The pre-tax acquisition costs incurred for the BVF transaction totaled \$234,000 during the third quarter of 2014.

The transaction will be accounted for using the acquisition method of accounting which requires, among other things, that the assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. The acquisition related disclosures required by the accounting guidance cannot be made as the initial accounting for the business transaction is incomplete. Key financial data such as the determination of the fair value of the assets acquired and liabilities assumed is not yet available.

On October 23, 2014, the Company announced that its Board of Directors declared a \$0.05 per share quarterly cash dividend to holders of common stock and Series C preferred stock (on an as converted basis). The dividend will be paid on November 24, 2014, to shareholders of record on November 6, 2014.

Table of Contents

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

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

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are discussed in our Form 10-K for the year ended December 31, 2013. There are no changes to these policies as of September 30, 2014.

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, 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, 2014, net income was \$3.4 million, or \$0.11 per average diluted common share, compared to \$3.2 million, or \$0.10 per average diluted common share, for the three months ended September 30, 2013. The Company's annualized return on average assets was 0.88% and annualized return on average equity was 7.46% for the three months ended September 30, 2014, compared to 0.90% and 7.58%, respectively, for the three months ended September 30, 2013.

For the nine months ended September 30, 2014, net income was \$9.8 million, or \$0.31 per average diluted common share, an increase from \$8.2 million, or \$0.26 per average diluted common share, for the nine months ended September 30, 2013. The Company's annualized return on average assets was 0.88% and annualized return on average equity was 7.34% for the nine months ended September 30, 2014, compared to 0.78% and 6.44%, respectively, for the nine months ended September 30, 2013.

On October 9, 2014, the Company announced that Heritage Bank of Commerce entered into a Stock Purchase Agreement ("Purchase Agreement") with BVF/CSNK Acquisition Corp., a Delaware corporation ("BVF") and its stockholders, pursuant to which HBC agreed to acquire all of the outstanding common stock from the stockholders of BVF for an aggregate purchase price of \$22.5 million. The acquisition was completed on November 1, 2014 and BVF became a wholly-owned subsidiary of HBC. At the Closing HBC delivered as payment on account of the purchase price

Table of Contents

\$20.3 million of the total purchase price, and \$2.2 million, or 10%, was deposited into an escrow account with an independent escrow agent to support the payment of indemnification claims, if any, by HBC against BVF stockholders pursuant to the Purchase Agreement. The escrow account will be released to the stockholders 18 months from the closing date, net of any payments made to HBC or amounts received for unresolved claims submitted by HBC. Based in Santa Clara, California, BVF is the parent company of CSNK Working Capital Finance Corp. dba Bay View Funding, which provides business-essential working capital factoring financing to various industries throughout the United States. Combining BVF's staff and national reach with Heritage Bank of Commerce's funding further diversifies the Company's commercial product offerings. The platform is scalable and is aligned with recent key product initiatives designed to deliver a full spectrum of commercial lending products to our markets. BVF had total assets of \$40.6 million as of September 30, 2014. Heritage Bank of Commerce expects to incur pre-tax acquisition and integration costs of approximately \$1.0 million to \$1.3 million in the third and fourth quarters of 2014. The pre-tax acquisition costs incurred by the Bank for the BVF transaction totaled \$234,000 during the third quarter of 2014.

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

The fully tax equivalent ("FTE") net interest margin decreased one basis point to 3.93% for the third quarter of 2014, from 3.94% for the third quarter of 2013. The decrease for the third quarter of 2014 was primarily due to a higher average balance of low interest earning short-term deposits at the Federal Reserve Bank in anticipation of the BVF acquisition. For the nine months ended September 30, 2014, the net interest margin increased 17 basis points to 4.02%, from 3.85% for the nine months ended September 30, 2013, reflecting loan growth, higher yields on securities, and a lower cost of funds.

The yield on the loan portfolio was 4.77% for the third quarter of 2014, compared to 4.85% for the third quarter of 2013. For the nine months ended September 30, 2014, the yield on the loan portfolio was 4.80%, compared to 4.97% for the nine months ended September 30, 2013. The decrease in the yield on the loan portfolio for the third quarter and nine months ended September 30, 2014, compared to the same periods in 2013, reflects increasing competitive market conditions for new loan production.

Driven primarily by loan growth and increases in core deposits, net interest income increased 9% to \$14.0 million for the third quarter of 2014, compared to \$12.8 million for the third quarter of 2013. Net interest income increased 10% to \$41.0 million for the nine months ended September 30, 2014, compared to \$37.1 million for the nine months ended September 30, 2013.

Strong credit quality metrics resulted in a \$24,000 credit to the provision for loan losses for the third quarter of 2014, compared to a \$534,000 credit to the provision for loan losses for the third quarter of 2013. There was a \$232,000 credit to the provision for loan losses for the nine months ended September 30, 2014, compared to an \$804,000 credit to the provision for loan losses for the nine months ended September 30, 2013.

Noninterest income was \$1.9 million for the third quarter of 2014, compared to \$1.7 million for the third quarter of 2013. For the nine months ended September 30, 2014, noninterest income was \$5.9 million, compared to \$5.3 million for the nine months ended September 30, 2013. Largely due to a higher gain on sales of Small Business Administration ("SBA") loans and gain on sales of securities, noninterest income was higher for the three months and for the nine months ended September 30, 2014, compared to the same periods in 2013.

Noninterest expense for the third quarter of 2014 was \$10.1 million, a decrease of 2% from \$10.4 million for the third quarter of 2013, primarily due to the reclassification of \$353,000 of low income housing investment losses, partially offset by \$234,000 in costs related to the BVF acquisition during the third quarter of 2014. Noninterest expense for the nine months ended

Table of Contents

September 30, 2014 increased 1% to \$31.8 million, compared to \$31.6 million for the nine months ended September 30, 2013. The increase in noninterest expense for nine months ended September 30, 2014, was primarily due to increased salaries and employee benefits expense and costs related to the BVF acquisition, partially offset by the reclassification of low income housing investment losses.

The efficiency ratio for the third quarter of 2014 improved to 63.92%, compared to 71.25% for the third quarter of 2013. The efficiency ratio for the nine months ended September 30, 2014 was 67.75%, compared to 74.32% for the nine months ended September 30, 2013. The decrease in the efficiency ratio for the three months and the nine months ended September 30, 2014, compared to the same periods in 2013, was primarily due to the reclassification of low income housing investment losses, and higher net interest income and noninterest income.

Income tax expense for the third quarter of 2014 was \$2.3 million, compared to \$1.5 million for the third quarter of 2013. The effective tax rate for the third quarter of 2014 increased to 40.4%, compared to 32.0% for the third quarter of 2013. Income tax expense for the nine months ended September 30, 2014 was \$5.5 million, compared to \$3.5 million for the nine months ended September 30, 2013. The effective tax rate for the nine months ended September 30, 2014 was 36.1%, compared to 30.1% for the nine months ended September 30, 2013. The increase in the effective tax rate for the three months and the nine months ended September 30, 2014, compared to the comparable periods in 2013, was primarily due to the adoption of the proportional amortization method of accounting for low income housing investments in the third quarter of 2014 and reduced income tax credits.

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

Cash, Federal funds sold, interest-bearing deposits in other financial institutions and securities available-for-sale increased 7% to \$345.8 million at September 30, 2014, from \$322.4 million at September 30, 2013, and decreased 12% from \$392.7 million at December 31, 2013.

Securities held-to-maturity, at amortized cost, were \$94.8 million at September 30, 2014, compared to \$89.7 million at September 30, 2013, and \$95.9 million at December 31, 2013.

Total loans, excluding loans held-for-sale, increased 15% to \$1.03 billion at September 30, 2014, from \$893.1 million at September 30, 2013, and increased 13% from \$914.9 million at December 31, 2013.

Nonperforming assets were \$7.7 million, or 0.50% of total assets, at September 30, 2014, compared to \$15.7 million, or 1.12%, of total assets, at September 30, 2013, and \$12.4 million, or 0.83% of total assets, at December 31, 2013.

Classified assets, net of SBA guarantees, decreased 24% to \$17.7 million at September 30, 2014, from \$23.3 million at September 30, 2013, and decreased 25% from \$23.6 million at December 31, 2013.

Net charge-offs totaled \$27,000 for the third quarter of 2014, compared to net recoveries of \$534,000 for the third quarter 2013, and net charge-offs of \$166,000 for the fourth quarter of 2013.

