

HERITAGE COMMERCE CORP
Form 10-Q
November 10, 2011

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, 2011

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)

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

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

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 <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input checked="" type="checkbox"/>
(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 26,295,001 shares of Common Stock outstanding on October 28, 2011.

Table of Contents

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

<u>Cautionary Note on Forward-Looking Statements</u>	Page No. <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 Operations</u>	<u>6</u>
<u>Consolidated Statement of Changes in Shareholders' Equity</u>	<u>7</u>
<u>Consolidated Statements of Cash Flows</u>	<u>8</u>
<u>Notes to Consolidated Financial Statements</u>	<u>9</u>
<u>Item 2.</u> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>32</u>
<u>Item 3.</u> <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>67</u>
<u>Item 4.</u> <u>Controls and Procedures</u>	<u>67</u>
 <u>PART II. OTHER INFORMATION</u>	
<u>Item 1.</u> <u>Legal Proceedings</u>	<u>68</u>
<u>Item 1A.</u> <u>Risk Factors</u>	<u>68</u>
<u>Item 2.</u> <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>68</u>
<u>Item 3.</u> <u>Defaults Upon Senior Securities</u>	<u>68</u>
<u>Item 4.</u> <u>Reserved</u>	<u>68</u>
<u>Item 5.</u> <u>Other Information</u>	<u>68</u>
<u>Item 6.</u> <u>Exhibits</u>	<u>69</u>
<u>SIGNATURES</u>	<u>70</u>
<u>EXHIBIT INDEX</u>	<u>71</u>

Table of Contents

Cautionary Note Regarding Forward-Looking Statements

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

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

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

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

Risks associated with concentrations in real estate related loans;

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

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

Stability of funding sources and continued availability of borrowings;

The effect of changes in laws and regulations with which the Company and Heritage Bank of Commerce must comply, including any increase in FDIC insurance premiums;

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

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

Future legislative or administrative changes to the U.S. Treasury Capital Purchase Program enacted under the Emergency Economic Stabilization Act of 2008;

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

The impact of the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009 and related rules and regulations on our business operations and competitiveness, including the impact of executive compensation restrictions, which may affect our ability to retain and recruit executives in competition with other firms who do not operate under those restrictions;

The impact of the Dodd Frank Wall Street Reform and Consumer Protection Act signed by President Obama on July 21, 2010;

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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

Changes in the deferred tax asset valuation allowance in future quarters;

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

The ability to increase market share and control expenses; and

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

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

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

	September 30, 2011	December 31, 2010
(Dollars in thousands, except per share data)		
Assets		
Cash and due from banks	\$ 23,720	\$ 7,692
Interest-bearing deposits in other financial institutions	52,058	64,485
Total cash and cash equivalents	75,778	72,177
Securities available-for-sale, at fair value	312,125	232,165
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	3,391	8,750
Loans held-for-sale other, at lower of cost or fair value, including deferred costs	421	2,260
Loans, including deferred costs	776,684	846,049
Allowance for loan losses	(21,049)	(25,204)
Loans, net	755,635	820,845
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	9,921	9,174
Company owned life insurance	45,202	43,682
Premises and equipment, net	8,019	8,397
Intangible assets	2,622	3,014
Accrued interest receivable and other assets	39,586	45,905
Total assets	\$ 1,252,700	\$ 1,246,369
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 344,470	\$ 280,258
Demand, interest-bearing	132,987	153,917
Savings and money market	274,489	272,399
Time deposits-under \$100	30,858	33,499
Time deposits-\$100 and over	119,429	137,514
Time deposits-CDARS	10,216	17,864
Time deposits-brokered	93,685	98,467
Total deposits	1,006,134	993,918
Securities sold under agreement to repurchase		5,000
Subordinated debt	23,702	23,702
Short-term borrowings		2,445
Accrued interest payable and other liabilities	25,801	39,152
Total liabilities	1,055,637	1,064,217
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Series A fixed rate cumulative preferred stock, 40,000 shares issued and outstanding (liquidation preference of \$40,250 at September 30, 2011 and \$42,810 at December 31, 2010)	39,846	39,846
Discount on Series A preferred stock	(934)	(1,227)
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at September 30, 2011 and December 31, 2010 (liquidation preference of \$21,004 at September 30, 2011 and December 31, 2010)	19,519	19,519
Common stock, no par value; 60,000,000 shares authorized; 26,295,001 shares issued and outstanding at September 30, 2011 and 26,233,001 shares issued and outstanding at December 31, 2010	131,015	130,531
Retained earnings / (Accumulated deficit)	4,886	(1,866)
Accumulated other comprehensive income (loss)	2,731	(4,651)
Total shareholders' equity	197,063	182,152
Total liabilities and shareholders' equity	\$ 1,252,700	\$ 1,246,369

See notes to consolidated financial statements

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
(Dollars in thousands, except per share data)				
Interest income:				
Loans, including fees	\$ 10,530	\$ 12,041	\$ 32,205	\$ 37,952
Securities	2,457	1,246	6,697	3,868
Interest-bearing deposits in other financial institutions	33	74	119	100
Total interest income	13,020	13,361	39,021	41,920
Interest expense:				
Deposits	852	1,929	3,191	6,451
Subordinated debt	468	473	1,400	1,407
Repurchase agreements		97	24	341
Short-term borrowings		31	38	93
Total interest expense	1,320	2,530	4,653	8,292
Net interest income before provision for loan losses	11,700	10,831	34,368	33,628
Provision for loan losses	1,515	2,058	3,239	25,754
Net interest income after provision for loan losses	10,185	8,773	31,129	7,874
Noninterest income:				
Service charges and fees on deposit accounts	605	536	1,759	1,664
Servicing income	434	442	1,280	1,288
Increase in cash surrender value of life insurance	426	428	1,270	1,249
Gain on sale of SBA loans	268	429	1,124	707
Gain on sale of securities		1,492		1,492
Loss on sale of other loans		(887)		(887)
Other	179	288	566	777
Total noninterest income	1,912	2,728	5,999	6,290
Noninterest expense:				
Salaries and employee benefits	5,000	5,272	15,504	16,645
Occupancy and equipment	1,012	1,081	3,082	3,023
Professional fees	707	780	2,002	3,202
Low income housing investment losses	617	214	820	572
Software subscriptions	256	261	785	747
Data processing	234	188	653	619
Insurance expense	232	241	718	765
FDIC deposit insurance premiums	167	849	1,074	3,059
Other real estate owned expense	84	49	231	537
Write-down of loans held-for-sale		1,080	29	1,080
Impairment of goodwill				43,181
Other	1,500	1,233	4,814	4,568

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total noninterest expense	9,809	11,248	29,712	77,998
Income (loss) before income taxes	2,288	253	7,416	(63,834)
Income tax benefit	(2,529)	(398)	(1,068)	(6,272)
Net income (loss)	4,817	651	8,484	(57,562)
Dividends and discount accretion on preferred stock	(532)	(193)	(1,732)	(1,792)
Net income (loss) allocable to common shareholders	\$ 4,285	\$ 458	\$ 6,752	\$ (59,354)
Earnings (loss) per common share:				
Basic	\$ 0.13	\$ 0.01	\$ 0.21	\$ (4.70)
Diluted	\$ 0.13	\$ 0.01	\$ 0.21	\$ (4.70)

See notes to consolidated financial statements

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

Nine Months Ended September 30, 2011 and 2010

	Preferred Stock			Common Stock		Retained Earnings/ (Accumulated Deficit)	Accumulated Other Comprehensive Income/ (Loss)	Total Shareholder Equity	Comprehensive Income/ (Loss)
	Shares	Amount	Discount	Shares	Amount				
(Dollars in thousands, except share data)									
Balance, January 1, 2010	40,000	\$ 39,846	\$ (1,598)	11,820,509	\$ 80,222	\$ 56,389	\$ (2,554)	\$ 172,305	
Net loss						(57,562)		(57,562)	\$ (57,562)
Net change in unrealized gain/(loss) on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes							1,026	1,026	1,026
Net change in liability and other postretirement obligations, net of deferred income taxes							202	202	202
Total comprehensive loss									\$ (56,334)
Issuance of Series B mandatorily convertible cumulative perpetual preferred stock, net of issuance costs	53,996	50,228						50,228	
Conversion of Series B mandatorily convertible cumulative perpetual preferred stock into common stock	(53,996)	(50,228)		14,398,992	50,228				
Issuance of Series C convertible perpetual preferred stock, net of issuance costs	21,004	19,538						19,538	
Issuance of restricted stock awards				13,500					
Amortization of restricted stock award, net of forfeitures and taxes					42			42	
Cash dividends accrued on Series A preferred stock						(1,516)		(1,516)	
Accretion of discount on Series A preferred stock			276			(276)			
Stock option expense, net of forfeitures and taxes					837			837	
Balance, September 30, 2010	61,004	\$ 59,384	\$ (1,322)	26,233,001	\$ 131,329	\$ (2,965)	\$ (1,326)	\$ 185,100	

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Balance, January 1, 2011	61,004	\$ 59,365	\$ (1,227)	26,233,001	\$ 130,531	\$ (1,866)	\$ (4,651)	\$ 182,152	
Net income						8,484		8,484	\$ 8,484
Net change in unrealized gain/(loss) on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes							6,732	6,732	6,732
Net change in liability and other postretirement obligations, net of deferred income taxes							650	650	650
Total comprehensive income									\$ 15,866
Issuance of restricted stock awards				62,000					
Amortization of restricted stock awards, net of forfeitures and taxes					27			27	
Cash dividends accrued on Series A preferred stock						(1,439)		(1,439)	
Accretion of discount on Series A preferred stock			293			(293)			
Stock option expense, net of forfeitures and taxes					457			457	
Balance, September 30, 2011	61,004	\$ 59,365	\$ (934)	26,295,001	\$ 131,015	\$ 4,886	\$ 2,731	\$ 197,063	

See notes to consolidated financial statements

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Nine Months Ended September 30,	
	2011	2010
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$ 8,484	\$ (57,562)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization (accretion) of discounts and premiums on securities	920	(1,295)
Gain on sale of securities available-for-sale		(1,492)
Gain on sale of SBA loans	(1,124)	(707)
Proceeds from sale of SBA loans originated for sale	12,347	17,146
Net change in SBA loans originated for sale	(5,864)	(17,458)
Loss on sale of other loans		887
Write-downs on other loans held-for-sale	29	1,080
Provision for loan losses	3,239	25,754
Increase in cash surrender value of life insurance	(1,270)	(1,249)
Depreciation and amortization	579	600
Amortization of other intangible assets	392	431
(Gains) losses on sale of foreclosed assets, net	(67)	546
Stock option expense, net	457	837
Amortization of restricted stock awards, net	27	42
Goodwill impairment		43,181
Effect of changes in:		
Accrued interest receivable and other assets	(173)	(2,963)
Accrued interest payable and other liabilities	(8,390)	(1,234)
Net cash provided by operating activities	9,586	6,544
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(95,841)	(41,434)
Maturities/paydowns/calls of securities available-for-sale	26,432	21,164
Proceeds from sale of securities available-for-sale		27,245
Net change in SBA loans previously transferred to held-for-sale		(320)
Net change in other loans transferred to held-for-sale	70	
Net change in loans	59,719	128,960
Changes in Federal Home Loan Bank stock and other investments	(747)	(883)
Purchase of premises and equipment	(201)	(171)
Proceeds from sale of foreclosed assets	2,465	11,595
Proceeds from sale of SBA loans transferred to held-for-sale		1,768
Proceeds from sale of other loans transferred to held-for-sale	1,769	10,303
(Purchases) redemption of company owned life insurance	(250)	308
Net cash (used in) provided by investing activities	(6,584)	158,535
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	12,216	(24,167)
Issuance of preferred stock, net of offering costs		69,766
Payment of cash dividends preferred stock	(4,172)	
Net change in securities sold under agreement to repurchase	(5,000)	(10,000)
Net change in short-term borrowings	(2,445)	(15,685)
Net cash provided by financing activities	599	19,914

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Net increase in cash and cash equivalents	3,601	184,993
Cash and cash equivalents, beginning of period	72,177	45,562

Cash and cash equivalents, end of period	\$	75,778	\$	230,555
--	----	--------	----	---------

Supplemental disclosures of cash flow information:

Interest paid	\$	7,054	\$	7,008
Income taxes paid		490		

Supplemental schedule of non-cash investing activity:

Due to broker for securities purchased	\$		\$	4,123
Transfer from portfolio loans to loans held-for-sale				17,079
Transfer of loans held-for-sale to loan portfolio				2,367
Loans transferred to foreclosed assets		2,252		10,593
Conversion of Series B preferred stock to common stock				50,228

See notes to consolidated financial statements

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2011

(Unaudited)

1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company") and its wholly owned subsidiary, Heritage Bank of Commerce (sometimes referred to as "HBC"), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes that were included in the Company's Form 10-K for the year ended December 31, 2010. The Company has also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III which are Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities.

HBC is a commercial bank serving customers located in Santa Clara, Alameda, and Contra Costa counties of California. No customer accounts for more than 10 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 the Company's opinion, all adjustments necessary for a fair presentation of these consolidated financial statements have been included and are of a normal and recurring nature. All intercompany transactions and balances have been eliminated.

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

The results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2011.