The allowance for loan losses at September 30, 2014 was \$18.5 million, or 1.80% of total loans, representing 257.16% of nonperforming loans. The allowance for loan losses at September 30, 2013 was \$19.3 million, or 2.17% of total loans, representing 127.95% of nonperforming loans. The allowance for loan losses at December 31, 2013 was \$19.2 million, or 2.09% of total loans, representing 162.16% of nonperforming loans.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

Deposits totaled \$1.34 billion at September 30, 2014, compared to \$1.20 billion at September 30, 2013, and \$1.29 billion at December 31, 2013. Deposits (excluding all time deposits and CDARS deposits) increased \$180.4 million, or 20%, to \$1.10 billion at September 30, 2014, from \$901.0 million at September 30, 2013 and increased \$107.9 million, or 11%, from \$973.6 million at December 31, 2013.

The ratio of noncore funding (which consists of time deposits-\$100,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase and short-term borrowings) to total assets was 15.42% at September 30, 2014, compared to 19.45% at September 30, 2013, and 19.51% at December 31, 2013.

The loan to deposit ratio was 76.73% at September 30, 2014, compared to 74.70% at September 30, 2013, and 71.13% at December 31, 2013.

The Company announced it will pay a quarterly cash dividend of \$0.05 per share in the fourth quarter of 2014 to holders of common stock and Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"), on an as converted basis.

Capital ratios exceed regulatory requirements for a well-capitalized financial institution, both on a consolidated basis and at the bank level at September 30, 2014:

Capital Ratios	Heritage Commerce Corp	Heritage Bank of Commerce	Well-Capitalized Financial Institution Regulatory Guidelines
Total Risk-Based	15.3%	14.3%	10.0%
Tier 1 Risk-Based	14.0%	13.1%	6.0%
Leverage	11.7%	10.9%	5.0%

Deposits

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

Deposits totaled \$1.34 billion at September 30, 2014, compared to \$1.20 billion at September 30, 2013, and \$1.29 billion at December 31, 2013. Deposits (excluding all time deposits and CDARS deposits) increased \$180.4 million, or 20%, to \$1.10 billion at September 30, 2014, from \$901.0 million at September 30, 2013 and increased \$107.9 million, or 11%, from \$973.6 million at December 31, 2013.

During the fourth quarter of 2013, the Company received \$27.5 million in deposits from a law firm which were placed in a CDARS money market account. All of the \$27.5 million in deposits from the law firm were withdrawn in January, 2014. The Company had \$28.1 million in brokered deposits at September 30, 2014, compared to \$62.8 million at September 30, 2013, and \$55.5 million at December 31, 2013. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators was \$33.6 million at September 30, 2014, compared to \$13.6 million at September 30, 2013, and \$37.6 million at December 31, 2013. Certificates of deposit from the State of California totaled \$98.0 million at September 30, 2014, September 30, 2013 and December 31, 2013.

Table of Contents

Liquidity

Our liquidity position refers to our ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely fashion. At September 30, 2014, we had \$154.1 million in cash and cash equivalents and approximately \$464.7 million in available borrowing capacity from various sources including the Federal Home Loan Bank ("FHLB"), the Federal Reserve Bank of San Francisco ("FRB"), and Federal funds facilities with several financial institutions. The Company also had \$135.0 million in unpledged securities available at September 30, 2014. Our loan to deposit ratio increased to 76.73% at September 30, 2014, compared to 74.70% at September 30, 2013, and 71.13% at December 31, 2013.

Lending

Our lending business originates principally through our branch offices located in our primary markets. Loans, excluding loans held-for-sale, increased 15% to \$1.03 billion at September 30, 2014, from \$893.1 million at September 30, 2013, and increased 13% from \$914.9 million at December 31, 2013. The loan portfolio remains well-diversified with commercial and industrial ("C&I") loans accounting for 42% of the loan portfolio at September 30, 2014. Commercial and residential real estate loans accounted for 45% of the total loan portfolio, of which 46% were owner-occupied by businesses. Consumer and home equity loans accounted for 8% of total loans, and land and construction loans accounted for the remaining 5% of total loans at September 30, 2014. C&I line usage was 43% at September 30, 2014, compared to 45% at September 30, 2013, and 41% at December 31, 2013.

Net Interest Income

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

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

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

Management of Credit Risk

We continue to proactively identify, quantify, and manage our problem loans. Early identification of problem loans and potential future losses helps enable us to resolve credit issues with potentially less risk and ultimate losses. We maintain an allowance for loan losses in an amount that we believe is adequate to absorb probable incurred losses in the portfolio. While we strive to carefully manage and monitor credit quality and to identify loans that may be deteriorating, circumstances can change at any time for loans included in the portfolio that may result in future losses, that as of the date of the financial statements have not yet been identified as potential problem loans. Through established credit practices, we adjust the allowance for loan losses accordingly. However, because future events are uncertain, there may be loans that 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

Table of Contents

loan portfolio contains a number of commercial loans, commercial real estate, construction and land development loans with relatively large balances, deterioration in the credit quality of one or more of these loans may require a significant increase to the allowance for loan losses. Future additions to the allowance may also be required based on changes in the financial condition of borrowers. Additionally, Federal and state banking regulators, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to recognize further loan loss provisions or charge-offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses would have an adverse effect, which may be material, on our financial condition and results of operation.

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

Noninterest Income

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

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company's performance. Noninterest expense for the third quarter of 2014 was \$10.1 million, a decrease of 2% from \$10.4 million for the third quarter of 2013. The decrease in noninterest expense for the third quarter of 2014, compared to the third quarter of 2013, was primarily due to the reclassification of low income housing investment losses, partially offset by costs related to the BVF acquisition during the third quarter of 2014. Noninterest expense for the nine months ended September 30, 2014 increased 1% to \$31.8 million, compared to \$31.6 million for the nine months ended September 30, 2013. The increase in noninterest expense for the nine months ended September 30, 2014 was primarily due to increased salaries and employee benefits expense and costs related to the BVF acquisition, partially offset by lower professional fees and the reclassification of low income housing investment losses.

Capital Management

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

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

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. The 21,004 shares of Series C Preferred Stock are convertible into 5,601,000 shares of common stock. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. The holders of Series C Preferred Stock receive dividends on an as converted basis when dividends are also declared for holders of common stock. The Series C Preferred Stock is not redeemable by the

Table of Contents

Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

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

During the third quarter of 2012, the Company completed the redemption of \$14 million fixed-rate subordinated debt, and during the third quarter of 2013, the Company completed the redemption of its remaining \$9 million of floating rate subordinated debt.

RESULTS OF OPERATIONS

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

Net Interest Income and Net Interest Margin

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

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

NET INTEREST INCOME AND NET INTEREST MARGIN	For the Three Months Ended September 30, 2014			For the Three Months Ended September 30, 2013		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
	(Dollars in thousands)					
Assets:						
Loans, gross(1)	\$ 1,004,271	\$ 12,077	4.77%	\$ 877,417	\$ 10,733	4.85%
Securities taxable	249,105	1,851	2.95%	310,460	2,247	2.87%
Securities tax exempt(2)	79,926	779	3.87%	69,866	671	3.81%
Federal funds sold and interest-bearing deposits in other financial institutions	108,490	58	0.21%	58,294	42	0.29%
Total interest earning assets(2)	1,441,792	14,765	4.06%	1,316,037	13,693	4.13%
Cash and due from banks	26,535			23,724		
Premises and equipment, net	7,435			7,513		
Intangible assets	1,247			1,716		
Other assets	66,245			70,491		
Total assets	\$ 1,543,254			\$ 1,419,481		
Liabilities and shareholders' equity:						
Deposits:						
Demand, noninterest-bearing	\$ 471,326			\$ 418,657		
Demand, interest-bearing	212,579	89	0.17%	169,233	57	0.13%
Savings and money market	379,733	171	0.18%	316,247	140	0.18%
Time deposits under \$100	20,163	16	0.31%	22,600	19	0.33%
Time deposits \$100 and over	196,062	158	0.32%	197,464	179	0.36%
Time deposits brokered	31,116	63	0.80%	71,105	178	0.99%
CDARS money market and time deposits	14,755	3	0.08%	16,372	2	0.05%
Total interest-bearing deposits	854,408	500	0.23%	793,021	575	0.29%
Total deposits	1,325,734	500	0.15%	1,211,678	575	0.19%
Subordinated debt				4,819	51	4.20%
Short-term borrowings	52		0.00%	91	1	4.36%
Total interest-bearing liabilities	854,460	500	0.23%	797,931	627	0.31%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,325,786	500	0.15%	1,216,588	627	0.20%
Other liabilities	35,373			34,639		

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total liabilities	1,361,159	1,251,227
Shareholders' equity	182,095	168,254
Total liabilities and shareholders' equity	\$ 1,543,254	\$ 1,419,481

Net interest income(2) / margin	14,265	3.93%	13,066	3.94%
Less tax equivalent adjustment(2)	(273)		(235)	
Net interest income	\$ 13,992		\$ 12,831	

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

NET INTEREST INCOME AND NET INTEREST MARGIN	For the Nine Months Ended September 30, 2014			For the Nine Months Ended September 30, 2013		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
(Dollars in thousands)						
Assets:						
Loans, gross(1)	\$ 970,032	\$ 34,832	4.80%	\$ 831,328	\$ 30,874	4.97%
Securities taxable	274,857	6,069	2.95%	351,290	7,107	2.70%
Securities tax exempt(2)	79,905	2,336	3.91%	56,405	1,603	3.80%
Federal funds sold and interest-bearing deposits in other financial institutions	68,056	120	0.24%	71,265	140	0.26%
Total interest earning assets(2)	1,392,850	43,357	4.16%	1,310,288	39,724	4.05%
Cash and due from banks	25,068			23,313		
Premises and equipment, net	7,295			7,548		
Intangible assets	1,365			1,832		
Other assets	64,136			68,803		
Total assets	\$ 1,490,714			\$ 1,411,784		
Liabilities and shareholders' equity:						
Deposits:						
Demand, noninterest-bearing	\$ 445,585			\$ 423,807		
Demand, interest-bearing	203,713	248	0.16%	167,138	174	0.14%
Savings and money market	357,535	489	0.18%	293,801	384	0.17%
Time deposits under \$100	20,643	49	0.32%	23,488	62	0.35%
Time deposits \$100 and over	195,122	473	0.32%	194,185	577	0.40%
Time deposits brokered	39,249	262	0.89%	81,352	594	0.98%
CDARS money market and time deposits	16,091	6	0.05%	15,273	5	0.04%
Total interest-bearing deposits	832,353	1,527	0.25%	775,237	1,796	0.31%
Total deposits	1,277,938	1,527	0.16%	1,199,044	1,796	0.20%
Subordinated debt				7,776	229	3.94%
Short-term borrowings	556	1	0.24%	148	1	0.90%
Total interest-bearing liabilities	832,909	1,528	0.25%	783,161	2,026	0.35%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,278,494	1,528	0.16%	1,206,968	2,026	0.22%
Other liabilities	33,253			34,951		
Total liabilities	1,311,747			1,241,919		
Shareholders' equity	178,967			169,865		

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total liabilities and shareholders' equity	\$ 1,490,714		\$ 1,411,784	
--	--------------	--	--------------	--

Net interest income(2) / margin	41,829	4.02%	37,698	3.85%
Less tax equivalent adjustment(2)	(818)		(561)	

Net interest income	\$ 41,011		\$ 37,137	
---------------------	-----------	--	-----------	--

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

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

Table of Contents**Volume and Rate Variances**

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

	Three Months Ended September 30, 2014 vs. 2013		
	Increase (Decrease) Due to Change In:		
	Average Volume	Average Rate	Net Change
(Dollars in thousands)			
Income from interest earning assets:			
Loans, gross	\$ 1,528	\$ (184)	\$ 1,344
Securities taxable	(457)	61	(396)
Securities tax exempt(1)	97	11	108
Federal funds sold and interest-bearing deposits in other financial institutions	27	(11)	16
Total interest income from interest earnings assets(1)	1,195	(123)	1,072
Expense on interest-bearing liabilities:			
Demand, interest-bearing	16	16	32
Savings and money market	28	3	31
Time deposits under \$100	(2)	(1)	(3)
Time deposits \$100 and over	(1)	(20)	(21)
Time deposits brokered	(80)	(35)	(115)
CDARS money market and time deposits		1	1
Subordinated debt	(51)		(51)
Short-term borrowings		(1)	(1)
Total interest expense on interest-bearing liabilities	(90)	(37)	(127)
Net interest income(1)	\$ 1,285	\$ (86)	1,199
Less tax equivalent adjustment(1)			(38)
Net interest income			\$ 1,161

(1)

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

Table of Contents

	Nine Months Ended September 30, 2014 vs. 2013		
	Increase (Decrease) Due to		
	Change In:		
	Average Volume	Average Rate	Net Change
	(Dollars in thousands)		
Income from interest earning assets:			
Loans, gross	\$ 4,986	\$ (1,028)	\$ 3,958
Securities taxable	(1,682)	644	(1,038)
Securities tax exempt(1)	686	47	733
Federal funds sold and interest-bearing deposits in other financial institutions	(8)	(12)	(20)
Total interest income from interest earnings assets(1)	3,982	(349)	3,633
Expense on interest-bearing liabilities:			
Demand, interest-bearing	48	26	74
Savings and money market	93	12	105
Time deposits under \$100	(7)	(6)	(13)
Time deposits \$100 and over	8	(112)	(104)
Time deposits brokered	(280)	(52)	(332)
CDARS money market and time deposits		1	1
Subordinated debt	(229)		(229)
Short-term borrowings	1	(1)	
Total interest expense on interest-bearing liabilities	(366)	(132)	(498)
Net interest income(1)	\$ 4,348	\$ (217)	4,131
Less tax equivalent adjustment(1)			(257)
Net interest income			\$ 3,874

(1)

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

The Company's net interest margin (FTE), expressed as a percentage of average earning assets decreased one basis point to 3.93% for the third quarter of 2014, from 3.94% for the third quarter of 2013. The decrease for the third quarter of 2014 was primarily due to a higher average balance of low interest earning short-term deposits at the Federal Reserve Bank in anticipation of the BVF acquisition. For the nine months ended September 30, 2014, the net interest margin increased 17 basis points to 4.02%, from 3.85% for the nine months ended September 30,

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

2013, reflecting loan growth, higher yields on securities, and a lower cost of funds.

Net interest income increased 9% to \$14.0 million for the third quarter of 2014, compared to \$12.8 million for the third quarter of 2013. Net interest income increased 10% to \$41.0 million for the nine months ended September 30, 2014, compared to \$37.1 million for the nine months ended September 30, 2013. The increase in the net interest income for the third quarter and for the nine months ended September 30, 2014, compared to the same periods in 2013, was primarily due to loan growth and an increase in core deposits.

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

Table of Contents**Provision for Loan Losses**

Credit risk is inherent in the business of making loans. The Company establishes an allowance for loan losses through charges to earnings, which are presented in the statements of income as the provision for loan losses. Specifically identifiable and quantifiable known losses are promptly charged off against the allowance. The provision for loan losses is determined by conducting a quarterly evaluation of the adequacy of the Company's allowance for loan losses and charging the shortfall 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 credit to the provision for loan losses of \$24,000 for the third quarter of 2014, which was primarily due to a reduction in required allowance for the quarter based on the evaluation at quarter end. This is compared to a credit to the provision for loan losses of \$534,000 for the third quarter of 2013, which was primarily due to net recoveries for the quarter. The credit to the provision for loan losses for the nine months ended September 30, 2014 was \$232,000, which was partially due to net charge-offs for the period of \$392,000 as well as a reduction in the required allowance. This is compared to a credit to the provision for loan losses of \$804,000, which was primarily due to net recoveries, for the nine months ended September 30, 2013.

The allowance for loan losses totaled \$18.5 million, or 1.80% of total loans at September 30, 2014, compared to \$19.3 million, or 2.17% of total loans at September 30, 2013, and \$19.2 million, or 2.09% of total loans at December 31, 2013. The allowance for loan losses to total loans decreased at September 30, 2014, compared to September 30, 2013, and December 31, 2013, was primarily due to increasing loan balances with no default histories, coupled with the decrease in nonperforming assets, improving the quality of the loan portfolio overall. Net charge-offs totaled \$27,000 for the third quarter of 2014, compared to net recoveries of \$534,000 for the third quarter of 2013, and net charge-offs of \$166,000 for the fourth quarter of 2013. Provisions for loan losses are charged to operations to bring the allowance for loan losses to a level deemed appropriate by the Company based on the factors discussed under "Allowance for Loan Losses".