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 July 2010, the FASB updated disclosure requirements with respect to the credit quality of financing receivables and the allowance for credit losses. According to the guidance there are two levels of detail at which credit information will be presented the portfolio segment and class levels. The portfolio segment level is defined as the level where financing receivables are aggregated in developing a Company's systematic method for calculating its allowance for credit losses. The class level is the second level at which credit information will be presented and represents the categorization of

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

1) Basis of Presentation (Continued)

financing related receivables at a slightly less aggregated level than the portfolio segment level. Companies will now be required to provide the following disclosures as a result of this update: a rollforward of the allowance for credit losses at the portfolio segment level with the ending balances further categorized according to impairment method along with the balance reported in the related financing receivables at period end; additional disclosure of nonaccrual and impaired financing receivables by class as of period end; credit quality and past due/aging information by class as of period end; information surrounding the nature and extent of loan modifications and troubled-debt restructurings and their effect on the allowance for credit losses during the period; and detail of any significant purchases or sales of financing receivables during the period. The increased period-end disclosure requirements became effective for periods ending on or after December 15, 2010, with the exception of additional disclosures surrounding troubled-debt restructurings, which were deferred in December 2010 and became effective for periods ending on or after June 15, 2011. The increased disclosures for activity within a reporting period became effective for periods beginning on or after December 15, 2010. The provisions of this update expanded the Company's current disclosures with respect to credit quality in addition to the allowance for loan losses.

In April 2011, the FASB amended existing guidance for assisting a creditor in determining whether a restructuring is a troubled debt restructuring. The amendments clarify the guidance for a creditor's evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. With regard to determining whether a concession has been granted, the updated guidance clarifies that creditors are precluded from using the effective interest method to determine whether a concession has been granted. In the absence of using the effective interest method, a creditor must now focus on other considerations such as the value of the underlying collateral, evaluation of other collateral or guarantees, the debtor's ability to access other funds at market rates, interest rate increases and whether the restructuring results in a delay in payment that is insignificant. This guidance is effective for interim and annual reporting periods beginning after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. For purposes of measuring impairment on newly identified troubled debt restructurings, the amendments should be applied prospectively for the first interim or annual period beginning on or after June 15, 2011. The adoption of this guidance expanded the Company's current disclosures with respect to troubled debt restructurings.

Newly Issued But Not Yet Effective Accounting Standards

In June 2011, the FASB issued an accounting standards update to increase the prominence of items included in Other Comprehensive Income and facilitate the convergence of U.S. GAAP with International Financial Reporting Standards ("IFRS"). The update prohibits continued presentation of Other Comprehensive Income in the statement of Stockholders' Equity. The update requires that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but continuous statements. The amendments in the update are effective for interim and annual periods beginning on or after December 15, 2011. The provisions of this update are only expected to change the manner in which our other comprehensive income is disclosed.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

2) Earnings Per Share

Basic earnings (loss) per common share is computed by dividing net income (loss), less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. On June 21, 2010, the Company issued to various institutional investors 53,996 shares of Series B Mandatorily Convertible Cumulative Perpetual Preferred Stock ("Series B Preferred Stock") and 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). Subject to the terms of the Series B Preferred Stock, the 53,996 shares of Series B Preferred Stock converted into 14,398,992 shares of common stock on September 16, 2010. The 21,004 shares of Series C Preferred Stock remain outstanding as of September 30, 2011, and are convertible into 5,601,000 shares of common stock. The Series B Preferred Stock and Series C Preferred Stock participate in the earnings of the Company and, therefore, the shares issued on the conversion of the Series B Preferred Stock and the Series C Preferred Stock are considered outstanding under the two-class method of computing basic earnings per common share during periods of earnings. The shares issued on the conversion of the Series B Preferred Stock and the Series C Preferred Stock are not considered outstanding for the nine months ended September 30, 2010 due to the net loss allocable to common shareholders for the period. Diluted earnings (loss) per share reflect potential dilution from outstanding stock options and common stock warrants, using the treasury stock method. Due to the Company's net loss allocable to common shareholders for the nine months ended September 30, 2010, all stock options and common stock warrants were excluded from the computation of diluted loss per average common share. A reconciliation of the weighted average shares used in computing basic and diluted earnings (loss) per common share is as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2010	2011	2010
Weighted average common shares outstanding	26,295,001	14,230,212	26,257,112	12,623,743
Effect of convertible preferred stock	5,601,000	17,600,160	5,601,000	N/A
Shares used in computing basic earnings (loss) per common share	31,896,001	31,830,372	31,858,112	12,623,743
Dilutive effect of stock options outstanding, using the treasury stock method	2,274		4,443	N/A
Shares used in computing diluted earnings (loss) per common share	31,898,275	31,830,372	31,862,555	12,623,743

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

3) Securities

The amortized cost and estimated fair value of securities at September 30, 2011 and December 31, 2010 were as follows:

September 30, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(Dollars in thousands)				
Securities available-for-sale:				
Agency Mortgage-Backed Securities	\$ 303,588	\$ 8,537	\$	\$ 312,125

December 31, 2010	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(Dollars in thousands)				
Securities available-for-sale:				
Agency Mortgage-Backed Securities	\$ 235,099	\$ 1,079	\$ (4,013)	\$ 232,165

At September 30, 2011 and December 31, 2010, all agency mortgage backed securities were issued by the Federal National Mortgage Association ("Fannie Mae") the Federal Home Loan Mortgage Corporation ("Freddie Mac"), or the Government National Mortgage Association ("Ginnie Mae"), and 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.

There were no securities with unrealized losses at September 30, 2011. At December 31, 2010, the Company held 106 securities, of which 54 had fair values below amortized cost. No securities had been carried with an unrealized loss for over 12 months. The Company did not consider these securities to be other-than-temporarily impaired at December 31, 2010.

The amortized cost and estimated fair values of securities as of September 30, 2011, by weighted average life, are shown below. The weighted average life will differ from contractual maturities because borrowers may have the right to call or pre-pay obligations with or without call or pre-payment penalties.

	Available-for-sale Amortized Cost	Estimated Fair Value
(Dollars in thousands)		
Due within one year	\$	\$
Due after one through five years	141,014	144,827
Due after five through ten years	144,858	148,853
Due after ten years	17,716	18,445
Total	\$ 303,588	\$ 312,125

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

4) Loans

Loans were as follows:

	September 30, 2011	December 31, 2010
	(Dollars in thousands)	
Loans held-for-sale:		
Loans held-for-sale SBA	\$ 3,391	\$ 8,750
Loans held-for-sale other	421	2,260
Total loans held-for-sale	\$ 3,812	\$ 11,010
Loans held-for-investment:		
Commercial	\$ 365,532	\$ 378,412
Real estate:		
Commercial and residential	310,722	337,457
Land and construction	36,357	62,356
Home equity	51,668	53,697
Consumer	11,829	13,244
Loans	776,108	845,166
Deferred loan origination costs and fees, net	576	883
Loans, including deferred costs	776,684	846,049
Allowance for loan losses	(21,049)	(25,204)
Loans, net	\$ 755,635	\$ 820,845

Prior to February 15, 2011, SBA loans that were sold were subject to a warranty for a period of 90 days. In accordance with generally accepted accounting principles, the Company treated sold SBA loans as secured borrowings during the warranty period. The secured borrowings were classified as "short-term borrowings" on the unaudited consolidated balance sheets. At December 31, 2010, the balance of loans held-for-sale included \$2,445,000 of SBA loans that were transferred to third parties, with associated deferred gains of \$192,000, which are included in other liabilities on the consolidated balance sheets. Effective February 15, 2011, the SBA no longer required a warranty period in loan sales agreements. Therefore, gains on loan sales completed after February 15, 2011 are recognized upon completion of the transaction, thus there are no short-term borrowings or deferred gains associated with the SBA loans held-for-sale at September 30, 2011.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

4) Loans (Continued)

Changes in the allowance for loan losses were as follows:

	Three Months Ended September 30, 2011				Three Months Ended September 30, 2010
	Commercial	Real Estate	Consumer	Total	Total
(Dollars in thousands)					
Balance, beginning of period	\$ 13,992	\$ 8,162	\$ 1,013	\$ 23,167	\$ 26,753
Charge-offs	(3,042)	(901)		(3,943)	(3,963)
Recoveries	283	25	2	310	442
Net (charge-offs)/recoveries	(2,759)	(876)	2	(3,633)	(3,521)
Provision/(credit) for loan losses	1,809	554	(848)	1,515	2,058
Balance, end of period	\$ 13,042	\$ 7,840	\$ 167	\$ 21,049	\$ 25,290

	Nine Months Ended September 30, 2011				Nine Months Ended September 30, 2010
	Commercial	Real Estate	Consumer	Total	Total
(Dollars in thousands)					
Balance, beginning of period	\$ 13,952	\$ 10,363	\$ 889	\$ 25,204	\$ 28,768
Charge-offs	(5,841)	(2,497)	(8)	(8,346)	(30,347)
Recoveries	513	436	3	952	1,115
Net charge-offs	(5,328)	(2,061)	(5)	(7,394)	(29,232)
Provision for loan losses	4,418	(462)	(717)	3,239	25,754
Balance, end of period	\$ 13,042	\$ 7,840	\$ 167	\$ 21,049	\$ 25,290

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

4) 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 as of September 30, 2011 and December 31, 2010:

	September 30, 2011				
	Commercial	Real Estate	Consumer	Total	
	(Dollars in thousands)				
Allowance for loan losses:					
Ending allowance balance attributable to loans:					
Individually evaluated for impairment	\$ 2,384	\$ 623	\$ 46	\$	3,053
Collectively evaluated for impairment	10,658	7,217	121		17,996
Total ending allowance balance	\$ 13,042	\$ 7,840	\$ 167	\$	21,049
Loans:					
Individually evaluated for impairment	\$ 10,442	\$ 8,016	\$ 617	\$	19,075
Collectively evaluated for impairment	355,090	390,731	11,212		757,033
Total ending loan balance	\$ 365,532	\$ 398,747	\$ 11,829	\$	776,108

	December 31, 2010			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 3,427	\$ 1,855	\$ 778	\$ 6,060
Collectively evaluated for impairment	10,525	8,508	111	19,144
Total ending allowance balance	\$ 13,952	\$ 10,363	\$ 889	\$ 25,204
Loans:				
Individually evaluated for impairment	\$ 14,374	\$ 16,041	\$ 898	\$ 31,313
Collectively evaluated for impairment	364,038	437,469	12,346	813,853
Total ending loan balance	\$ 378,412	\$ 453,510	\$ 13,244	\$ 845,166

[Table of Contents](#)**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2011****(Unaudited)****4) Loans (Continued)**

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of September 30, 2011 and December 31, 2010. 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, 2011			December 31, 2010		
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
	(Dollars in thousands)					
With no related allowance recorded:						
Commercial	\$ 4,270	\$ 3,580	\$	\$ 5,557	\$ 5,125	\$
Real estate:						
Commercial and residential	1,297	1,297		4,392	2,431	
Land and construction	4,962	4,434		6,138	3,429	
Consumer	161	161				
Total with no related allowance recorded	10,690	9,472		16,087	10,985	
With an allowance recorded:						
Commercial	7,361	6,862	2,384	9,695	9,249	3,427
Real estate:						
Commercial and residential	85	85	14	4,753	4,753	1,002
Land and construction	3,429	2,200	609	6,862	5,428	853
Home Equity						
Consumer	456	456	46	898	898	778
Total with an allowance recorded	11,331	9,603	3,053	22,208	20,328	6,060
Total	\$ 22,021	\$ 19,075	\$ 3,053	\$ 38,295	\$ 31,313	\$ 6,060

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2011****(Unaudited)****4) Loans (Continued)**

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

Three Months Ended September 30, 2011								Three Months Ended September 30, 2010 Total
Real Estate								
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total		
	(Dollars in thousands)							
Average of impaired loans during the period	\$ 11,740	\$ 1,297	\$ 4,411	\$ 3,317	\$ 800	\$ 21,565	\$ 47,111	
Interest income during impairment	\$	\$	\$	\$	\$ 2	\$ 2	\$ 1	
Cash-basis interest earned	\$	\$	\$	\$	\$	\$	\$	

Nine Months Ended September 30, 2011								Nine Months Ended September 30, 2010 Total
Real Estate								
Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total			
(Dollars in thousands)								
Average of impaired loans during the period	\$ 12,777	\$ 3,186	\$ 6,213	\$ 1,729	\$ 848	\$ 24,753	\$ 55,950	
Interest income during impairment	\$ 2	\$	\$	\$ 1	\$ 2	\$ 5	\$ 41	
Cash-basis interest earned	\$	\$	\$	\$ 1	\$	\$ 1	\$ 27	

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, 2011	September 30, 2010	December 31, 2010
	(Dollars in thousands)		
Nonaccrual loans held-for-sale	\$ 191	\$ 4,552	\$ 2,026
Nonaccrual loans held-for-investment	16,419	41,757	28,821
Restructured and loans over 90 days past due and still accruing	2,656	2,687	2,492
Total	\$ 19,266	\$ 48,996	\$ 33,339

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2011****(Unaudited)****4) Loans (Continued)**

The following table presents the nonperforming loans by class as of September 30, 2011 and December 31, 2010:

	September 30, 2011			December 31, 2010		
	Restructured and Loans Over 90 Days Past Due and Still Accruing			Restructured and Loans Over 90 Days Past Due and Still Accruing		
	Nonaccrual		Total	Nonaccrual		Total
(Dollars in thousands)						
Commercial	\$ 8,487	\$ 2,206	\$ 10,693	\$ 13,545	\$ 829	\$ 14,374
Real estate:						
Commercial and residential	1,285		1,285	6,450	1,663	8,113
Land and construction	6,831		6,831	9,954		9,954
Home equity						
Consumer	7	450	457	898		898
Total	\$ 16,610	\$ 2,656	\$ 19,266	\$ 30,847	\$ 2,492	\$ 33,339

The following table presents the aging of past due loans as of September 30, 2011 by class of loans:

	September 30, 2011					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
(Dollars in thousands)						
Commercial	\$ 1,976	\$ 2,950	\$ 4,126	\$ 9,052	\$ 356,480	\$ 365,532
Real estate:						
Commercial and residential	1,065			1,065	309,657	310,722
Land and construction			5,761	5,761	30,596	36,357
Home equity	400			400	51,268	51,668
Consumer			456	456	11,373	11,829
Total	\$ 3,441	\$ 2,950	\$ 10,343	\$ 16,734	\$ 759,374	\$ 776,108