Noninterest Income

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

	For the Three Months Ended September 30,		Increase (decrease) 2014 versus 2013	
	2014	2013	Amount	Percent
(Dollars in thousands)				
Service charges and fees on deposit accounts	\$ 631	\$ 645	\$ (14)	-2%
Increase in cash surrender value of life insurance	401	414	(13)	-3%
Servicing income	316	331	(15)	-5%
Gain on sales of SBA loans	259	103	156	151%
Gain on sales of securities	47		47	N/A
Other	216	245	(29)	-12%
Total noninterest income	\$ 1,870	\$ 1,738	\$ 132	8%

Table of Contents

	For the Nine Months Ended September 30,		Increase (decrease) 2014 versus 2013	
	2014	2013	Amount	Percent
(Dollars in thousands)				
Service charges and fees on deposit accounts	\$ 1,897	\$ 1,840	\$ 57	3%
Increase in cash surrender value of life insurance	1,196	1,240	(44)	-4%
Servicing income	977	1,081	(104)	-10%
Gain on sales of SBA loans	858	373	485	130%
Gain on sales of securities	97	38	59	155%
Other	909	744	165	22%
Total noninterest income	\$ 5,934	\$ 5,316	\$ 618	12%

The increase in noninterest income in the third quarter and nine months ended September 30, 2014, compared to the same periods in 2013 was primarily attributable to a higher gain on sales of SBA loans and gain on sales of securities.

Historically, a significant percentage of the Company's noninterest income has been associated with its SBA lending activity, as gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. For the three months ended September 30, 2014, SBA loan sales resulted in a \$259,000 gain, compared to a \$103,000 gain on sale of SBA loans for the three months ended September 30, 2013. For the nine months ended September 30, 2014, SBA loan sales resulted in an \$858,000 gain, compared to a \$373,000 gain on sale of SBA loans for the nine months ended September 30, 2013.

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

Table of Contents**Noninterest Expense**

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

	For the Three Months Ended September 30,		Increase (decrease) 2014 versus 2013	
	2014	2013	Amount	Percent
(Dollars in thousands)				
Salaries and employee benefits	\$ 6,228	\$ 5,772	\$ 456	8%
Occupancy and equipment	1,055	986	69	7%
Professional fees	617	602	15	2%
Insurance expense	292	255	37	15%
Software subscriptions	264	381	(117)	-31%
Data processing	238	259	(21)	-8%
FDIC deposit insurance premiums	220	200	20	10%
Correspondent bank charges	174	170	4	2%
Foreclosed assets, net		8	(8)	-100%
Low income housing investment losses	(353)	320	(673)	-210%
Other	1,404	1,427	(23)	-2%
Total noninterest expense	\$ 10,139	\$ 10,380	\$ (241)	-2%

	For the Nine Months Ended September 30,		Increase (decrease) 2014 versus 2013	
	2014	2013	Amount	Percent
(Dollars in thousands)				
Salaries and employee benefits	\$ 19,290	\$ 17,647	\$ 1,643	9%
Occupancy and equipment	2,987	3,082	(95)	-3%
Professional fees	1,329	1,984	(655)	-33%
Insurance expense	830	763	67	9%
Software subscriptions	702	966	(264)	-27%
Data processing	741	838	(97)	-12%
FDIC deposit insurance premiums	674	666	8	1%
Correspondent bank charges	539	513	26	5%
Foreclosed assets, net	(19)	(242)	223	-92%
Subordinated debt redemption charges		167	(167)	-100%
Low income housing investment losses		930	(930)	-100%
Other	4,734	4,236	498	12%
Total noninterest expense	\$ 31,807	\$ 31,550	\$ 257	1%

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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

Noninterest Expense by Category

	For the Three Months Ended September 30,			
	2014	Percent of Total	2013	Percent of Total
	(Dollars in thousands)			
Salaries and employee benefits	\$ 6,228	61%	\$ 5,772	56%
Occupancy and equipment	1,055	10%	986	9%
Professional fees	617	6%	602	6%
Insurance expense	292	3%	255	2%
Software subscriptions	264	3%	381	4%
Data processing	238	2%	259	2%
FDIC deposit insurance premiums	220	2%	200	2%
Correspondent bank charges	174	2%	170	2%
Foreclosed assets, net		0%	8	0%
Low income housing investment losses	(353)	-3%	320	3%
Other	1,404	14%	1,427	14%
Total noninterest expense	\$ 10,139	100%	\$ 10,380	100%

	For the Nine Months Ended September 30,			
	2014	Percent of Total	2013	Percent of Total
	(Dollars in thousands)			
Salaries and employee benefits	\$ 19,290	61%	\$ 17,647	56%
Occupancy and equipment	2,987	9%	3,082	10%
Professional fees	1,329	4%	1,984	6%
Insurance expense	830	3%	763	2%
Software subscriptions	702	2%	966	3%
Data processing	741	2%	838	3%
FDIC deposit insurance premiums	674	2%	666	2%
Correspondent bank charges	539	2%	513	2%
Foreclosed assets, net	(19)	0%	(242)	-1%
Subordinated debt redemption charges		0%	167	1%
Low income housing investment losses		0%	930	3%
Other	4,734	15%	4,236	13%
Total noninterest expense	\$ 31,807	100%	\$ 31,550	100%

Noninterest expense for the third quarter of 2014 was \$10.1 million, a decrease of 2% from \$10.4 million for the third quarter of 2013. The decrease in noninterest expense for the third quarter of 2014, compared to the third quarter of 2013 was primarily due to the reclassification of \$353,000 of low income housing investment losses and lower data processing and software subscriptions expense, partially offset by higher salaries and employee benefits expense and \$234,000 in costs related to the BVF acquisition during the third quarter of 2014. Noninterest expense for the nine months ended September 30, 2014 increased 1% to \$31.8 million, compared to \$31.6 million for the nine months ended

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

September 30, 2013. The increase in noninterest expense for nine months ended September 30, 2014 was primarily due to increased salaries and employee benefits expense, costs related to the BVF acquisition, and a lower net gain on the disposition of foreclosed assets. The increases were partially offset by the reclassification of low income housing investment losses, and lower professional fees, data processing and software subscriptions expense. Subordinated debt redemption charges in 2013 related the redemption of outstanding subordinated debt.

Table of Contents

Higher salaries and employee benefits expense reflected the growth in staffing for business initiatives, and costs associated with the reorganization of administrative responsibilities in the second quarter of 2014. Full time equivalent employees were 200 at September 30, 2014, compared to 192 at September 30, 2013. Professional fees were lower due to net recoveries in legal fees as a result of the resolution or payoff of certain problem loans in the second quarter of 2014. Data processing and software subscriptions were lower mainly due to system conversion costs in the second and third quarters of 2013.

The Company adopted the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014. The Company quantified the impact of adopting the proportional amortization method compared to the equity method to its current year and prior period financial statements. The Company determined that the adoption of the proportional amortization method did not have a material impact to its financial statements; therefore, the Company did not adjust its prior period financial statements. During the third quarter of 2014, the Company reclassified \$353,000 of low income housing investment losses that was previously reported as noninterest expense for the first six months of 2014. The low income housing investment losses, net of the tax benefits received, are included in income tax expense on the consolidated statements of income for the three months and nine months ended September 30, 2014. The change in accounting method also resulted in an increase in the effective tax rate to 40.4% and 36.1% for the three months and nine months ended September 30, 2014, respectively, compared to 32.0% and 30.1% for the three months and nine months ended September 30, 2013. Low income housing investment losses of \$320,000 and \$930,000 are reported in noninterest expense for the three months and nine months ended September 30, 2013, respectively. Under the equity method of accounting for the low income housing investments for the three months ended September 30, 2014, the low income housing investment losses included in noninterest expense would have been \$261,000, income tax expense would have been \$1.7 million and the effective tax rate would have been 33.4%. Under the equity method of accounting for the low income housing investments for the nine months ended September 30, 2014, the low income housing investment losses included in noninterest expense would have been \$614,000, income tax expense would have been \$4.9 million and the effective tax rate would have been 33.5%.

In the normal course of business, the Company becomes a party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. These financial instruments include commitments to extend credit in the form of loans, or through commercial or standby letters of credit, and financial guarantees. These instruments represent varying degrees of exposure to risk in excess of the amounts included in the accompanying condensed consolidated balance sheets. The Company calculates an off-balance sheet credit risk reserve for all unfunded commitments.

Income Tax Expense

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

Table of Contents

The Company's Federal and state income tax expense for the three months and the nine months ended September 30, 2014 was \$2.3 million and \$5.5 million, respectively. The income tax expense was \$1.5 million and \$3.5 million for the same periods in 2013. The following table shows the Company's effective income tax rates for the periods indicated:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Effective income tax rate	40.4%	32.0%	36.1%	30.1%

The increase in the effective tax rate for the three months and the nine months ended September 30, 2014, compared to the comparable periods in 2013, was primarily due to the adoption of the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014, and reduced income tax credits. The difference in the effective tax rate for the periods reported, compared to the combined Federal and state statutory tax rate of 42%, is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes, tax credits related to investments in low income housing limited partnerships, and tax-exempt interest income earned on municipal bonds. These reductions were partially offset by an increase in the effective tax rate from the adoption of the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014, and reduced income tax credits. The Company had California Enterprise Zone tax savings of approximately \$162,000 for 2013. The California state legislature eliminated the Enterprise Zone tax deductions beginning January 1, 2014.