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2011****(Unaudited)****4) Loans (Continued)**

The following table presents the aging of past due loans as of December 31, 2010 by class of loans:

	December 31, 2010					
	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	\$ 3,176	\$ 807	\$ 14,374	\$ 18,357	\$ 360,055	\$ 378,412
Real estate:						
Commercial and residential	1,078	1,595	7,184	9,857	327,600	337,457
Land and construction			8,857	8,857	53,499	62,356
Home equity	80			80	53,617	53,697
Consumer			898	898	12,346	13,244
Total	\$ 4,334	\$ 2,402	\$ 31,313	\$ 38,049	\$ 807,117	\$ 845,166

Past due loans 30 days or greater totaled \$16,734,000 and \$38,049,000 at September 30, 2011 and December 31, 2010, respectively, of which \$10,045,000 and \$28,821,000 were on nonaccrual. At September 30, 2011, there were also \$6,374,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. There were no current loans included in nonaccrual loans held-for-investment at December 31, 2010. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

Credit Quality Indicators

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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2011****(Unaudited)****4) Loans (Continued)**

accordance with contractual loans terms. Classified loans are those loans that are assigned a substandard, substandard-nonaccrual, or doubtful risk rating using the following definitions:

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

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

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

The following table provides a summary of the loan portfolio by loan type and credit quality classification at September 30, 2011 and December 31, 2010:

	September 30, 2011			December 31, 2010		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)					
Commercial	\$ 336,855	\$ 28,677	\$ 365,532	\$ 340,319	\$ 38,093	\$ 378,412
Real estate:						
Commercial and residential	291,686	19,036	310,722	320,867	16,590	337,457
Land and construction	14,165	22,192	36,357	32,664	29,692	62,356
Home equity	51,019	649	51,668	50,757	2,940	53,697
Consumer	11,647	182	11,829	12,346	898	13,244
Total	\$ 705,372	\$ 70,736	\$ 776,108	\$ 756,953	\$ 88,213	\$ 845,166

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

During the three months and nine months ended September 30, 2011, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or more combination of the following: a reduction of the stated interest rate of the loan; an extension of maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2011****(Unaudited)****4) Loans (Continued)**

As a result of adopting the amended guidance in determining whether a restructuring is a troubled debt restructuring, the Company reassessed all restructurings that occurred on or after January 1, 2011 for identification as troubled debt restructurings. The Company did not identify any loans as troubled debt restructurings for which the allowance for loan losses had previously been measured under a general allowance for loan losses methodology.

The book balance of troubled debt restructurings at September 30, 2011 was \$5,651,000, which included \$3,445,000 of nonaccrual loans and \$2,206,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2010 was \$7,924,000, which included \$5,432,000 of nonaccrual loans and \$2,492,000 of accruing loans. Approximately \$301,000 and \$1,134,000 in specific reserves were established with respect to these loans as of September 30, 2011 and December 31, 2010. As of September 30, 2011 and December 31, 2010, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

The following table presents loans by class modified as troubled debt restructurings during the three month period ended September 30, 2011:

		During the Three Months Ended September 30, 2011	
	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
(Dollars in thousands)			
Commercial	6	\$ 1,557	\$ 1,370

The troubled debt restructurings described above increased the allowance for loan losses by \$144,000 through the allocation of specific reserves, and resulted in net charge-offs of \$174,000 during the three month period ended September 30, 2011.

The following table presents loans by class modified as troubled debt restructurings during the nine month period ended September 30, 2011:

		During the Nine Months Ended September 30, 2011	
	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
		(Dollars in thousands)	
Commercial	7	\$ 2,249	\$ 2,057

The troubled debt restructurings described above increased the allowance for loan losses by \$158,000 through the allocation of specific reserves, and resulted in net charge-offs of \$174,000 during the nine months period ended September 30, 2011.

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the three month and nine month periods ended September 30, 2011.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

5) Preferred Stock

Series A Preferred Stock

On November 21, 2008, the Company issued 40,000 shares of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") to the U.S. Treasury under the terms of the U.S. Treasury Capital Purchase Program for \$40,000,000 with a liquidation preference of \$1,000 per share. The Series A Preferred Stock carries a coupon of 5% for five years and 9% thereafter. In November 2009, the Company announced that it was exercising its right to suspend payment of dividends on its Series A Preferred Stock. On July 28, 2011, the Board of Directors of the Company declared a dividend on its Series A Preferred Stock held by the U.S. Treasury in an aggregate amount of \$4,172,000. The dividend was paid on August 1, 2011. Of the aggregate dividend declared and paid, \$3,500,000 was attributable to the dividend periods ending November 15, 2009 through May 15, 2011 and \$172,000 was for interest on the deferred dividend payments. The balance of \$500,000 was the dividend payable for the period ending August 15, 2011. As a result of the dividend payment, the Company is current with respect to dividends accrued and owed to the U.S. Treasury.

Private Placement

On June 21, 2010, the Company issued to various institutional investors 53,996 shares of Series B Mandatory Convertible Perpetual Preferred Stock ("Series B Preferred Stock") and 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") for an aggregate purchase price of \$75,000,000. The Series B Preferred Stock was mandatorily convertible into common stock, upon approval by the shareholders, at a conversion price of \$3.75 per share. The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon both approval by the shareholders and thereafter, a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. The Series B Preferred Stock and the Series C Preferred Stock did not include a beneficial conversion feature, as the conversion price of \$3.75 per share was not below the fair market value of the Company's common stock on the commitment date.

At the Company's Special Meeting of shareholders held on September 15, 2010, the Company's shareholders approved the issuance of common stock upon the conversion of the Series B Preferred Stock and upon the conversion of the Series C Preferred Stock, as required by the NASDAQ Stock Market and California corporate law. As a result, on September 16, 2010, the Series B Preferred Stock was converted into 14,398,992 shares of common stock of the Company and the shares of Series B Preferred Stock ceased to be outstanding.

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

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

6) Income Taxes

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

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

The Company had net deferred tax assets of \$27,361,000, net of a \$3,700,000 partial valuation allowance, as of December 31, 2010. In analyzing the deferred tax assets as of September 30, 2011, based on the factors above, the Company estimated it was more likely than not that the Company will realize approximately \$21,134,000 of the benefits of the deductible differences, and therefore, a \$700,000 partial valuation allowance for deferred tax assets was recorded as of September 30, 2011. The income tax benefit of \$2,529,000 for the third quarter of 2011, and \$1,068,000 for the nine months ended September 30, 2011, are net of the \$3,000,000 reduction in the partial valuation allowance from \$3,700,000 as of December 31, 2010 to \$700,000 as of September 30, 2011.

7) Benefit Plans*Supplemental Retirement Plan*

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in thousands)			
Components of net periodic benefit cost:				
Service cost	\$ 236	\$ 244	\$ 708	\$ 732
Interest cost	206	209	618	627
Amortization of prior service cost	9	9	27	27
Amortization of net actuarial loss	31	17	93	51
Net periodic benefit cost	\$ 482	\$ 479	\$ 1,446	\$ 1,437

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

7) Benefit Plans (Continued)

Split-Dollar Life Insurance Benefit Plan

The Company maintains life insurance policies for current and former directors and officers that are subject to split-dollar life insurance agreements. During the third quarter of 2011, participants in the split-dollar life insurance benefit plan agreed to amend their agreements. As a result of the amended agreements, the benefit plan liability was reduced from \$6,361,000 as of December 31, 2010 to \$3,642,000 as of September 30, 2011.

The following table sets forth the funded status of the split-dollar life insurance benefits for the nine months ended September 30, 2011 and the twelve months ended December 31, 2010:

	September 30, 2011	December 31, 2010
	(Dollars in thousands)	
Change in projected benefit obligation		
Projected benefit obligation at beginning of year	\$ 6,361	\$ 6,957
Interest cost	254	392
Actuarial gain		(833)
Benefits paid		(155)
Amendments to split dollar agreements	(2,973)	
Projected benefit obligation at end of period	\$ 3,642	\$ 6,361

Amounts recognized in accumulated other comprehensive loss at September 30, 2011 and December 31, 2010 consist of the following:

	September 30, 2011	December 31, 2010
	(Dollars in thousands)	
Net actuarial gain	\$ (407)	\$ (407)
Prior transition obligation	1,939	4,049
Accumulated other comprehensive loss	\$ 1,532	\$ 3,642

8) Fair Value

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

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

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

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

8) Fair Value (Continued)

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

Financial Assets and Liabilities Measured on a Recurring Basis

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

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

	Balance	Fair Value Measurements Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
(Dollars in thousands)			
Assets at September 30, 2011:			
Available-for-sale securities:			
Agency Mortgage-Backed Securities	\$ 312,125		\$ 312,125
I/O strip receivables	2,180		2,180
Assets at December 31, 2010:			
Available-for-sale securities:			
Agency Mortgage-Backed Securities	\$ 232,165		\$ 232,165
I/O strip receivables	2,140		2,140
There were no transfers between Level 1 and Level 2 during the period for assets measured at fair value on a recurring basis.			

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

Assets and Liabilities Measured on a Non-Recurring Basis

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

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

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

8) Fair Value (Continued)

Nonrecurring adjustments to certain commercial and residential estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

	Fair Value Measurements Using			
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Dollars in thousands)			
Assets at September 30, 2011:				
Impaired loans held-for-sale other:				
Real estate:				
Land and construction	\$ 191		\$ 191	
Impaired loans held-for-investment:				
Commercial	\$ 5,993			\$ 5,993
Real estate:				
Commercial and residential	967			967
Land and construction	3,277			3,277
Consumer	410			410
	\$ 10,647			\$ 10,647
Other real estate owned	\$ 1,229			\$ 1,229
Assets at December 31, 2010:				
Impaired loans held-for-sale other:				
Real estate:				
Commercial and residential	\$ 929		\$ 929	
Land and construction	1,097		1,097	
	\$ 2,026		\$ 2,026	
Impaired loans held-for-investment:				
Commercial	\$ 6,725			\$ 6,725
Real estate:				
Commercial and residential	5,982			5,982
Land and construction	8,005			8,005
Consumer	120			120
	\$ 20,832			\$ 20,832
Other real estate owned	\$ 1,296			\$ 1,296

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

8) Fair Value (Continued)

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

	September 30, 2011	December 31, 2010
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	\$ 13,700	\$ 26,892
Book value of impaired loans held-for-investment carried at cost	5,375	4,421
Total impaired loans held-for-investment	\$ 19,075	\$ 31,313
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	\$ 13,700	\$ 26,892
Specific valuation allowance	(3,053)	(6,060)
Impaired loans held-for-investment carried at fair value, net	\$ 10,647	\$ 20,832

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were \$19,075,000 at September 30, 2011, after partial charge-offs of \$2,946,000 in the first nine months of 2011. In addition, these loans had a specific valuation allowance of \$3,053,000 at September 30, 2011. Impaired loans held-for-investment totaling \$13,700,000 at September 30, 2011 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining \$5,375,000 of impaired loans were carried at cost at September 30, 2011, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during the first nine months of 2011 on impaired loans held-for-investment carried at fair value at September 30, 2011 resulted in an additional provision for loan losses of \$2,725,000.

Total other real estate owned, consisting of two properties, had a fair value of \$1,229,000 at September 30, 2011.

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral totaled \$31,313,000 at December 31, 2010, after partial charge-offs of \$6,982,000 in 2010. In addition, these loans had a specific valuation allowance of \$6,060,000 at December 31, 2010. Impaired loans held-for-investment totaling \$26,892,000 at December 31, 2010 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining \$4,421,000 of impaired loans were carried at cost at December 31, 2010, 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 2010 on impaired loans held-for-investment carried at fair value at December 31, 2010 resulted in an additional provision for loan losses of \$9,791,000.

Total other real estate owned, consisting of one property, had a fair value of \$1,296,000 at December 31, 2010.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

8) Fair Value (Continued)

The carrying amounts and estimated fair values of the Company's financial instruments for the periods indicated were as follows:

	September 30, 2011		December 31, 2010	
	Carrying	Estimated Fair	Carrying	Estimated
	(Dollars in thousands)			
Assets:				
Cash and cash equivalents	\$ 23,720	\$ 23,720	\$ 72,177	\$ 72,177
Securities available-for-sale	312,125	312,125	232,165	232,165
Loans (including loans held-for-sale), net	759,447	761,555	831,855	855,327
FHLB and FRB stock	9,921	N/A	9,174	N/A
Accrued interest receivable	3,297	3,297	3,215	3,215
Loan servicing rights and I/O strips receivables	2,989	5,479	3,055	5,340
Liabilities:				
Time deposits	\$ 254,188	\$ 255,082	\$ 287,344	\$ 288,798
Other deposits	751,946	751,946	706,574	706,574
Securities sold under agreement to repurchase			5,000	5,018
Short-term borrowings			2,445	2,445
Subordinated debt	23,702	15,465	23,702	14,445
Accrued interest payable	409	409	2,810	2,810

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

Cash and Cash Equivalents and Accrued Interest Receivable and Payable

The carrying amount approximates fair value because of the short maturities of these instruments.

Loans

Loans with similar financial characteristics are grouped together for purposes of estimating their fair value. Loans are segregated by type such as commercial, term real estate, construction and land development, and consumer. Each loan category is further segmented into fixed and adjustable rate interest terms.

The fair value of performing, fixed rate loans is calculated by discounting scheduled future cash flows using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The fair value of variable rate loans approximates the carrying amount as these loans generally reprice within 90 days.

The fair value of loans held-for-sale is based on estimated market values from third party investors.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

8) Fair Value (Continued)

FHLB and FRB Stock

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

Deposits

The fair value of deposits with no stated maturity, such as demand deposits, savings, and money market accounts, approximates the amount payable on demand. The carrying amount approximates the fair value of time deposits with a remaining maturity of less than 90 days. The fair value of all other time deposits is calculated based on discounting the future cash flows using rates currently offered for time deposits with similar remaining maturities.

Subordinated Debt and Securities Sold Under Agreement to Purchase

The fair values of subordinated debt and securities sold under agreement to repurchase were determined based on the current market value for like kind instruments of a similar maturity and structure.

Short-term Borrowings and Note Payable

The carrying amount approximates the fair value of short-term borrowings and the note payable that reprice frequently and fully.

Off-Balance Sheet Items

The fair value of off-balance sheet items, such as commitments to extend credit, is not considered material and therefore is not included in the table above.

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.

9) Regulatory Matters

In 2011, the Federal Reserve Bank of San Francisco ("FRB") and the State of California Department of Financial Institutions ("DFI") issued a joint order terminating the regulatory written agreement ("Written Agreement") entered into on February 17, 2010, among the Company, HBC, the FRB and the DFI. Effective June 9, 2011, the Company and HBC are no longer subject to the terms and conditions of the Written Agreement.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

10) Equity Plan

The Company granted 62,000 restricted shares of its common stock, at a grant price of \$5.16, to eight officers pursuant to the terms of the restricted stock agreements, dated June 16, 2011, under the Amended and Restated 2004 Equity Plan. Under the terms of the agreements, the common stock is subject to risk of forfeiture until the common stock has vested. The common stock will vest upon the later of: (a) the date the Company has redeemed all of the issued and outstanding shares of the Company's Series A Fixed Rate Cumulative Perpetual Preferred Stock, or (b) upon the second anniversary of the grant date. However, upon the occurrence of a change in control, or the death or disability of the participant, the common stock will vest immediately. The fair value of stock awards at the grant date was \$319,920, which is being amortized over a two year period on the straight-line method. Amortization expense related to the 62,000 shares was \$46,000 for the nine months ended September 30, 2011. None of the shares were vested at September 30, 2011.

The Company also granted 150,000 shares of unqualified stock options to directors and employees in June 2011. The exercise price was \$5.16 per share, and the options vest over four years. Stock option expense related to the 150,000 shares was \$33,000 for the nine months ended September 30, 2011. As of September 30, 2011, there was \$402,000 of unrecognized compensation expense related to the 150,000 nonvested stock options granted in June 2011.

11) Comprehensive Income (Loss)

Comprehensive income (loss) consists of other comprehensive income and net income (loss). Other comprehensive income refers to gains and losses that are included in comprehensive income (loss) but are excluded from net income (loss) because they have been recorded directly in equity under the provisions of other accounting guidance. The following is a summary of the components of other comprehensive (loss) income:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in thousands)			
Net income (loss)	\$ 4,817	\$ 651	\$ 8,484	\$ (57,562)
Net unrealized holding gains on available-for-sale securities and I/O strips	7,733	1,417	11,607	1,769
Less: Deferred income tax	(3,248)	(595)	(4,875)	(743)
 Change in unrealized gains on available-for-sale securities and I/O strips, net of deferred income tax	 4,485	 822	 6,732	 1,026
Net pension and other post retirement plan liability adjustment	2,034	112	2,229	348
Less: Deferred income tax	(1,498)	(47)	(1,579)	(146)
 Change in pension and other post retirement plan liability, net of deferred income tax	 536	 65	 650	 202
 Other comprehensive income	 5,021	 887	 7,382	 1,228
 Total comprehensive income (loss)	 \$ 9,838	 \$ 1,538	 \$ 15,866	 \$ (56,334)

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2011

(Unaudited)

12) Subordinated Debt

In November 2009, the Company announced that it was exercising its right to defer regularly scheduled interest payments on its \$23,702,000 of junior subordinated notes relating to its trust preferred securities. From the time it deferred interest payments, the Company accrued the expense of each deferred interest payment at the normal rate on a compounded basis. On June 24, 2011, the Company paid all of the deferred interest payments on its outstanding trust preferred subordinated debt securities in the amount of \$3,884,000, which includes all payments due through September 8, 2011. As a result of the interest payment, the Company is current with respect to interest accrued on trust preferred subordinated debt securities.

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") and its wholly owned subsidiary, Heritage Bank of Commerce (sometimes referred to as "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. Reference to "HCC" refers only to Heritage Commerce Corp, the holding company of HBC.

EXECUTIVE SUMMARY

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

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

Performance Overview

For the three months ended September 30, 2011, net income was \$4.8 million. The net income allocable to common shareholders was \$4.3 million, or \$0.13 per common share for the three months ended September 30, 2011, which included a \$1.5 million provision for loan losses and a \$3.0 million reduction of the partial valuation allowance for deferred tax assets. For the three months ended September 30, 2010, net income was \$651,000. The net income allocable to common shareholders was \$458,000 or \$0.01 per average diluted common share for the three months ended September 30, 2010, which included a \$2.1 million provision for loan losses, a \$1.1 million write-down of loans held-for-sale, and an \$887,000 loss on the sale of other loans, partially offset by a \$1.5 million gain on sale of securities.

For the nine months ended September 30, 2011, net income was \$8.5 million. The net income allocable to common shareholders was \$6.8 million, or \$0.21 per common share, which included a \$3.2 million provision for loan losses and a \$3.0 million reduction of its partial valuation allowance for deferred tax assets. For the nine months ended September 30, 2010, the net loss was \$57.6 million. The net loss allocable to common shareholders was \$59.4 million, or \$(4.70) per average diluted common share, which included a \$43.2 million charge for impairment of goodwill, a \$25.8 million provision for loan losses, and \$3.7 million expense to establish a partial valuation allowance on the deferred tax assets.

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

The net interest margin increased 49 basis points to 4.01% for the third quarter of 2011, compared with 3.52% for the third quarter of 2010, and increased 6 basis points from 3.95% for

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

the second quarter of 2011, principally due to a higher yield on loans, a lower level of interest-bearing deposits in other institutions, a lower cost of deposits as a result of higher noninterest-bearing demand deposit balances, and a lower level of nonaccrual loans. The Company's net interest margin increased to 3.97% for the nine months ended September 30, 2011, compared to 3.72% for the nine months ended September 30, 2010, primarily as a result of a higher yield on loans, a lower level of interest-bearing deposits in other institutions, a lower cost of deposits as a result of higher noninterest-bearing demand deposit balances, and a lower level of nonaccrual loans as credit quality improved.

Net interest income was \$11.7 million for the third quarter of 2011, compared to \$10.8 million for the third quarter of 2010. Net interest income was \$34.4 million for the nine months ended September 30, 2011, compared to \$33.6 million for the nine months ended September 30, 2010. The increase in net interest income in 2011 compared to the same periods in 2010 was primarily due to an increase in the average balance of investment securities and lower interest expense on deposits, partially offset by a decrease in average loans.

The provision for loan losses was \$1.5 million for the third quarter of 2011, compared to \$2.1 million for the third quarter of 2010. The provision for loan losses for the nine months ended September 30, 2011 was \$3.2 million, compared to \$25.8 million for the nine months ended September 30, 2010. The decrease in 2011 compared to 2010 reflects a lower volume of classified assets and nonperforming loans, and contraction of the loan portfolio.

Noninterest income decreased 30% to \$1.9 million for the third quarter of 2011 from \$2.7 million for the third quarter of 2010, and decreased 5% to \$6.0 million for the nine months ended September 30, 2011 from \$6.3 million for the nine months ended September 30, 2010, primarily due to a \$1.5 million gain on the sale of securities, which was partially offset by an \$887,000 loss on sale of other loans in the third quarter of 2010.

Noninterest expense was \$9.8 million for the third quarter of 2011, compared to \$11.2 million for the third quarter of 2010. For the nine months ended September 30, 2011, noninterest expense was \$29.7 million, compared to \$34.8 million for the nine months ended September 30, 2010, excluding a \$43.2 million impairment of goodwill. The decrease in noninterest expense in the third quarter and nine months ended September 30, 2011 was due to a decline in salaries and employee benefits expense, FDIC insurance premiums and professional fees. This was partially offset by an increase in investment losses on the Company's low income housing investments in the third quarter and nine months ended September 30, 2011.

The efficiency ratio was 72.06% for the third quarter of 2011, compared to 82.96% for the third quarter of 2010, excluding the impairment of goodwill. The efficiency ratio for the nine months ended September 30, 2011 was 73.60%, compared to 87.22% for the nine months ended September 30, 2010, excluding the impairment of goodwill. The improvement was primarily due to lower noninterest expense as management continues to focus on controlling expenses and higher net interest income.

The income tax benefit for the quarter ended September 30, 2011 was \$2.5 million, compared to an income tax benefit of \$398,000 in the third quarter of 2010. For the nine months ended September 30, 2011, the income tax benefit was \$1.1 million, compared to an income tax benefit of \$6.3 million in the nine months September 30, 2010. The income tax benefit for the third quarter and for the nine months ended September 30, 2011 included the \$3.0 million reversal of the partial valuation allowance for deferred tax assets. The difference in the effective tax rate compared to the combined federal and state statutory tax rate of 42% is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes, and tax credits related to investments in low income housing limited partnerships.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

Cash and due from banks, interest-bearing deposits in other financial institutions and securities available-for-sale increased 13% to \$387.9 million at September 30, 2011, from \$342.0 million at September 30, 2010, and increased 27% from \$304.3 million at December 31, 2010.

Total loans, excluding loans held-for-sale, decreased \$109.9 million, or 12%, to \$776.7 million at September 30, 2011, compared to \$886.6 million at September 30, 2010, and decreased \$69.4 million, or 8%, from \$846.0 million at December 31, 2010. Land and construction loans decreased \$55.3 million, or 60%, to \$36.4 million at September 30, 2011, compared to \$91.7 million at September 30, 2010, and decreased \$26.0 million, or 42%, from \$62.4 million at December 31, 2010.

Classified assets decreased to \$72.4 million at September 30, 2011, compared to \$116.5 million at September 30, 2010, and \$91.8 million at December 31, 2010.

The allowance for loan losses at September 30, 2011 was \$21.0 million, or 2.71% of total loans compared to \$25.3 million, or 2.85% of total loans at September 30, 2010. The allowance for loan losses at December 31, 2010, was \$25.2 million, or 2.98% of total loans.

The allowance for loan losses to total nonperforming loans, increased to 109.25% at September 30, 2011, compared to 51.62% at September 30, 2010, and 75.60% at December 31, 2010.

The allowance for loan losses to total nonperforming loans, excluding nonaccrual loans held-for-sale, increased to 110.35% at September 30, 2011, compared to 56.90% at September 30, 2010, and 80.49% at December 31, 2010.

Nonperforming assets were \$20.5 million, or 1.64% of total assets at September 30, 2011, compared to \$49.7 million or 3.73% of total assets at September 30, 2010, and \$34.6 million, or 2.78% of total assets at December 31, 2010.

Net loan charge-offs were \$3.6 million in the third quarter of 2011, compared to \$3.5 million in the third quarter of 2010.

Noninterest-bearing demand deposits increased 28% to \$344.5 million at September 30, 2011, from \$269.5 million at September 30, 2010, and increased 23% from \$280.3 million at December 31, 2010.

Brokered deposits decreased 29% to \$93.7 million at September 30, 2011, from \$132.4 million at September 30, 2010, and decreased 5% from \$98.5 million at December 31, 2010.

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 17.83% at September 30, 2011, compared to 22.61% at September 30, 2010, and 20.96% at December 31, 2010.

The loan to deposit ratio was 77.19% at September 30, 2011, compared to 83.24% at September 30, 2010, and 85.12% at December 31, 2010.

Capital ratios exceed regulatory requirements for a well-capitalized financial institution, both on a consolidated basis and at the bank level at September 30, 2011. The leverage ratio at the holding company was 16.0%, with a Tier 1 risk-based capital ratio of 21.1%, and a total risk-based capital ratio of 22.3% at September 30, 2011. The leverage ratio for HBC was 14.2%,

with a Tier 1 risk-based capital ratio of 18.7%, and a total risk-based capital ratio of 19.9% at

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

September 30, 2011. The regulatory well-capitalized guidelines are a minimum of a 5% leverage ratio, a 6% Tier 1 risk-based capital ratio, and a 10% total risk-based capital ratio.

Significant Third Quarter 2011 Events

On July 28, 2011, the Company's Board of Directors declared a dividend on its Series A Preferred Stock held by the U.S. Treasury in an aggregate amount of \$4.2 million. The dividend was paid on August 1, 2011. Of the aggregate dividend declared and paid, \$3.5 million was attributable to the dividend periods ending November 15, 2009 through May 15, 2011 and \$172,000 was for interest on the deferred dividend payments, that have been previously accrued. The balance of \$500,000 was the dividend payable for the period ending August 15, 2011. As a result of the dividend payment, the Company is current with respect to dividends accrued and owed to the U.S. Treasury.

The Company had net deferred tax assets of \$27.4 million, net of a \$3.7 million partial valuation allowance, as of December 31, 2010. In analyzing the deferred tax assets as of September 30, 2011, based on the factors above, the Company estimated it was more likely than not that the Company will realize approximately \$21.1 million of the benefits of the deductible differences, and therefore, a \$700,000 partial valuation allowance for deferred tax assets was recorded as of September 30, 2011. The income tax benefit of \$2.5 million for the third quarter of 2011, and \$1.1 million for the nine months ended September 30, 2011, are net of the \$3.0 million reduction in the partial valuation allowance from \$3.7 million as of December 31, 2010 to \$700,000 as of September 30, 2011.