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

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

The Company had net deferred tax assets of \$18.7 million at September 30, 2014, and \$23.3 million at December 31, 2013. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at September 30, 2014 and December 31, 2013 will be fully realized in future years.

FINANCIAL CONDITION

As of September 30, 2014, total assets increased to \$1.56 billion, compared to \$1.40 billion at September 30, 2013, and increased from \$1.49 billion at December 31, 2013. Securities available-for-sale (at fair value) were \$191.7 million at September 30, 2014, a decrease of 32% from

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

\$280.5 million at September 30, 2013, and a decrease of 32% from \$280.1 million at December 31, 2013. Securities held-to-maturity (at amortized cost) were \$94.8 million at September 30, 2014, compared to \$89.7 million at September 30, 2013, and \$95.9 million at December 31, 2013. The total loan portfolio, excluding loans held-for-sale, was \$1.03 billion at September 30, 2014, an increase of 15% from \$893.1 million at September 30, 2013, and an increase of 13% from \$914.9 million at December 31, 2013.

Deposits totaled \$1.34 billion at September 30, 2014, compared to \$1.20 billion at September 30, 2013, and \$1.29 billion at December 31, 2013. Deposits (excluding all time deposits and CDARS deposits) increased \$180.4 million, or 20%, to \$1.1 billion at September 30, 2014, from \$901.0 million at September 30, 2013 and increased \$107.9 million, or 11%, from \$973.6 million at December 31, 2013.

Securities Portfolio

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

	September 30,		December 31,	
	2014	2013	2013	
(Dollars in thousands)				
Securities available-for-sale (at fair value):				
Agency mortgage-backed securities	\$ 139,777	\$ 212,514	\$ 207,644	
Corporate bonds	36,416	47,747	52,046	
Trust preferred securities	15,487	20,210	20,410	
Total	\$ 191,680	\$ 280,471	\$ 280,100	

Securities held-to-maturity (at amortized cost):

Agency mortgage-backed securities	\$ 14,851	\$ 13,229	\$ 15,932	
Municipals Tax Exempt	79,908	76,503	79,989	
Total	\$ 94,759	\$ 89,732	\$ 95,921	

The following table summarizes the weighted average life and weighted average yields of securities at September 30, 2014:

	Weighted Average Life							
	After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
(Dollars in thousands)								
Securities available-for-sale (at fair value):								
Agency mortgage-backed securities	\$ 56,663	3.19%	\$ 83,114	2.74%	\$ 139,777		2.92%	
Corporate bonds	6,685	2.76%	29,731	3.10%			36,416	3.04%
Trust preferred securities					15,487	5.95%	15,487	5.95%

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total	\$ 63,348	3.15%	\$ 112,845	2.84%	\$ 15,487	5.95%	\$ 191,680	3.19%
-------	-----------	-------	------------	-------	-----------	-------	------------	-------

Securities held-to-maturity (at
amortized cost):

Agency mortgage-backed securities	\$ 11,754	2.10%	\$		\$ 3,097	2.91%	\$ 14,851	2.28%
Municipals Tax Exempt(1)	4,107	4.37%	30,696	4.03%	45,105	3.80%	79,908	3.92%

Total	\$ 15,861	2.69%	\$ 30,696	4.03%	\$ 48,202	3.74%	\$ 94,759	3.66%
-------	-----------	-------	-----------	-------	-----------	-------	-----------	-------

(1)

Reflects tax equivalent yield based on a 35% 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

Table of Contents

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

The Company's portfolio may include: (i) U.S. Treasury securities and U.S. Government sponsored entities' debt securities for liquidity and pledging; (ii) mortgage-backed securities, which in many instances can also be used for pledging, and which generally enhance the yield of the portfolio; (iii) municipal obligations, which provide tax free income and limited pledging potential; (iv) collateralized mortgage obligations, which generally enhance the yield of the portfolio; and (v) single entity issue trust preferred securities, which generally enhance the yield on the portfolio.

The Company classifies its securities as either available-for-sale or held-to-maturity at the time of purchase. Accounting guidance requires available-for-sale securities to be marked to fair value with an offset to accumulated other comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available-for-sale securities. The investment securities available-for-sale portfolio totaled \$191.7 million at September 30, 2014, a decrease of 32% from \$280.5 million at September 30, 2013, and a decrease of 32% from \$280.1 million at December 31, 2013. At September 30, 2014, the securities available-for-sale portfolio was comprised of \$139.8 million agency mortgage-backed securities (all issued by U.S. Government sponsored entities), \$36.4 million of corporate bonds, and \$15.5 million of single entity issue trust preferred securities.

During the third quarter of 2014, the Company received proceeds of \$58.5 million from the sales of securities available-for-sale, for a net gain on sales of securities of \$47,000. The sale of securities consisted of \$27.3 million of asset-backed securities, \$22.8 million of corporate bonds, and \$8.4 million of agency mortgage-backed securities.

The investment securities held-to-maturity portfolio, at amortized cost, totaled \$94.8 million at September 30, 2014, compared to \$89.7 million at September 30, 2013, and \$95.9 million at December 31, 2013. At September 30, 2014, the investment securities held-to-maturity portfolio was comprised of \$79.9 million of tax-exempt municipal bonds, and \$14.9 million of agency mortgage-backed securities.

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

Loans

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

Gross loans, excluding loans held-for-sale, represented 66% of total assets at September 30, 2014, 64% at September 30, 2013, and 61% of total assets at December 31, 2013. The ratio of loans to deposits increased to 76.73% at September 30, 2014, from 74.70% at September 30, 2013, and from 71.13% at December 31, 2013.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

Loan Distribution

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

	September 30, 2014		September 30, 2013		December 31, 2013	
	Balance	% of Total	Balance	% of Total	Balance	% of Total
(Dollars in thousands)						
Commercial	\$ 436,481	42%	\$ 410,933	46%	\$ 393,074	43%
Real estate:						
Commercial and residential	464,991	45%	387,777	43%	423,288	46%
Land and construction	53,064	5%	30,780	3%	31,443	3%
Home equity	61,079	6%	50,100	6%	51,815	6%
Consumer	14,609	2%	13,712	2%	15,677	2%
Total loans	1,030,224	100%	893,302	100%	915,297	100%
Deferred loan (fees) costs, net	(628)		(250)		(384)	
Loans, including deferred fees and costs	1,029,596	100%	893,052	100%	914,913	100%
Allowance for loan losses	(18,541)		(19,342)		(19,164)	
Loans, net	\$ 1,011,055		\$ 873,710		\$ 895,749	

The Company's loan portfolio is concentrated in commercial loans, primarily manufacturing, wholesale, and services, and commercial real estate, with the remaining balance in land development and construction, home equity and consumer loans. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 56% of its gross loans were secured by real property at September 30, 2014, compared to 52% at September 30, 2013, and 55% at December 31, 2013. While no specific industry concentration is considered significant, the Company's lending operations are located in areas that are dependent on the technology and real estate industries and their supporting companies.

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

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such guaranteed loans (collectively referred to as "SBA loans"). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold the Company retains the servicing rights for the sold portion. During the three months and the nine months ended September 30, 2014, loans were sold resulting in a gain on sale of SBA loans of \$259,000 and \$858,000, respectively.

Table of Contents

As of September 30, 2014, commercial and residential real estate mortgage loans of \$465.0 million consist primarily of adjustable and fixed-rate loans secured by deeds of trust on commercial and residential property. The real estate mortgage loans at September 30, 2014, consist of \$214.4 million, or 46%, of commercial owner occupied properties, \$250.1 million, or 54%, of commercial investment properties, and \$469,000 (less than 1%) in residential properties. Properties securing the commercial real estate mortgage loans are generally located in the Greater San Francisco Bay Area, the Company's primary market.

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

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Construction loans are provided only in our market area, and the Company has extensive controls for the disbursement process. The projects are typically infill construction in strong markets. Land and construction loans increased \$22.3 million to \$53.1 million, at September 30, 2014, from \$30.8 million, at September 30, 2013, and increased \$21.6 million from \$31.4 million, at December 31, 2013, primarily as a result of strong housing demand within the Company's lending area.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 75% loan to value ratio. Home equity lines are reviewed at least semiannually, with specific emphasis on loans with a loan to value ratio greater than 70%. The Company takes measures to work with customers to reduce line commitments and minimize potential losses. There have been no adverse classifications to date as a result of the review.