The Company has investments in low-income housing funds ("LIHFs") that earn tax credits and tax benefits, which reduces the Company's effective tax rate compared to statutory tax rates. Based on the projected future operating results of the LIHFs, the Company recognized additional LIHF investment losses in the third quarter of 2011. LIHF investments losses were \$617,000 and \$820,000 during the third quarter and first nine months of 2011, respectively, compared to \$214,000 and \$572,000 for the same periods in 2010.

The Company maintains life insurance policies for current and former directors and officers that are subject to split-dollar life insurance agreements. During the third quarter of 2011, participants in the split-dollar life insurance benefit plan agreed to amend their agreements. As a result of the amended agreements, the benefit plan liability was reduced from \$6.4 million as of December 31, 2010 to \$3.6 million as of September 30, 2011.

Deposits

The composition and cost of the Company's deposit base are important in analyzing the Company's net interest margin and balance sheet liquidity characteristics. Except for brokered time deposits, the Company's depositors are generally located in its primary market area. Depending on loan demand and other funding requirements, the Company also obtains deposits from wholesale sources including deposit brokers. The Company had \$93.7 million in brokered deposits at September 30, 2011, compared to \$132.4 million at September 30, 2010, and \$98.5 million at December 31, 2010. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators decreased to \$30.5 million at September 30, 2011, compared to \$50.1 million at September 30, 2010, and \$39.0 million at December 31, 2010. The Company has a policy to monitor all deposits that may be sensitive to interest rate changes to help assure that liquidity risk does not become excessive due to concentrations. Deposits at September 30, 2011 were \$1.0 billion, compared to \$1.1 billion at September 30, 2010, and \$993.9 million at December 31, 2010. At September 30, 2011, our reliance on noncore funding has improved with the ratio of noncore funding to total assets at 17.83%, compared to 22.61% at September 30, 2010, and 20.96% at December 31, 2010.

HBC is a member of the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program allows customers with deposits in excess of FDIC insured limits to obtain

coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through this program are considered brokered deposits under regulatory guidelines. Deposits in the CDARS program totaled \$10.2 million at September 30, 2011, compared to \$16.3 million at September 30, 2010, and \$17.9 million at December 31, 2010.

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, 2011, we had \$75.8 million in cash and cash equivalents and approximately \$328.3 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 \$280.4 million in unpledged securities available at September 30, 2011. Our loan to deposit ratio decreased to 77.19% at September 30, 2011, compared to 83.24% at September 30, 2010, and 85.12% at December 31, 2010, primarily due to a reduction in the loan portfolio.

Lending

Our lending business originates primarily through our branch offices located in our primary market. The Company also has an additional SBA loan production office in Santa Rosa, California. The total loan portfolio remains well diversified with commercial and industrial ("C&I") loans accounting for 47% of the portfolio at September 30, 2011. Commercial and residential real estate loans accounted for 40% of the total loan portfolio at September 30, 2011, of which 52% were owner-occupied by businesses. We have actively lowered our exposure to land and construction loans and our overall credit risk on these portfolios has been reduced. Land and construction loans decreased \$55.3 million to \$36.4 million at September 30, 2011, compared to \$91.7 million at September 30, 2010, and accounted for 5% of our total loan portfolio at September 30, 2011, compared to 10% at September 30, 2010, and 7% at December 31, 2010. Consumer and home equity loans accounted for the remaining 8% of total loans at September 30, 2011. The yield on the loan portfolio was 5.29% for the third quarter of 2011 and 5.30% for the nine months ended September 30, 2011, compared to 5.10% and 5.07% for the respective comparable periods in 2010. Loans, excluding loans held-for-sale, decreased 12% to \$776.7 million at September 30, 2011, from \$886.6 million a year ago, and decreased 8% from \$846.0 million at December 31, 2010. The decline in gross loans for the nine months ended September 30, 2011 was primarily due to diminished loan demand, loan payoffs exceeding draw downs of loan commitments and the result of efforts to reduce classified loans. Lower volume of loan originations can be attributed in part to lower demand for certain types of credit as well as more selectivity with respect to the types of loans the Company chooses to originate.

Net Interest Income

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

Because of our focus on commercial lending to closely held businesses, the Company will continue to have a high percentage of floating rate loans and other assets. Given the current volume, mix and repricing characteristics of our interest-bearing liabilities and interest-earning assets, we believe our interest rate spread is expected to increase in a rising rate environment, and decrease in a declining interest rate environment.

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.

The net interest margin expanded for the nine months ended September 30, 2011, compared to the same period in 2010 primarily due to a lower cost of deposits as a result of higher noninterest-bearing demand deposit balances, along with a lower level of nonaccrual loans.

Management of Credit Risk

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

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

Noninterest Income

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

A portion of the Company's noninterest income is associated with its SBA lending activity, consisting of gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing retained. Prior to February 15, 2011, the sale of SBA loans were subject to a warranty for a period of 90 days. In accordance with generally accepted accounting principles, the Company treated the SBA loans sold as secured borrowings during the warranty period. Effective February 15, 2011, the SBA no longer required a warranty period in loan sales agreements. Therefore, gains on loan sales completed after February 15, 2011 are recognized upon completion of the transaction.

Table of Contents

Other sources of noninterest income include loan servicing fees, service charges and fees, cash surrender value from company owned life insurance policies, and gains on the sale of securities.

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company's performance. The Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. Noninterest expense decreased \$5.1 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, excluding the impairment of goodwill, primarily due to lower salaries and benefits, FDIC deposit insurance premiums, professional fees related to problem loans, and expenses related to OREO properties.

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. The terms of the U.S. Treasury Capital Purchase Program could reduce investment returns to our shareholders by restricting dividends to common shareholders, diluting existing shareholders' interests, and restricting capital management practices.

Under the terms of the Capital Purchase Program with the U.S. Treasury, so long as our Series A Preferred Stock is outstanding, we are prohibited from increasing quarterly dividends on our common stock in excess of \$0.08 per share, and from making certain repurchases of equity securities, including our common stock, without the U.S. Treasury consent until the third anniversary of the U.S. Treasury investment or until the U.S. Treasury has transferred all of the Series A Preferred Stock it purchased under the Capital Purchase Program to third parties. As long as the Series A Preferred Stock is outstanding, dividend payments and repurchases or redemptions relating to certain equity securities, including our common stock, and the Series C Preferred Stock, are also prohibited until all accrued and unpaid dividends are paid on such preferred stock, subject to certain limited exceptions. On November 6, 2009, we suspended dividend payments on our Series A Preferred Stock. On July 28, 2011, the Company's Board of Directors declared a dividend on its Series A Preferred Stock held by the U.S. Treasury in an aggregate amount of \$4.2 million. The dividend was paid on August 1, 2011. Of the aggregate dividend declared and paid, \$3.5 million was attributable to the dividend periods ending November 15, 2009 through May 15, 2011 and \$172,000 was for interest on the deferred dividend payments, that have been previously accrued. The balance of \$500,000 was the dividend payable for the period ending August 15, 2011. As a result of the dividend payment, the Company is current with respect to dividends accrued and owed to the U.S. Treasury.

On June 21, 2010, the Company issued Series B Mandatorily Convertible Cumulative Perpetual Preferred Stock ("Series B Preferred Stock") and Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") to a limited number of institutional investors for an aggregate amount of \$75.0 million. HCC then downstreamed \$40 million of the proceeds from the private placement to the capital of HBC.

After receiving shareholder approval in September 2010, the outstanding Series B Preferred Stock converted into approximately 14.4 million shares of the Company's common stock. The Series C Preferred Stock remains outstanding until converted to common stock upon the transfer of the Series C Preferred Stock in accordance with its terms. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock.

Table of Contents

We have supported our growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt that we issued to the trusts is senior to our shares of common stock, Series A Preferred Stock, and Series C Preferred Stock. As a result, we must make payments on the subordinated debt before any dividends can be paid on our common stock, Series A Preferred Stock, and Series C Preferred Stock. Under the terms of the subordinated debt, we may defer interest payments for up to five years. On November 6, 2009, we exercised our right to defer regularly scheduled interest payments on our \$23.7 million of subordinated debt relating to our trust preferred securities. During the second quarter of 2011, the Company paid all the deferred interest payments on its outstanding trust preferred subordinated debt securities in the amount of \$3.9 million that it had previously accrued.

At September 30, 2011, HBC's total risk-based capital ratio was 19.9%, compared to the 10% regulatory requirement for well-capitalized banks under the regulatory framework for prompt corrective actions. HBC's Tier 1 risk-based capital ratio of 18.7% and leverage ratio of 14.2% at September 30, 2011 also exceeded regulatory guidelines for well-capitalized banks under the prompt corrective actions framework. On a consolidated basis, the Company has a total risk-based capital ratio of 22.3%, a Tier 1 risk-based capital ratio of 21.1%, and a leverage ratio of 16.0% at September 30, 2011.

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, 2011			For the Three Months Ended September 30, 2010		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
(Dollars in thousands)						
Assets:						
Loans, gross(1)	\$ 789,378	\$ 10,530	5.29%	\$ 936,917	\$ 12,041	5.10%
Securities	317,908	2,457	3.07%	146,061	1,246	3.38%
Federal funds sold and interest-bearing deposits in other financial institutions	51,301	33	0.26%	136,451	74	0.22%
Total interest earning assets	1,158,587	13,020	4.46%	1,219,429	13,361	4.35%
Cash and due from banks	21,662			21,434		
Premises and equipment, net	8,053			8,677		
Goodwill and other intangible assets	2,698			3,249		
Other assets	67,084			69,470		
Total assets	\$ 1,258,084			\$ 1,322,259		
Liabilities and shareholders' equity:						
Deposits:						
Demand, noninterest-bearing	\$ 340,023			\$ 266,190		
Demand, interest-bearing	131,667	57	0.17%	157,501	87	0.22%
Savings and money market	282,368	195	0.27%	290,711	343	0.47%
Time deposits under \$100	31,270	54	0.69%	38,316	125	1.29%
Time deposits \$100 and over	115,617	272	0.93%	135,204	470	1.38%
Time deposits CDARS	14,293	13	0.36%	17,624	32	0.72%
Time deposits brokered	93,666	261	1.11%	151,359	872	2.29%
Total interest-bearing deposits	668,881	852	0.51%	790,715	1,929	0.97%
Total interest-bearing liabilities	1,008,904	852	0.34%	1,056,905	1,929	0.72%
Subordinated debt	23,702	468	7.83%	23,702	473	7.92%
Securities sold under agreement to repurchase			N/A	17,663	97	2.18%
Short-term borrowings			N/A	3,601	31	3.42%
Total interest-bearing liabilities	692,583	1,320	0.76%	835,681	2,530	1.20%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,032,606	1,320	0.51%	1,101,871	2,530	0.91%
Other liabilities	34,841			32,794		

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total liabilities	1,067,447	1,134,665
Shareholders' equity	190,637	187,594
Total liabilities and shareholders' equity	\$ 1,258,084	\$ 1,322,259
Net interest income / margin	\$ 11,700 4.01%	\$ 10,831 3.52%

(1)

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

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, 2011			For the Nine Months Ended September 30, 2010		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
(Dollars in thousands)						
Assets:						
Loans, gross(1)	\$ 813,132	\$ 32,205	5.30%	\$ 1,000,791	\$ 37,952	5.07%
Securities	281,156	6,697	3.18%	140,843	3,868	3.67%
Federal funds sold and interest-bearing deposits in other financial institutions	63,187	119	0.25%	65,510	100	0.20%
Total interest earning assets	1,157,475	39,021	4.51%	1,207,144	41,920	4.64%
Cash and due from banks	21,052			21,148		
Premises and equipment, net	8,180			8,818		
Goodwill and other intangible assets	2,828			31,858		
Other assets	68,022			67,301		
Total assets	\$ 1,257,557			\$ 1,336,269		
Liabilities and shareholders' equity:						
Deposits:						
Demand, noninterest-bearing	\$ 328,302			\$ 259,879		
Demand, interest-bearing	133,153	189	0.19%	152,505	256	0.22%
Savings and money market	277,049	721	0.35%	295,617	1,105	0.50%
Time deposits under \$100	32,216	186	0.77%	38,794	407	1.40%
Time deposits \$100 and over	123,732	1,033	1.12%	133,223	1,438	1.44%
Time deposits CDARS	18,998	62	0.44%	18,609	133	0.96%
Time deposits brokered	93,615	1,000	1.43%	168,559	3,112	2.47%
Total interest-bearing deposits	678,763	3,191	0.63%	807,307	6,451	1.07%
Total interest-bearing liabilities	1,007,065	3,191	0.42%	1,067,186	6,451	0.81%
Subordinated debt	23,702	1,400	7.90%	23,702	1,407	7.94%
Securities sold under agreement to repurchase	952	24	3.37%	20,110	341	2.27%
Short-term borrowings	1,236	38	4.11%	9,867	93	1.26%
Total interest-bearing liabilities	704,653	4,653	0.88%	860,986	8,292	1.29%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,032,955	4,653	0.60%	1,120,865	8,292	0.99%
Other liabilities	38,239			35,504		
Total liabilities	1,071,194			1,156,369		
Shareholders' equity	186,363			179,900		

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total liabilities and shareholders' equity	\$ 1,257,557	\$ 1,336,269
---	--------------	--------------

Net interest income / margin	\$ 34,368	3.97%	\$ 33,628	3.72%
------------------------------	-----------	-------	-----------	-------

(1)