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

With certain exceptions, state chartered banks are permitted to make extensions of credit to any one borrowing entity up to 15% of the bank's capital and reserves for unsecured loans and up to 25% of the bank's capital and reserves for secured loans. For HBC, these lending limits were \$28.3 million and \$47.2 million at September 30, 2014, respectively.

Loan Maturities

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale) as of September 30, 2014. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

Street Journal. As of September 30, 2014, approximately 60% of the Company's loan portfolio consisted of floating interest rate loans.

	Due in One Year or Less	Over One Year But Less than Five Years	Over Five Years	Total
(Dollars in thousands)				
Commercial	\$ 373,056	\$ 52,979	\$ 10,446	\$ 436,481
Real estate:				
Commercial and residential	75,688	218,329	170,974	464,991
Land and construction	52,583	481		53,064
Home equity	58,040	1,140	1,899	61,079
Consumer	14,009	532	68	14,609
Loans	\$ 573,376	\$ 273,461	\$ 183,387	\$ 1,030,224

Loans with variable interest rates	\$ 533,500	\$ 74,199	\$ 9,137	\$ 616,836
Loans with fixed interest rates	39,876	199,262	174,250	413,388

Loans	\$ 573,376	\$ 273,461	\$ 183,387	\$ 1,030,224
-------	------------	------------	------------	--------------

Loan Servicing

As of September 30, 2014 and 2013, \$133.9 million and \$136.0 million, respectively, in SBA loans were serviced by the Company for others. Activity for loan servicing rights was as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
(Dollars in thousands)				
Beginning of period balance	\$ 606	\$ 631	\$ 525	\$ 709
Additions	69	28	293	86
Amortization	(76)	(93)	(219)	(229)
End of period balance	\$ 599	\$ 566	\$ 599	\$ 566

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, 2014 and 2013, as the fair value of the assets was greater than the carrying value.

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
(Dollars in thousands)				
Beginning of period balance	\$ 1,633	\$ 1,726	\$ 1,647	\$ 1,786
Unrealized holding loss	(28)	(79)	(42)	(139)
End of period balance	\$ 1,605	\$ 1,647	\$ 1,605	\$ 1,647

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

Table of Contents

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

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

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

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

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

	September 30,		December 31,
	2014	2013	2013
	(Dollars in thousands)		
Nonaccrual loans held-for-investment	\$ 7,010	\$ 14,615	\$ 11,326
Restructured and loans over 90 days past due and still accruing	200	502	492
Total nonperforming loans	7,210	15,117	11,818
Foreclosed assets	532	631	575
Total nonperforming assets	\$ 7,742	\$ 15,748	\$ 12,393
Nonperforming assets as a percentage of loans plus foreclosed assets	0.75%	1.76%	1.35%
Nonperforming assets as a percentage of total assets	0.50%	1.12%	0.83%

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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

	September 30, 2014			December 31, 2013		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
(Dollars in thousands)						
Commercial	\$ 3,198	\$ 200	\$ 3,398	\$ 4,414	\$ 492	\$ 4,906
Real estate:						
Commercial and residential	1,672		1,672	4,363		4,363
Land and construction	1,655		1,655	1,761		1,761
Home equity	479		479	666		666
Consumer	6		6	122		122
Total	\$ 7,010	\$ 200	\$ 7,210	\$ 11,326	\$ 492	\$ 11,818

Nonperforming assets were \$7.7 million, or 0.50% of total assets, at September 30, 2014, compared to \$15.7 million, or 1.12% of total assets, at September 30, 2013, and \$12.4 million, or 0.83% of total assets, at December 31, 2013. Included in total nonperforming assets were foreclosed assets of \$532,000 at September 30, 2014, compared to \$631,000 at September 30, 2013, and \$575,000 at December 31, 2013. The decline in nonperforming assets at September 30, 2014 was primarily due to loan payoffs, charge-offs, and upgrades in nonperforming loans' risk categories.

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

	September 30, 2014			September 30, 2013			December 31, 2013		
	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total
(Dollars in thousands)									
Commercial	\$ 428,372	\$ 8,109	\$ 436,481	\$ 396,102	\$ 14,831	\$ 410,933	\$ 380,806	\$ 12,268	\$ 393,074
Real estate:									
Commercial and residential	458,671	6,320	464,991	380,470	7,307	387,777	416,992	6,296	423,288
Land and construction	51,408	1,656	53,064	28,931	1,849	30,780	29,682	1,761	31,443
Home equity	59,945	1,134	61,079	47,364	2,736	50,100	48,818	2,997	51,815
Consumer	14,252	357	14,609	13,354	358	13,712	15,336	341	15,677
Total	\$ 1,012,648	\$ 17,576	\$ 1,030,224	\$ 866,221	\$ 27,081	\$ 893,302	\$ 891,634	\$ 23,663	\$ 915,297

*

Classified loans in the table above are gross of SBA guarantees.

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Nine Months Ended September 30, 2014
Performing TDRs Nonperforming TDRs Total

(Dollars in thousands)

Balance at January 1, 2014	\$ 492	\$ 3,230	\$ 3,722
Principal repayments/advances/upgrades	(262)	(1,792)	(2,054)
Net charge-offs	(30)		(30)

Balance at September 30, 2014	\$ 200	\$ 1,438	\$ 1,638
-------------------------------	--------	----------	----------

Table of Contents

	Nine Months Ended September 30, 2013		
	Performing TDRs	Nonperforming TDRs	Total
	(Dollars in thousands)		
Balance at January 1, 2013	\$ 2,309	\$ 1,798	\$ 4,107
Principal repayments/advances/upgrades	(1,798)	(91)	(1,889)
Net charge-offs		(372)	(372)
Change in TDR classification		199	199
Balance at September, 2013	\$ 511	\$ 1,534	\$ 2,045

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.

Loans with a well-defined weakness, which are characterized by the distinct possibility that the Company will sustain a loss if the deficiencies are not corrected, are categorized as "classified." Classified assets include all loans considered as substandard, substandard-nonaccrual, and doubtful and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate), and foreclosed assets. The principal balance of classified assets, net of SBA guarantees, was \$17.7 million at September 30, 2014, \$23.3 million at September 30, 2013, and \$23.6 million at December 31, 2013. Loans held-for-sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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 FRB 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, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 11,454	\$ 7,069	\$ 69	\$ 18,592
Charge-offs	(132)		(25)	(157)
Recoveries	123	7		130
Net (charge-offs) recoveries	(9)	7	(25)	(27)
Provision (credit) for loan losses	163	(205)	18	(24)
Balance, end of period	\$ 11,608	\$ 6,871	\$ 62	\$ 18,541

RATIOS:

Annualized net charge-offs (recoveries) to average loans(1)	0.00%	0.00%	0.01%	0.01%
Allowance for loan losses to total loans(1)	1.12%	0.67%	0.01%	1.80%

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

	Three Months Ended September 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 12,811	\$ 6,388	\$ 143	\$ 19,342
Charge-offs	(254)	(40)		(294)
Recoveries	820	7	1	828
Net recoveries	566	(33)	1	534
Provision (credit) for loan losses	(10)	(461)	(63)	(534)
Balance, end of period	\$ 13,367	\$ 5,894	\$ 81	\$ 19,342

RATIOS:

Annualized net recoveries to average loans(1)	-0.26%	0.02%	0.00%	-0.24%
Allowance for loan losses to total loans(1)	1.50%	0.66%	0.01%	2.17%

(1)

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

Nine Months Ended September 30, 2014				
	Commercial	Real Estate	Consumer	Total
(Dollars in thousands)				
Balance, beginning of period	\$ 12,533	\$ 6,548	\$ 83	\$ 19,164
Charge-offs	(726)		(25)	(751)
Recoveries	309	51		360
Net (charge-offs) recoveries	(417)	51	(25)	(391)
Provision (credit) for loan losses	(508)	272	4	(232)
Balance, end of period	\$ 11,608	\$ 6,871	\$ 62	\$ 18,541

RATIOS:

Annualized net charge-offs (recoveries) to average loans(1)	0.04%	-0.01%	0.01%	0.04%
Allowance for loan losses to total loans(1)	1.12%	0.67%	0.01%	1.80%

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

Nine Months Ended September 30, 2013				
	Commercial	Real Estate	Consumer	Total
(Dollars in thousands)				
Balance, beginning of period	\$ 12,866	\$ 6,034	\$ 127	\$ 19,027
Charge-offs	(1,213)	(96)		(1,309)
Recoveries	2,158	269	1	2,428
Net (charge-offs) recoveries	945	173	1	1,119
Provision (credit) for loan losses	(444)	(313)	(47)	(804)
Balance, end of period	\$ 13,367	\$ 5,894	\$ 81	\$ 19,342

RATIOS:

Annualized net charge-offs (recoveries) to average loans(1)	-0.15%	-0.03%	0.00%	-0.18%
Allowance for loan losses to total loans(1)	1.50%	0.66%	0.01%	2.17%

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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,		September 30,		December 31,	
	2014	Percent of Loans in each category to total	2013	Percent of Loans in each category to total	2013	Percent of Loans in each category to total
	Allowance	loans	Allowance	loans	Allowance	loans
	(Dollars in thousands)					
Commercial	\$ 11,608	42%	\$ 13,367	46%	\$ 12,533	43%
Real estate:						
Commercial and residential	4,616	45%	4,310	43%	4,922	46%
Land and construction	799	5%	373	3%	356	3%
Home equity	1,456	6%	1,211	6%	1,270	6%
Consumer	62	2%	81	2%	83	2%
Total	\$ 18,541	100%	\$ 19,342	100%	\$ 19,164	100%

The allowance for loan losses totaled \$18.5 million, or 1.80% of total loans at September 30, 2014, compared to \$19.3 million, or 2.17% of total loans at September 30, 2013, and \$19.2 million, or 2.09% of total loans at December 31, 2013. The allowance for loan losses to total loans decreased at September 30, 2014, compared to September 30, 2013, and December 31, 2013, primarily due to increasing loan balances with no default histories, coupled with the decrease in nonperforming assets, improving the quality of the loan portfolio overall. Loan charge-offs reflect the realization of losses in the portfolio that were partially recognized previously through the provision for loan losses. The Company had net charge-offs of \$27,000, or 0.01% of average loans, for the third quarter of 2014, compared to net recoveries of \$534,000, or 0.24% of average loans, for the third quarter of 2013, and net charge-offs of \$166,000, or 0.07% of average loans, for the fourth quarter of 2013.

The allowance for loan losses related to the commercial portfolio decreased \$925,000 at September 30, 2014 from December 31, 2013, as a result of a credit to the provision for loan losses of \$508,000 and net charge-offs of \$417,000. The decrease in the allowance for loan losses was primarily due to a decline in problem loans. The allowance for loan losses related to the real estate portfolio increased \$323,000 at September 30, 2014 from December 31, 2013, as a result of a provision for loan losses of \$272,000 and net recoveries of \$51,000. The increase in the allowance for loan losses was primarily due to an increase in the balance of real estate loans outstanding, partially offset by a decline in problem loans.

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 in California, and the Company's market area in particular, weaken. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed \$100,000, as customers with balances of that magnitude are typically more rate-sensitive than customers with smaller balances.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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

	September 30, 2014		September 30, 2013		December 31, 2013	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
(Dollars in thousands)						
Demand, noninterest-bearing	\$ 488,987	36%	\$ 409,269	34%	\$ 431,085	34%
Demand, interest-bearing	223,121	17%	178,783	15%	195,451	15%
Savings and money market	369,378	28%	312,991	26%	347,052	27%
Time deposits under \$100	20,067	1%	22,029	2%	21,646	2%
Time deposits \$100 and over	197,562	15%	195,321	17%	195,005	15%
Time deposits brokered	28,099	2%	62,833	5%	55,524	4%
CDARS money market and time deposits	14,608	1%	14,311	1%	40,458	3%
 Total deposits	 \$ 1,341,822	 100%	 \$ 1,195,537	 100%	 \$ 1,286,221	 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 8% of deposits at September 30, 2014, 9% at September 30, 2013 and December 31, 2013.

Total deposits increased \$146.3 million to \$1.34 billion at September 30, 2014, compared to \$1.20 billion at September 30, 2013, and increased \$55.6 million from \$1.29 billion at December 31, 2013. Noninterest-bearing demand deposits increased \$79.7 million at September 30, 2014 from September 30, 2013, and increased \$57.9 million from December 31, 2013. Interest-bearing demand deposits increased \$44.3 million at September 30, 2014 from September 30, 2013, and increased \$27.7 million from December 31, 2013. Brokered deposits decreased \$34.7 million at September 30, 2014 from September 30, 2013, and decreased \$27.4 million from December 31, 2013. During the fourth quarter of 2013, the Company received \$27.5 million from a law firm for escrow pending a corporate transaction, which were placed in a CDARS money market account. All of the \$27.5 million in deposits from the law firm retained from this escrow were withdrawn in January, 2014 when the transaction was completed. Deposits (excluding all time deposits and CDARS deposits) increased \$180.4 million, or 20%, to \$1.1 billion at September 30, 2014, from \$901.0 million at September 30, 2013, and increased \$107.9 million, or 11%, from \$973.6 million at December 31, 2013.

At September 30, 2014, the Company had \$109.5 million (at fair value) of securities pledged for \$98.0 million in certificates of deposits from the State of California. At September 30, 2013, the Company had \$112.7 million (at fair value) of securities pledged for \$98.0 million in certificates of deposits from the State of California. At December 31, 2013, the Company had \$108.0 million (at fair value) of securities pledged for \$98.0 million in certificates of deposits from the State of California.

CDARS deposits were comprised of \$7.0 million of money market accounts and \$7.6 million of time deposits at September 30, 2014. CDARS deposits were comprised of \$7.9 million of money market accounts and \$6.4 million of time deposits at September 30, 2013. CDARS deposits were comprised of \$34.8 million of money market accounts and \$5.7 million of time deposits at December 31, 2013.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

The following table indicates the contractual maturity schedule of the Company's time deposits of \$100,000 and over, and all CDARS time deposits and brokered deposits as of September 30, 2014:

	Balance	% of Total
	(Dollars in thousands)	
Three months or less	\$ 75,609	32%
Over three months through six months	86,205	37%
Over six months through twelve months	39,760	17%
Over twelve months	31,647	14%
Total	\$ 233,221	100%

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

Return on Equity and Assets

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Annualized return on average assets	0.88%	0.90%	0.88%	0.78%
Annualized return on average tangible assets	0.88%	0.90%	0.88%	0.78%
Annualized return on average equity	7.46%	7.58%	7.34%	6.44%
Annualized return on average tangible equity	7.51%	7.65%	7.40%	6.51%
Dividend payout ratio(1)	46.66%	29.82%	42.30%	11.70%
Average equity to average assets ratio	11.80%	11.85%	12.01%	12.03%

- (1) Percentage is calculated based on dividends paid on common stock and Series C Preferred Stock (on an as converted basis) divided by net income.

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 \$408.5 million September 30, 2014, compared to \$353.1 million at September 30, 2013, and \$377.2 million at December 31, 2013. Unused commitments represented 40% of outstanding gross loans at September 30, 2014 and September 30, 2013, and 41% at December 31, 2013.

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

Table of Contents

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,					
	2014		2013		December 31, 2013	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)					
Unused lines of credit and commitments to make loans	\$ 8,104	\$ 388,354	\$ 7,220	\$ 335,384	\$ 6,136	\$ 359,955
Standby letters of credit		12,047		10,524		11,099
	\$ 8,104	\$ 400,401	\$ 7,220	\$ 345,908	\$ 6,136	\$ 371,054

Liquidity and Asset/Liability Management

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

One of the measures we analyze for liquidity is our loan to deposit ratio. Our loan to deposit ratio was 76.73% at September 30, 2014, compared to 74.70% at September 30, 2013, and 71.13% at December 31, 2013.

FHLB and FRB Borrowings and Available Lines of Credit

The Company has off-balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. The Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. The Company had no overnight borrowings from the FHLB at September 30, 2014, September 30, 2013 and December 31, 2013. The Company had \$256.8 million of loans pledged to the FHLB as collateral on an available line of credit of \$146.5 million at September 30, 2014.

The Company can also borrow from the FRB's discount window. The Company had \$391.5 million of loans pledged to the FRB as collateral on an available line of credit of \$263.3 million at September 30, 2014, none of which was outstanding.

At September 30, 2014, the Company had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at September 30, 2014, September 30, 2013 and December 31, 2013.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

The Company may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase at September 30, 2014, September 30, 2013, and December 31, 2013.

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

	September 30,		December 31,
	2014	2013	2013
(Dollars in thousands)			
Average balance year-to-date	\$ 513	\$	\$ 58
Average interest rate year-to-date	0.12%	N/A	0.20%
Maximum month-end balance during the quarter	\$	\$	\$
Average rate at period-end	N/A	N/A	N/A

Capital Resources

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

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

	September 30,		December 31,				
	2014	2013	2013				
(Dollars in thousands)							
Capital components:							
Tier 1 Capital	\$ 179,563	\$ 161,523	\$ 165,162				
Tier 2 Capital	16,043	14,508	14,754				
Total risk-based capital	\$ 195,606	\$ 176,031	\$ 179,916				
Risk-weighted assets	\$ 1,280,332	\$ 1,155,477	\$ 1,175,813				
Average assets for capital purposes	\$ 1,535,168	\$ 1,408,107	\$ 1,477,082				
Capital ratios:							
Total risk-based capital	15.3%	15.2%	15.3%	Well-Capitalized Regulatory Requirements	10.00%	Minimum Regulatory Requirements	8.00%
Tier 1 risk-based capital	14.0%	14.0%	14.0%		6.00%		4.00%
Leverage(1)	11.7%	11.5%	11.2%		N/A		4.00%

(1)

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

The table above presents the capital ratios of the consolidated Company computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements for bank holding companies.

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of HBC:

	September 30,		December 31,		
	2014	2013	2013		
(Dollars in thousands)					
Capital components:					
Tier 1 Capital	\$ 167,436	\$ 144,097	\$ 149,037		
Tier 2 Capital	16,065	14,499	14,790		
Total risk-based capital	\$ 183,501	\$ 158,596	\$ 163,827		
Risk-weighted assets	\$ 1,282,159	\$ 1,154,758	\$ 1,178,719		
Average assets for capital purposes	\$ 1,536,812	\$ 1,407,011	\$ 1,477,168		
				Well-Capitalized Regulatory Requirements	
				Minimum Regulatory Requirements	
Capital ratios:					
Total risk-based capital	14.3%	13.7%	13.9%	10.00%	8.00%
Tier 1 risk-based capital	13.1%	12.5%	12.6%	6.00%	4.00%
Leverage(1)	10.9%	10.2%	10.1%	5.00%	4.00%

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

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

At September 30, 2014, the Company's and HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under 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 and 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, 2014, September 30, 2013, and December 31, 2013, the Company and HBC met all capital adequacy guidelines to which they were subject. There are no conditions or events since September 30, 2014 that management believes have changed the categorization of the Company or HBC as well-capitalized.

At September 30, 2014, the Company had total shareholders' equity of \$182.9 million, including \$19.5 million in preferred stock, \$133.2 million in common stock, \$31.0 million in retained earnings, and (\$812,000) of accumulated other comprehensive loss.

The accumulated other comprehensive loss was (\$812,000) at September 30, 2014, compared to accumulated other comprehensive loss of (\$4.3) million at September 30, 2013, and an accumulated other comprehensive loss of (\$4.0) million at December 31, 2013. The unrealized gain (loss) on securities available-for-sale included in accumulated other comprehensive loss was an unrealized gain of \$1.9 million, net of taxes, at September 30, 2014, compared to an unrealized loss of (\$69,000), net of taxes, at September 30, 2013, and an unrealized loss of (\$1.4) million, net of taxes, at December 31,

Table of Contents

2013. The components of accumulated other comprehensive loss, net of taxes, at September 30, 2014 include the following: an unrealized gain on available-for-sale securities of \$1.9 million; the remaining unamortized unrealized gain on securities available-for-sale transferred to held-to-maturity of \$442,000; a liability adjustment on split dollar insurance contracts of (\$1.9) million; a liability adjustment on the supplemental executive retirement plan of (\$2.2) million; and an unrealized gain on interest-only strip from SBA loans of \$932,000.

Mandatory Redeemable Cumulative Trust Preferred Securities

To enhance regulatory capital and to provide liquidity, the Company, through unconsolidated subsidiary grantor trusts, issued mandatory redeemable cumulative trust preferred securities of subsidiary grantor trusts. The subordinated debt was recorded as a component of long-term debt and included the value of the common stock issued by the trusts to the Company. The common stock was recorded as other assets for the amount issued. Under applicable regulatory guidelines, the trust preferred securities qualified as Tier I capital. The subsidiary trusts were not consolidated in the Company's consolidated financial statements.

During the third quarter of 2012, the Company redeemed its 10.875% fixed-rate subordinated debentures in the amount of \$7 million issued to Heritage Capital Trust I and the Company's 10.600% fixed-rate subordinated debentures in the amount of \$7 million issued to Heritage Statutory Trust I. The related trust securities issued by Capital Trust I and Statutory Trust I were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved.

During the third quarter of 2013, the Company redeemed its Company's variable-rate subordinated debentures in the amount of \$5 million issued to Heritage Statutory Trust II and the Company's variable-rate subordinated debentures in the amount of \$4 million issued to Heritage Statutory Trust III. The related trust securities issued by Statutory Trust II and Statutory Trust III were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved.

U.S. Treasury Capital Purchase Program

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

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

Series C Preferred Stock

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of newly issued Series C Preferred Stock. The Series C Preferred Stock is mandatorily convertible into 5,601,000 shares of common stock at a conversion price of \$3.75 per share upon a subsequent transfer of the Series C Preferred stock to third parties not affiliates with the holder in a widely dispersed offering. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. The holders of Series C Preferred Stock receive dividends on an as converted basis when dividends are also declared for holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

Table of Contents

Market Risk

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

Interest Rate Management

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

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

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

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

The Company uses modeling software for asset/liability management in order to simulate the effects of potential interest rate changes on the Company's net interest margin, and to calculate the estimated fair values of the Company's financial instruments under different interest rate scenarios. The program imports current balances, interest rates, maturity dates and repricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company's 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)

Table of Contents

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, 2014. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

	Increase/(Decrease) in Estimated Net Interest Income	
	Amount	Percent
	(Dollars in thousands)	
Change in Interest Rates (basis points)		
+400	\$ 16,822	31.3%
+300	\$ 12,554	23.4%
+200	\$ 8,329	15.5%
+100	\$ 4,029	7.5%
0	\$	0.0%
-100	\$ (4,713)	-8.8%
-200	\$ (9,789)	-18.2%

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

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4 CONTROLS AND PROCEDURES**Disclosure Control and Procedures**

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of

Table of Contents

September 30, 2014. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded the Company's disclosure controls were effective as of September 30, 2014, the period covered by this report on Form 10-Q.

During the three and nine months ended September 30, 2014, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to affect, our internal controls over financial reporting.

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

We may fail to realized the anticipated benefits of the acquisition of Bay View Funding if we do not successfully integrate the business, employees and operations of Bay View Funding.

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, 2013, which could materially affect our business, financial condition and/or operating results. Except as set forth above, there were no material changes from risk factors previously disclosed in our 2013 Annual Report on Form 10-K. The risk factors identified are in addition to those contained in any other cautionary statements, written or oral, which may be made or otherwise addressed in connection with a forward-looking statement or contained in any of our subsequent filings with the Securities and Exchange Commission.

ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 MINE SAFETY DISCLOSURES

None

ITEM 5 OTHER INFORMATION

None

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

ITEM 6 EXHIBITS

Exhibit	Description
3.1	Heritage Commerce Corp Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 4, 2010)
3.2	Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp as filed with the California Secretary of State on June 1, 2010 (incorporated by reference to Exhibit 3.1 to the Registrant's Registration Statement on Form S-1 filed July 23, 2010).
3.3	Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 28, 2013)
4.1	Certificate of Determination for Series C Convertible Perpetual Preferred Stock (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 22, 2010)
12.1	Calculation of Ratio of Earnings to Fixed Charges and Ratio of Earnings to Fixed Charges and Preferred Stock Dividends
31.1	Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350
32.2	Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350
101.INS	XBRL Instance Document, furnished herewith
101.SCH	XBRL Taxonomy Extension Schema Document, furnished herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, furnished herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, furnished herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, furnished herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, furnished herewith

Table of Contents

SIGNATURES

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

Heritage Commerce Corp (Registrant)

Date: November 6, 2014

/s/ WALTER T. KACZMAREK

Walter T. Kaczmarek
Chief Executive Officer

Date: November 6, 2014

/s/ LAWRENCE D. MCGOVERN

Lawrence D. McGovern
Chief Financial Officer

81

Table of Contents

EXHIBIT INDEX

Exhibit	Description
3.1	Heritage Commerce Corp Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 4, 2010)
3.2	Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp as filed with the California Secretary of State on June 1, 2010 (incorporated by reference to Exhibit 3.1 to the Registrant's Registration Statement on Form S-1 filed July 23, 2010).
3.3	Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 28, 2013)
4.1	Certificate of Determination for Series C Convertible Perpetual Preferred Stock (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 22, 2010)
12.1	Calculation of Ratio of Earnings to Fixed Charges and Ratio of Earnings to Fixed Charges and Preferred Stock Dividends
31.1	Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350
32.2	Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350
101.INS	XBRL Instance Document, furnished herewith
101.SCH	XBRL Taxonomy Extension Schema Document, furnished herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, furnished herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, furnished herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, furnished herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, furnished herewith