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

Table of Contents**Volume and Rate Variances**

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

Three Months Ended September 30, 2011 vs. 2010 Increase (Decrease) Due to Change In:				
	Average		Average Rate	Net Change
	Volume			
(Dollars in thousands)				
Income from interest earning assets:				
Loans, gross	\$ (1,963)	\$	452	\$ (1,511)
Securities	1,327		(116)	1,211
Federal funds sold and interest-bearing deposits in other financial institutions	(56)		15	(41)
Total interest income from interest earnings assets	(692)		351	(341)
Expense on interest-bearing liabilities:				
Demand, interest-bearing	(10)		(20)	(30)
Savings and money market	(3)		(145)	(148)
Time deposits under \$100	(13)		(58)	(71)
Time deposits \$100 and over	(45)		(153)	(198)
Time deposits CDARS	(3)		(16)	(19)
Time deposits brokered	(162)		(449)	(611)
Subordinated debt			(5)	(5)
Securities sold under agreement to repurchase	(97)			(97)
Short-term borrowings	(31)			(31)
Total interest expense on interest-bearing liabilities	(364)		(846)	(1,210)
Net interest income	\$ (328)	\$	1,197	\$ 869

Table of Contents

Nine Months Ended September 30, 2011 vs. 2010 Increase (Decrease) Due to Change In: Average Average Net Volume Rate Change (Dollars in thousands)			
Income from interest earning assets:			
Loans, gross	\$ (7,467)	\$ 1,720	\$ (5,747)
Securities	3,347	(518)	\$ 2,829
Federal funds sold and interest-bearing deposits in other financial institutions	(3)	22	\$ 19
Total interest income from interest earnings assets	(4,123)	1,224	(2,899)
Expense on interest-bearing liabilities:			
Demand, interest-bearing	(28)	(39)	(67)
Savings and money market	(53)	(331)	(384)
Time deposits under \$100	(37)	(184)	(221)
Time deposits \$100 and over	(83)	(322)	(405)
Time deposits CDARS	1	(72)	(71)
Time deposits brokered	(803)	(1,309)	(2,112)
Subordinated debt		(7)	(7)
Securities sold under agreement to repurchase	(483)	166	(317)
Short-term borrowings	(265)	210	(55)
Total interest expense on interest-bearing liabilities	(1,751)	(1,888)	(3,639)
Net interest income	\$ (2,372)	\$ 3,112	\$ 740

The Company's net interest margin, expressed as a percentage of average earning assets, was 4.01% for the third quarter of 2011, an increase of 49 basis points from 3.52% for the third quarter a year ago. For the nine months ended September 30, 2011, the net interest margin increased to 3.97% compared to 3.72% for the same period in 2010, primarily as a result of lower deposit and borrowing costs. The increase in the net interest margin for the third quarter and the nine months ended September 30, 2011 was principally due to a lower cost of deposits as a result of higher noninterest-bearing demand deposit balances and a lower level of nonaccrual loans.

Net interest income in the third quarter of 2011 increased 8% to \$11.7 million, compared to \$10.8 million in the third quarter of 2010. Net interest income for the nine months ended September 30, 2011 increased 2% to \$34.4 million, compared to \$33.6 million for the nine months ended September 30, 2010. The increase in net interest income was primarily due to an increase in the average balance of investment securities, partially offset by a decrease in average loans.

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

Provision for Loan Losses

Credit risk is inherent in the business of making loans. The Company establishes an allowance for loan losses through charges to earnings, which are shown in the statements of operations as the

Table of Contents

provision for loan losses. Specifically identifiable and quantifiable known losses are promptly charged off against the allowance. The provision for loan losses is determined by conducting a quarterly evaluation of the adequacy of the Company's allowance for loan losses and charging the shortfall, if any, to the current quarter's expense. This has the effect of creating variability in the amount and frequency of charges to the Company's earnings. The provision for loan losses and level of allowance for each period are dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of the quality of the loan portfolio, the valuation of problem loans and the general economic conditions in the Company's market area.

The Company had a provision for loan losses of \$1.5 million for the quarter ended September 30, 2011 and \$3.2 million for the nine months ended September 30, 2011. The Company had a provision for loan losses of \$2.1 million for the quarter ended September 30, 2010 and \$25.8 million for the nine months ended September 30, 2010.

The allowance for loan losses represented 2.71%, 2.85% and 2.98% of total loans at September 30, 2011, September 30, 2010, and December 31, 2010, respectively. Provisions for loan losses are charged to operations to bring the allowance for loan losses to a level deemed appropriate by the Company based on the factors discussed under "Allowance for Loan Losses".

Noninterest Income

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

	For the Three Months Ended September 30,		Increase (decrease) 2011 versus 2010	
	2011	2010	Amount	Percent
(Dollars in thousands)				
Service charges and fees on deposit accounts	\$ 605	\$ 536	\$ 69	13%
Servicing income	434	442	(8)	-2%
Increase in cash surrender value of life insurance	426	428	(2)	0%
Gain on sale of SBA loans	268	429	(161)	-38%
Gain on sale of securities		1,492	(1,492)	-100%
Loss on sale of other loans		(887)	887	-100%
Other	179	288	(109)	-38%
Total noninterest income	\$ 1,912	\$ 2,728	\$ (816)	-30%

Table of Contents

	For the Nine Months Ended September 30,		Increase (decrease) 2011 versus 2010	
	2011	2010	Amount	Percent
(Dollars in thousands)				
Service charges and fees on deposit accounts	\$ 1,759	\$ 1,664	\$ 95	6%
Servicing income	1,280	1,288	(8)	-1%
Increase in cash surrender value of life insurance	1,270	1,249	21	2%
Gain on sale of SBA loans	1,124	707	417	59%
Gain on sale of securities		1,492	(1,492)	-100%
Loss on sale of other loans		(887)	887	-100%
Other	566	777	(211)	-27%
Total noninterest income	\$ 5,999	\$ 6,290	\$ (291)	-5%

The decrease in noninterest income in third quarter and first nine months of 2011 compared to the same periods in 2010 was primarily attributable to a \$1.5 million gain on the sale of securities, which was partially offset by an \$887,000 loss on sale of other loans in the third quarter of 2010.

A portion of the Company's noninterest income is associated with its SBA lending activity, consisting of gains on sale of loans sold in the secondary market and servicing income from loans sold with servicing retained. Prior to February 15, 2011, when the Company sold SBA loans to third parties, the loans were subject to a 90 day SBA warranty. In accordance with generally accepted accounting principles, the Company treated the SBA loans sold as secured borrowings during the warranty period. Effective February 15, 2011, the SBA no longer required a warranty period in loan sales agreements. Therefore, gains on loan sales completed after February 15, 2011 were recognized upon completion of the transaction. For the nine months ended September 30, 2011, SBA loan sales resulted in an \$1.1 million gain, compared to a \$707,000 gain on sale of SBA loans for the nine months ended September 30, 2010. The servicing assets that result from the sale of SBA loans with servicing retained, are amortized over the expected term of the loans using a method approximating the interest method. Servicing income generally declines as the respective loans are repaid.

Other sources of noninterest income include loan servicing fees, service charges and fees, and cash surrender value from company owned life insurance policies.

The increase in cash surrender value of life insurance approximates a 3.89% after tax yield on the policies. To realize this tax advantaged yield, the policies must be held until death of the insured individuals, who are current and former officers and directors of the Company.

Table of Contents
Noninterest Expense

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

	For the Three Months Ended September 30,		Increase (decrease) 2011 versus 2010	
	2011	2010	Amount	Percent
	(Dollars in thousands)			
Salaries and employee benefits	\$ 5,000	\$ 5,272	\$ (272)	-5%
Occupancy and equipment	1,012	1,081	(69)	-6%
Professional fees	707	780	(73)	-9%
Low income housing investment losses	617	214	403	188%
Software subscriptions	256	261	(5)	-2%
Data processing	234	188	46	24%
Insurance expense	232	241	(9)	-4%
FDIC deposit insurance premiums	167	849	(682)	-80%
Other real estate owned expense	84	49	35	71%
Write-down of loans held-for-sale		1,080	(1,080)	-100%
Other	1,500	1,233	267	22%
Total noninterest expense	\$ 9,809	\$ 11,248	\$ (1,439)	-13%

	For the Nine Months Ended September 30,		Increase (decrease) 2011 versus 2010	
	2011	2010	Amount	Percent
	(Dollars in thousands)			
Salaries and employee benefits	\$ 15,504	\$ 16,645	\$ (1,141)	-7%
Occupancy and equipment	3,082	3,023	59	2%
Professional fees	2,002	3,202	(1,200)	-37%
Low income housing investment losses	820	572	248	43%
Software subscriptions	785	747	38	5%
Data processing	653	619	34	5%
Insurance expense	718	765	(47)	-6%
FDIC deposit insurance premiums	1,074	3,059	(1,985)	-65%
Other real estate owned expense	231	537	(306)	-57%
Write-down of loans held-for-sale	29	1,080	(1,051)	-97%
Impairment of goodwill		43,181	(43,181)	-100%
Other	4,814	4,568	246	5%
Total noninterest expense	\$ 29,712	\$ 77,998	\$ (48,286)	-62%

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,				
	2011	Percent of Total	2010	Percent of Total
(Dollars in thousands)				
Salaries and employee benefits	\$ 5,000	51%	\$ 5,272	47%
Occupancy and equipment	1,012	10%	1,081	10%
Professional fees	707	7%	780	7%
Low income housing investment losses	617	6%	214	2%
Software subscriptions	256	3%	261	2%
Data processing	234	3%	188	2%
Insurance expense	232	2%	241	2%
FDIC deposit insurance premiums	167	2%	849	7%
Other real estate owned expense	84	1%	49	0%
Writedown of loans held-for-sale		0%	1,080	10%
Other	1,500	15%	1,233	11%
Total noninterest expense	\$ 9,809	100%	\$ 11,248	100%

For The Nine Months Ended September 30,				
	2011	Percent of Total	2010	Percent of Total
(Dollars in thousands)				
Salaries and employee benefits	\$ 15,504	52%	\$ 16,645	21%
Occupancy and equipment	3,082	10%	3,023	4%
Professional fees	2,002	7%	3,202	4%
Low income housing investment losses	820	3%	572	1%
Software subscriptions	785	3%	747	1%
Data processing	653	2%	619	1%
Insurance expense	718	2%	765	1%
FDIC deposit insurance premiums	1,074	4%	3,059	4%
Other real estate owned expense	231	1%	537	1%
Writedown of loans held-for-sale	29	0%	1,080	1%
Impairment of goodwill		0%	43,181	55%
Other	4,814	16%	4,568	6%
Total noninterest expense	\$ 29,712	100%	\$ 77,998	100%

Noninterest expense for the third quarter of 2011 declined 13% to \$9.8 million, compared to \$11.2 million for the third quarter of 2010, primarily due to a \$1.1 million write-down on loans held-for-sale in the third quarter of 2010, a decrease in salaries and benefits expense and lower FDIC insurance premiums. This was partially offset by an increase in investment losses on the Company's low income housing investments. Salaries and employee benefits decreased \$272,000, or 5%, for the third quarter of 2011 from the same period in 2010, primarily due to a reduction in staff implemented in the fourth quarter of 2010. Full-time equivalent employees were 190 and 204 at September 30, 2011 and 2010, respectively. FDIC deposit insurance premiums decreased \$682,000, or 80%, to \$167,000 for the third quarter of 2011, compared to \$849,000 for the same period in 2010, due to a decrease in the FDIC deposit assessment rate. The Company's low income housing investment losses increased

Table of Contents

\$403,000, or 188%, to \$617,000 in the third quarter of 2011, compared to \$214,000 in the third quarter of 2010.

Noninterest expense for the nine months ended September 30, 2011 declined 15% to \$29.7 million, compared to \$34.8 million (excluding the \$43.2 million impairment of goodwill) for the nine months ended September 30, 2010. The decrease in noninterest for the nine months ended September 30, 2011 was primarily due to the \$1.1 million write-down on loans held-for-sale included for the nine months ended September 30, 2010, and a decrease in salaries and benefits expense, lower professional fees and lower FDIC insurance premiums. This was partially offset by an increase in investment losses on the Company's low income housing investments. Salaries and employee benefits decreased \$1.1 million, or 7%, for the nine months ended September 30, 2011 from the same period in 2010, primarily due to a reduction in staff implemented in the fourth quarter of 2010. Professional fees decreased \$1.2 million, or 37%, for the nine months ended September 30, 2011 from the same period in 2010 primarily due to a decrease in legal fees related to loan workouts and litigation and decreased expenses for bank regulatory compliance. FDIC deposit insurance premiums decreased \$2.0 million, or 65%, for the nine months ended September 30, 2011 compared to the same period in 2010, due to a decrease in the FDIC deposit assessment rate. OREO expense decreased \$306,000 or 57%, for the nine months ended September 30, 2011, compared to the same period in 2010 due to a decrease in write-downs of OREO properties. The Company's low income housing investment losses increased \$248,000, or 43%, to \$820,000 for the nine months ended September 30, 2011, compared to \$572,000 for the nine months ended September 30, 2010.

Income Tax Expense

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

The Company's Federal and state income tax benefit for the quarter and nine months ended 2011 was \$2.5 million and \$1.1 million, respectively. The income tax benefit for the third quarter and first nine months of 2011 included the \$3.0 million reduction of the partial valuation allowance for deferred tax assets. The income tax benefit was \$398,000 and \$6.3 million for the same periods in 2010. 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,	
	2011	2010	2011	2010
Effective income tax rate	-110.5%	-157.3%	-14.4%	-9.8%

The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes and tax credits related to investments in low income housing limited partnerships.

The Company has total investments of \$3.9 million in low-income housing limited partnerships as of September 30, 2011. These investments have generated annual tax credits of approximately \$1.0 million and \$1.1 million in the years ended December 31, 2010 and 2009, respectively.

Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles, leading to timing differences between the Company's actual tax liability and the amount accrued for this liability based on book income. These temporary

Table of Contents

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 \$27.4 million, net of a \$3.7 million partial valuation allowance, as of December 31, 2010. In analyzing the deferred tax assets as of September 30, 2011, based on the factors above, the Company estimated it was more likely than not that the Company will realize approximately \$21.1 million of the benefits of the deductible differences, and therefore, a \$700,000 partial valuation allowance for deferred tax assets was recorded as of September 30, 2011. The income tax benefit of \$2.5 million for the third quarter of 2011, and \$1.1 million for the nine months ended September 30, 2011, are net of the \$3.0 million reduction in the partial valuation allowance from \$3.7 million as of December 31, 2010 to \$700,000 as of September 30, 2011.

FINANCIAL CONDITION

As of September 30, 2011, total assets decreased to \$1.25 billion, compared to \$1.33 billion at September 30, 2010, and remained relatively flat compared to December 31, 2010. Total securities available-for-sale (at fair value) were \$312.1 million at September 30, 2011, an increase of 180% from \$111.5 million at September 30, 2010, and an increase of 34% from \$232.2 million at December 31, 2010. The total loan portfolio, excluding loans held-for-sale, was \$776.7 million at September 30, 2011, a decrease of 12% from \$886.6 million at September 30, 2010, and a decrease of 8% from \$846.0 million at December 31, 2010. Total deposits decreased 6% to \$1.01 billion at September 30, 2011, from \$1.07 billion at September 30, 2010. Total deposits increased 1% when compared to \$993.9 million at December 31, 2010. There were no securities sold under agreement to repurchase at September 30, 2011, compared to \$15.0 million at September 30, 2010, and \$5.0 million at December 31, 2010.

Securities Portfolio

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

	September 30,		December 31,	
	2011	2010	2010	
	(Dollars in thousands)			
Securities available-for-sale (at fair value)				
Agency Mortgage-Backed Securities	\$ 312,125	\$ 111,322	\$ 232,165	
Collateralized Mortgage Obligations		137		
Total	\$ 312,125	\$ 111,459	\$ 232,165	

The following table summarizes the weighted average life and weighted average yields of securities at September 30, 2011:

	Within One Year		After One and Within Five Years		Weighted Average Life After Five and Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(Dollars in thousands)									
Securities available-for-sale (at fair value):										
Agency Mortgage-Backed Securities	\$		\$ 144,827	3.04%	\$ 148,853	3.32%	\$ 18,445	3.87%	\$ 312,125	3.22%

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 any analysis of the financial condition of the Company. The portfolio serves the following purposes: (i) it provides a source of pledged assets for securing certain deposits and borrowed funds, as may be required by law or by specific agreement with a depositor or lender; (ii) it 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 (iii) it is an alternative interest-earning use of funds when loan demand is low or when deposits grow more rapidly than loans.

The Company's securities are all currently classified under existing accounting rules as "available-for-sale" to allow flexibility for the management of the portfolio. Accounting guidance requires available-for-sale securities to be marked to fair value with an offset to accumulated other

comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available-for-sale securities.

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

The securities portfolio increased by \$200.7 million, or 180%, and increased to 25% of total assets at September 30, 2011 from 8% of total assets at September 30, 2010, and increased by \$80.0 million, or 34%, from December 31, 2010. The Company increased its holding of mortgage-back securities to offset a portion of the contraction in the loan portfolio.

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 62% of total assets at September 30, 2011, as compared to 67% of total assets at September 30, 2010, and 68% of total assets at December 31, 2010. The ratio of loans to deposits decreased to 77.19% at September 30, 2011 from 83.24% at September 30, 2010 and 85.12% at December 31, 2010. Demand for loans has weakened within the Company's markets due to the current economic environment, and the Company has been more selective with respect to the types of loans the Company chooses to originate.

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, 2011		September 30, 2010		December 31, 2010	
	Balance	% of Total	Balance	% of Total	Balance	% of Total
(Dollars in thousands)						
Commercial	\$ 365,532	47%	\$ 370,939	42%	\$ 378,412	45%
Real estate:						
Commercial and residential	310,722	40%	353,565	40%	337,457	40%
Land and construction	36,357	5%	91,706	10%	62,356	7%
Home equity	51,668	7%	53,772	6%	53,697	6%
Consumer	11,829	1%	15,793	2%	13,244	2%
Total loans	776,108	100%	885,775	100%	845,166	100%
Deferred loan costs	576		841		883	
Loans, including deferred costs	776,684	100%	886,616	100%	846,049	100%
Allowance for loan losses	(21,049)		(25,290)		(25,204)	
Loans, net	\$ 755,635		\$ 861,326		\$ 820,845	

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

The Company's loan portfolio is concentrated in commercial loans, primarily manufacturing, wholesale, and services, and commercial real estate, with the balance in land development and construction and home equity and consumer loans. The decrease in the Company's loan portfolio in the third quarter of 2011 compared to the third and fourth quarters of 2010 is due to diminished loan

demand, and loan payoffs exceeding draw downs of loan commitments. Outstanding loan balances to total loan commitments were 74% at September 30, 2011, 75% at September 30, 2010 and 75% at December 31, 2010. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 51% of its gross loans were secured by real property at September 30, 2011, compared to 56% at September 30, 2010, and 54% at December 31, 2010. While no specific industry concentration is considered significant, the Company's lending operations are located in areas that are dependent on the technology and real estate industries and their supporting companies.

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

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such guaranteed loans (collectively referred to as "SBA loans"). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold, the Company retains the servicing rights for the sold portion. During the nine months ended September 30, 2011, loans were sold resulting in a gain on sale of SBA loans of \$1.1 million.

As of September 30, 2011, commercial and residential real estate mortgage loans of \$310.7 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, 2011 consist of \$161.6 million, or 52%, of commercial owner occupied properties, \$145.9 million, or 47%, of commercial investment properties, and \$3.2 million, or 1% in residential properties. Properties securing the commercial real estate mortgage loans are generally located in the Company's primary market, which is the Greater San Francisco Bay Area.

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

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Land and construction loans decreased \$55.3 million to \$36.4 million, or 5% of total loans at September 30, 2011, from \$91.7 million, or 10% of total loans at September 30, 2010, and decreased \$26.0 million from \$62.4 million, or 7% of total loans at December 31, 2010.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 70% loan to value ratio. Home equity lines are reviewed at least semiannually, with specific emphasis on loans with a loan to value ratio greater than 70% and loans that were underwritten from mid-2005 through 2008, when real estate values were at the peak in the cycle. The Company takes measures to work with customers to reduce line

commitments and minimize potential losses. There have been no adverse classifications to date as a result of the review.

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

With certain exceptions, state chartered banks are permitted to make extensions of credit to any one borrowing entity up to 15% of the bank's capital and reserves for unsecured loans and up to 25% of the bank's capital and reserves for secured loans. For HBC, these lending limits were \$32.1 million and \$53.6 million at September 30, 2011, respectively.

Loan Maturities

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale) as of September 30, 2011. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall Street Journal. As of September 30, 2011, approximately 67% 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	\$ 248,779	\$ 36,769	\$ 79,984	\$ 365,532
Real estate:				
Commercial and residential	86,493	187,255	36,974	310,722
Land and construction	34,747	139	1,471	36,357
Home equity	49,510	491	1,667	51,668
Consumer	11,382	447		11,829
Loans	\$ 430,911	\$ 225,101	\$ 120,096	\$ 776,108

Loans with variable interest rates	\$ 387,980	\$ 52,991	\$ 76,392	\$ 517,363
Loans with fixed interest rates	42,931	172,110	43,704	258,745
Loans	\$ 430,911	\$ 225,101	\$ 120,096	\$ 776,108

Loan Servicing

As of September 30, 2011 and 2010, \$172.6 million and \$170.2 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,	
	2011	2010	2011	2010
(Dollars in thousands)				
Beginning of period balance	\$ 836	\$ 956	\$ 915	\$ 1,067
Additions	67	153	222	281
Amortization	(103)	(115)	(337)	(354)
End of period balance	\$ 800	\$ 994	\$ 800	\$ 994

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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, 2011 and 2010, as the fair value of the assets was greater than the carrying value.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in thousands)			
Beginning of period balance	\$ 2,185	\$ 2,060	\$ 2,140	\$ 2,116
Amortization	(18)	(61)	(96)	(189)
Unrealized holding gain	13	116	136	188
End of period balance	\$ 2,180	\$ 2,115	\$ 2,180	\$ 2,115

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

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

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

Nonperforming assets are comprised of the following: loans and loans held-for-sale for which the Company is no longer accruing interest; restructured loans; 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 OREO from foreclosures. 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. OREO consists of properties acquired by foreclosure or similar

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

means that management is offering or will offer for sale. Total OREO was \$1.2 million at September 30, 2011, compared to \$657,000 at September 30, 2010 and \$1.3 million at December 31, 2010. At September 30, 2011, the \$20.5 million of nonperforming assets included \$816,000 of SBA guaranteed loans.

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

	September 30, 2011	September 30, 2010	December 31, 2010
	(Dollars in thousands)		
Nonaccrual loans held-for-sale	\$ 191	\$ 4,552	\$ 2,026
Nonaccrual loans held-for-investment	16,419	41,757	28,821
Restructured and loans over 90 days past due and still accruing	2,656	2,687	2,492
Total nonperforming loans	19,266	48,996	33,339
Other real estate owned	1,229	657	1,296
Total nonperforming assets	\$ 20,495	\$ 49,653	\$ 34,635

Nonperforming assets as a percentage of loans plus other real estate owned plus nonaccruals loans held-for-sale	2.63%	5.57%	4.08%
---	-------	-------	-------

Nonperforming assets as a percentage of total assets	1.64%	3.73%	2.78%
--	-------	-------	-------

The following table provides nonaccrual loans by loan type as of September 30, 2011:

	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)		
Commercial	\$ 8,487	\$ 2,206	\$ 10,693
Real estate:			
Commercial and residential	1,285		1,285
Land and construction	6,831		6,831
Home equity			
Consumer	7	450	457
Total	\$ 16,610	\$ 2,656	\$ 19,266

Allowance for Loan Losses

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

Specific allowances are established for impaired loans. Management considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the loan agreement, including scheduled interest payments. Loans for which the terms have been modified with a concession granted, and for which the borrower is experiencing financial

difficulties, are considered troubled debt restructurings and classified as impaired. When a loan is considered to be impaired, the amount of impairment is measured based on the fair

value of the collateral less costs to sell if the loan is collateral dependent, or on the present value of expected future cash flows or values that are observable in the secondary market. If the measure of the impaired loans is less than the investment in the loan, the deficiency will be charged off against the allowance for loan losses if the amount is a confirmed loss, or, alternatively, a specific allocation within the allowance will be established. Loans that are considered impaired are specifically excluded from the formula portion of the allowance for loan losses analysis.

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

Loans that demonstrate a weakness for which there is a possibility of loss if the weakness is not corrected, are categorized as "classified." Classified assets include all loans considered as substandard, substandard-nonaccrual, and doubtful and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate), and OREO. The principal balance of classified assets, net of SBA guarantees of \$903,000, was \$72.4 million at September 30, 2011, \$116.5 million at September 30, 2010, and \$91.8 million at December 31, 2010. Included in the \$72.4 million of classified assets at September 30, 2011, were \$421,000 of loans held-for-sale. Loans held-for-sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses. Reducing classified assets will continue to be a focus for executive management, the lending staff and the Company's Special Assets Department.

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

	Three Months Ended September 30, 2011				Three Months Ended September 30, 2010
	Commercial	Real Estate	Consumer	Total	Total
(Dollars in thousands)					
Balance, beginning of period	\$ 13,992	\$ 8,162	\$ 1,013	\$ 23,167	\$ 26,753
Charge-offs	(3,042)	(901)		(3,943)	(3,955)
Recoveries	283	25	2	310	434
Net charge-offs	(2,759)	(876)	2	(3,633)	(3,521)
Provision for loan losses	1,809	554	(848)	1,515	2,058
Balance, end of period	\$ 13,042	\$ 7,840	\$ 167	\$ 21,049	\$ 25,290
RATIOS:					
Net charge-offs to average loans(1)	1.40%	0.44%	0.00%	1.84%	1.53%
Allowance for loan losses to total loans(1)	1.68%	1.01%	0.02%	2.71%	2.85%
Allowance for loan losses to nonperforming loans	67.69%	40.69%	0.87%	109.25%	51.62%

	Nine Months Ended September 30, 2011				Nine Months Ended September 30, 2010
	Commercial	Real Estate	Consumer	Total	Total
(Dollars in thousands)					
Balance, beginning of period	\$ 13,952	\$ 10,363	\$ 889	\$ 25,204	\$ 28,768
Charge-offs	(5,841)	(2,497)	(8)	(8,346)	(30,347)
Recoveries	513	436	3	952	1,115
Net charge-offs	(5,328)	(2,061)	(5)	(7,394)	(29,232)
Provision for loan losses	4,418	(462)	(717)	3,239	25,754
Balance, end of period	\$ 13,042	\$ 7,840	\$ 167	\$ 21,049	\$ 25,290
RATIOS:					
Net charge-offs to average loans(1)	0.89%	0.34%	0.00%	1.23%	3.97%
Allowance for loan losses to total loans(1)	1.68%	1.01%	0.02%	2.71%	2.85%
Allowance for loan losses to nonperforming loans	67.69%	40.69%	0.87%	109.25%	51.62%

(1)

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

The Company's allowance for loan losses decreased \$4.2 million at September 30, 2011 from September 30, 2010, and December 31, 2010. The decrease in the allowance for loan losses at September 30, 2011 was primarily due to a lower volume of classified and nonperforming loans and lower total loans.

Net loans charged-off reflects the realization of losses in the portfolio that were partially recognized previously through provisions for loan losses. Net charge-offs were \$7.4 million for the nine months ended September 30, 2011, compared to net charge-offs of \$29.2 million for the nine months ended September 30, 2010, including \$13.9 million of net charge-offs related to real estate loans transferred to "held-for-sale".

Historical net loan charge-offs are not necessarily indicative of the amount of net charge-offs that the Company will realize in the future.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

Allocation of Allowance for Loan Losses

	September 30,		December 31,	
	2011	2010	2010	
	Percent of Loans in each category to total loans	Percent of Loans in each category to total loans	Percent of Loans in each category to total loans	
	Allowance	Allowance	Allowance	
(Dollars in thousands)				
Commercial	\$ 13,042	47%	\$ 15,110	42%
Real estate:				
Commercial and residential	4,981	40%	3,765	40%
Land and construction	2,373	5%	4,960	10%
Home equity	486	7%	556	6%
Consumer	167	1%	899	2%
Total	\$ 21,049	100%	\$ 25,290	100%

Deposits

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

	September 30, 2011		September 30, 2010		December 31, 2010	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
(Dollars in thousands)						
Demand deposits, noninterest-bearing \$	344,470	34%	\$ 269,482	25%	\$ 280,258	28%
Demand deposits, interest-bearing	132,987	13%	156,912	15%	153,917	16%
Savings and money market	274,489	27%	318,221	30%	272,399	27%
Time deposits under \$100	30,858	3%	38,909	4%	33,499	3%
Time deposits \$100 and over	119,429	12%	132,862	12%	137,514	14%
Time deposits CDARS	10,216	1%	16,297	2%	17,864	2%
Time deposits brokered	93,685	10%	132,435	12%	98,467	10%
Total deposits	\$ 1,006,134	100%	\$ 1,065,118	100%	\$ 993,918	100%

The Company obtains deposits from a cross-section of the communities it serves. The Company's business is not generally seasonal in nature. The Company is not dependent upon funds from sources outside the United States. At September 30, 2011 and 2010, less than 1% of deposits were from public sources, respectively.

Noninterest-bearing demand deposit accounts increased \$75.0 million, or 28%, at September 30, 2011 from September 30, 2010, and increased \$64.2 million, or 23%, from December 31, 2010. At September 30, 2011, brokered deposits decreased \$38.8 million, or 29%, to \$93.7 million, compared to \$132.4 million at September 30, 2010, decreased \$4.8 million, or 5%, from \$98.5 million at December 31, 2010.

The following table indicates the contractual maturity schedule of the Company's time deposits of \$100,000 and over, and all CDARS and brokered deposits as of September 30, 2011:

	Balance	% of Total
(Dollars in thousands)		
Three months or less	\$ 73,519	33%
Over three months through six months	30,171	13%
Over six months through twelve months	36,949	17%
Over twelve months	82,691	37%
Total	\$ 223,330	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.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Return (Loss) on Equity and Assets

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Annualized return (loss) on average assets	1.52%	0.20%	0.90%	-5.76%
Annualized return (loss) on average tangible assets	1.52%	0.20%	0.90%	-5.90%
Annualized return (loss) on average equity	10.02%	1.38%	6.09%	-42.78%
Annualized return (loss) on average tangible equity	10.17%	1.40%	6.18%	-51.99%
Average equity to average assets ratio	15.15%	14.19%	14.82%	13.46%

Off-Balance Sheet Arrangements

In the normal course of business, the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in the contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, yet are not reflected on the Company's consolidated balance sheets. Total unused commitments to extend credit were \$272.3 million at September 30, 2011, as compared to \$288.0 million at September 30, 2010 and \$284.0 million at December 31, 2010. Unused commitments represented 35%, 32%, and 34% of outstanding gross loans at September 30, 2011 and 2010, and December 31, 2010, respectively.

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

	September 30,				December 31,	
	2011		2010		2010	
	(Dollars in thousands)					
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Unused lines of credit and commitments to make loans	\$ 6,439	\$ 247,620	\$ 4,846	\$ 262,938	\$ 6,740	\$ 256,575
Standby letters of credit	2,291	15,931	407	19,815	2,291	18,419
	\$ 8,730	\$ 263,551	\$ 5,253	\$ 282,753	\$ 9,031	\$ 274,994

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.

At September 30, 2011, the Company had loan contraction, including loans held-for-sale, of \$118.9 million from September 30, 2010, and it has experienced an improvement in its liquidity position. One of the measures we analyze for liquidity is our loan to deposit ratio. Our loan to deposit ratio improved to 77.19% at September 30, 2011 compared to 83.24% at September 30, 2010, and 85.12% at December 31, 2010.

FHLB and FRB Borrowings & Available Lines of Credit

The Company has off-balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. The Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. The Company had no overnight borrowings from the FHLB at September 30, 2011, September 30, 2010 and December 31, 2010. The Company had \$189.0 million of loans pledged to the FHLB as collateral on an available line of credit of \$103.2 million at September 30, 2011.

The Company can also borrow from FRB's discount window. The Company had \$239.8 million of loans pledged to the FRB as collateral on an available line of credit of \$172.4 million at September 30, 2011, none of which was outstanding.

At September 30, 2011, the Company had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at September 30, 2011, September 30, 2010, and December 31, 2010.

The Company had no secured borrowings at September 30, 2011. The Company had a \$4.3 million secured borrowing at September 30, 2010, and a \$2.4 million secured borrowing at December 31, 2010. Secured borrowings represented the guaranteed portions of SBA 7a loans transferred to third parties subject to a SBA warranty for a period of 90 days. This required the Company to treat these loans as secured borrowings during the warranty period. Effective February 15, 2011, the SBA no longer required a warranty period in loan sales agreements.

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, 2011, compared to \$15.0 million at September 30, 2010, and \$5.0 million at December 31, 2010. Repurchase agreements are accounted for as collateralized financial transactions and were secured by mortgage-backed securities carried at an amortized cost of approximately \$18.8 million at September 30, 2010, and \$6.3 million at December 31, 2010.

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,
	2011	2010	2010
(Dollars in thousands)			
Average balance year-to-date	\$ 952	\$ 26,952	\$ 23,888
Average interest rate year-to-date	3.41%	1.74%	1.78%
Maximum month-end balance during the quarter	\$	\$ 23,246	\$ 73,000
Average rate at period-end	N/A	1.53%	3.09%

Capital Resources

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

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

	September 30,		December 31,				
	2011	2010	2010				
	(Dollars in thousands)						
Capital components:							
Tier 1 Capital	\$	197,908	\$	182,852	\$	185,775	
Tier 2 Capital		11,868		12,303		11,988	
Total risk-based capital	\$	209,776	\$	195,155	\$	197,763	
Risk-weighted assets	\$	940,039	\$	970,922	\$	945,499	
Average assets for capital purposes	\$	1,234,544	\$	1,290,706	\$	1,316,600	
					Well-Capitalized Regulatory Requirements	Minimum Regulatory Requirements	
Capital ratios:							
Total risk-based capital		22.3%		20.1%	20.9%	10.00%	8.00%
Tier 1 risk-based capital		21.1%		18.8%	19.7%	6.00%	4.00%
Leverage(1)		16.0%		14.2%	14.1%	N/A	4.00%

(1)

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

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.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

	September 30,		December 31,				
	2011	2010	2010				
(Dollars in thousands)							
Capital components:							
Tier 1 Capital	\$	175,903	\$	154,283	\$	159,192	
Tier 2 Capital		11,892		12,305		11,993	
Total risk-based capital	\$	187,795	\$	166,588	\$	171,185	
Risk-weighted assets	\$	941,923	\$	971,050	\$	945,918	
Average assets for capital purposes	\$	1,236,239	\$	1,290,776	\$	1,316,969	
					Well-Capitalized Regulatory Requirements	Minimum Regulatory Requirements	
Capital ratios:							
Total risk-based capital		19.9%		17.2%	18.1%	10.00%	8.00%
Tier 1 risk-based capital		18.7%		15.9%	16.8%	6.00%	4.00%
Leverage(1)		14.2%		12.0%	12.1%	5.00%	4.00%

(1)

Tier 1 capital divided by quarterly average assets (excluding goodwill, other 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, 2011 and 2010, and December 31, 2010, HCC's and HBC's capital met all minimum regulatory requirements. As of September 30, 2011, HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under the prompt corrective action provisions.

At September 30, 2011, the Company had total shareholders' equity of \$197.0 million, including \$58.4 million in preferred stock, \$131.0 million in common stock, \$4.9 million in retained earnings, and \$2.7 million of accumulated other comprehensive income. The components of other comprehensive income at September 30, 2011 include the following: an unrealized gain on available-for-sale securities of \$5.0 million, an unrealized loss on the supplemental executive retirement plan of (\$2.0) million, an unrealized loss on the split dollar life insurance benefit plan of (\$1.5) million and an unrealized gain on interest-only strip from SBA loans of \$1.2 million.

Mandatory Redeemable Cumulative Trust Preferred Securities

To enhance regulatory capital and to provide liquidity, the Company, through unconsolidated subsidiary grantor trusts, issued the following mandatory redeemable cumulative trust preferred securities of subsidiary grantor trusts: In the first quarter of 2000, the Company issued \$7.2 million aggregate principal amount of 10.87% subordinated debt due on March 8, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2000, the Company issued \$7.2 million aggregate principal amount of 10.60% subordinated debt due on September 7, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2001, the Company issued \$5.2 million aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on July 31, 2031 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2002, the Company issued \$4.1 million of aggregate principal amount of Floating Rate Junior Subordinated

Deferrable Interest Debentures due on September 26, 2032 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. The subordinated debt is recorded as a component of long-term debt and includes the value of the common stock issued by the trusts to the Company. The common stock is recorded as other assets for the amount issued. Under applicable regulatory guidelines, the trust preferred securities currently qualify as Tier I capital. The subsidiary trusts are not consolidated in the Company's consolidated financial statements. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, certain trust preferred securities will no longer be eligible to be included as Tier 1 capital for regulatory purposes. However, an exception to this statutory prohibition applies to securities issued prior to May 19, 2010 by bank holding companies with less than \$15 billion of total assets; therefore, our trust preferred securities will continue to be eligible to be treated as Tier 1 capital, subject to other rules and limitations.

In November 2009, the Company announced that it was exercising its right to defer interest payments on its outstanding trust preferred subordinated debt securities. During the second quarter of 2011, the Company paid all of the deferred interest payments on its outstanding trust preferred subordinated debt securities in the amount of \$3.9 million, which includes all payments due through September 8, 2011.

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 qualifies as a component of Tier 1 capital. In November 2009, the Company announced that it was exercising its right to suspend payment of dividends on its Series A Preferred Stock. On August 1, 2011, the Company paid a dividend on its Series A Preferred Stock held by the U.S. Treasury in an aggregate amount of \$4.2 million. As a result of the dividend payment, the Company is current in the dividends accrued and owed to the U.S. Treasury.

Private Placement

On June 21, 2010, the Company issued to various institutional investors 53,996 shares of Series B Mandatorily Convertible Cumulative Perpetual Preferred Stock ("Series B Preferred Stock") and 21,004 shares of newly issued Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") for an aggregate purchase price of \$75.0 million. The Series B Preferred Stock was mandatorily convertible into common stock, upon approval by the shareholders at a conversion price of \$3.75 per share. The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon both approval by the shareholders and thereafter, a subsequent transfer of the Series C Preferred stock to third parties not affiliates with the holder in a widely dispersed offering. The Series B Preferred Stock and the Series C Preferred Stock did not include a beneficial conversion feature, as the conversion price at \$3.75 per share was not below the fair market value of the Company's common stock on the commitment date.

At the Company's Special Meeting of shareholders held on September 15, 2010, the Company's shareholders approved the issuance of common stock upon the conversion of the Series B Preferred Stock and upon the conversion of the Series C Preferred Stock. As a result, on September 16, 2010, the Series B Preferred Stock was converted into 14,398,992 shares of common stock of the Company and the shares of Series B Preferred Stock ceased to be outstanding.

The Series C Preferred Stock remains outstanding until it has been converted into common stock in accordance with its terms. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are

paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock and ranks on parity with the Company's Series A Preferred Stock.

Market Risk

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

Interest Rate Management

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

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

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

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

The Company uses modeling software for asset/liability management in order to simulate the effects of potential interest rate changes on the Company's net interest margin, and to calculate the estimated fair values of the Company's financial instruments under different interest rate scenarios. The program imports current balances, interest rates, maturity dates and repricing information for individual

financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company's interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Company's investment, loan, deposit and borrowed funds portfolios. These rate projections can be shocked (an immediate and parallel change in all base rates, up or down) and ramped (an incremental increase or decrease in rates over a specified time period), based on current trends and econometric models or stable economic conditions (unchanged from current actual levels).

The following table sets forth the estimated changes in the Company's annual net interest income that would result from the designated instantaneous parallel shift in interest rates noted, as of September 30, 2011. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

	Increase/(Decrease) in Estimated Net Interest Income	
	Amount	Percent
	(Dollars in thousands)	
Change in Interest Rates (basis points)		
+400	\$ 12,709	25.9%
+300	\$ 9,466	19.3%
+200	\$ 6,082	12.4%
+100	\$ 2,729	5.6%
0	\$	0.0%
-100	\$ (3,861)	-7.9%
-200	\$ (8,001)	-16.3%

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

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

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are discussed in our Form 10-K for the year ended December 31, 2010. There are no changes to these policies as of September 30, 2011.

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4 CONTROLS AND PROCEDURES

Disclosure Control and Procedures

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of September 30, 2011. 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, 2011, the period covered by this report on Form 10-Q.

During the nine months ended September 30, 2011, 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

In addition to the other information set forth in this Report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2010, which could materially affect our business, financial condition and/or operating results. There were no material changes from risk factors previously disclosed in our 2010 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 RESERVED

ITEM 5 OTHER INFORMATION

None

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

ITEM 6 EXHIBITS

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

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 9, 2011

/s/ WALTER T. KACZMAREK

Walter T. Kaczmarek
Chief Executive Officer

Date: November 9, 2011

/s/ LAWRENCE D. MCGOVERN

Lawrence D. McGovern
Chief Financial Officer

EXHIBIT INDEX

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