

HERITAGE COMMERCE CORP  
Form 10-Q  
November 10, 2010

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, 2010

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       Accelerated filer       Non-accelerated filer       Smaller reporting company   
(Do not check if a  
smaller reporting company)

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

The Registrant had 26,233,001 shares of Common Stock outstanding on October 29, 2010.

---

Table of Contents

**Heritage Commerce Corp and Subsidiaries  
Quarterly Report on Form 10-Q  
Table of Contents**

|   | <b>Page No.</b>  |
|---|------------------|
| <b><u>PART I. FINANCIAL INFORMATION</u></b>   |                  |
| <u>Item 1.</u> <u>Consolidated Financial Statements (unaudited):</u>  | <u>3</u>         |
| <u>Consolidated Balance Sheets</u>  | <u>3</u>         |
| <u>Consolidated Statements of Operations</u>  | <u>4</u>         |
| <u>Consolidated Statement of Changes in Shareholders' Equity</u>  | <u>5</u>         |
| <u>Consolidated Statements of Cash Flows</u>  | <u>6</u>         |
| <u>Notes to Consolidated Financial Statements</u>   | <u>7</u>         |
| <u>Item 2.</u> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>23</u>        |
| <u>Item 3.</u> <u>Quantitative and Qualitative Disclosures About Market Risk</u>                            | <u>59</u>        |
| <u>Item 4.</u> <u>Controls and Procedures</u>   | <u>59</u>        |
| <b><u>PART II. OTHER INFORMATION</u></b>  |                  |
| <u>Item 1.</u> <u>Legal Proceedings</u>   | <u>60</u>        |
| <u>Item 1A.</u> <u>Risk Factors</u>   | <u>60</u>        |
| <u>Item 2.</u> <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>                           | <u>61</u>        |
| <u>Item 3.</u> <u>Defaults Upon Senior Securities</u>   | <u>61</u>        |
| <u>Item 4.</u> <u>Reserved</u>  | <u>61</u>        |
| <u>Item 5.</u> <u>Other Information</u>   | <u>61</u>        |
| <u>Item 6.</u> <u>Exhibits</u>  | <u>62</u>        |
| <b><u>SIGNATURES</u></b>  | <b><u>63</u></b> |
| <b><u>EXHIBIT INDEX</u></b>   | <b><u>64</u></b> |

Table of Contents**Part I FINANCIAL INFORMATION****ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****Heritage Commerce Corp****Consolidated Balance Sheets (Unaudited)**

|   | September 30,<br>2010  | December 31,<br>2009 |
|---|------------------------|----------------------|
|   | (Dollars in thousands) |                      |
| <b>Assets</b>   |                        |                      |
| Cash and due from banks   | \$ 230,365             | \$ 45,372            |
| Federal funds sold  | 100                    | 100                  |
| Interest-bearing deposits in other financial institutions   | 90                     | 90                   |
| <b>Total cash and cash equivalents</b>  | <b>230,555</b>         | <b>45,562</b>        |
| Securities available-for-sale, at fair value  | 111,459                | 109,966              |
| Loans held-for-sale SBA, at lower of cost or market, including deferred costs                     | 7,967                  | 10,742               |
| Loans held-for-sale Other, at lower of cost or market, including deferred costs                   | 4,788                  |                      |
| Loans, including deferred costs   | 886,616                | 1,070,113            |
| Allowance for loan losses   | (25,290)               | (28,768)             |
| <b>Loans, net</b>   | <b>861,326</b>         | <b>1,041,345</b>     |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost                                    | 9,337                  | 8,454                |
| Company owned life insurance  | 43,255                 | 42,313               |
| Premises and equipment, net   | 8,577                  | 9,006                |
| Goodwill  |                        | 43,181               |
| Intangible assets   | 3,158                  | 3,589                |
| Accrued interest receivable and other assets  | 50,448                 | 49,712               |
| <b>Total assets</b>   | <b>\$ 1,330,870</b>    | <b>\$ 1,363,870</b>  |
| <b>Liabilities and Shareholders' Equity</b>   |                        |                      |
| Liabilities:  |                        |                      |
| Deposits:   |                        |                      |
| Demand, noninterest bearing   | \$ 269,482             | \$ 260,840           |
| Demand, interest-bearing  | 156,912                | 146,828              |
| Savings and money market  | 318,221                | 295,404              |
| Time deposits under \$100   | 38,909                 | 40,197               |
| Time deposits \$100 and over  | 132,862                | 129,831              |
| Time deposits CDARS   | 16,297                 | 38,154               |
| Time deposits brokered  | 132,435                | 178,031              |
| <b>Total deposits</b>   | <b>1,065,118</b>       | <b>1,089,285</b>     |
| Securities sold under agreement to repurchase   | 15,000                 | 25,000               |
| Subordinated debt   | 23,702                 | 23,702               |
| Short-term borrowings   | 4,315                  | 20,000               |
| Accrued interest payable and other liabilities  | 37,635                 | 33,578               |
| <b>Total liabilities</b>  | <b>1,145,770</b>       | <b>1,191,565</b>     |
| Shareholders' equity:   |                        |                      |
| Preferred stock, no par value; 10,000,000 shares authorized                                       |                        |                      |
| Series A fixed rate cumulative preferred stock, 40,000 shares issued and outstanding (liquidation | 39,846                 | 39,846               |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|   |                |                |
|---|----------------|----------------|
| preference of \$42,300 at September 30, 2010 and \$40,783 at December 31, 2009)   |                |                |
| Discount on Series A preferred stock  | (1,322)        | (1,598)        |
| Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at September 30, 2010 and none at December 31, 2009 (liquidation preference of \$21,004 at September 30, 2010) | 19,538         |                |
| Common stock, no par value; 60,000,000 shares authorized; 26,233,001 shares issued and outstanding at September 30, 2010 and 11,820,509 shares issued and outstanding at December 31, 2009          | 131,329        | 80,222         |
| Retained earnings / (Accumulated deficit)   | (2,965)        | 56,389         |
| Accumulated other comprehensive loss  | (1,326)        | (2,554)        |
| <b>Total shareholders' equity</b>   | <b>185,100</b> | <b>172,305</b> |
| <br>  |                |                |
| Total liabilities and shareholders' equity  | \$ 1,330,870   | \$ 1,363,870   |

See notes to consolidated financial statements

Table of Contents**Heritage Commerce Corp****Consolidated Statements of Operations (Unaudited)**

|   | <b>Three Months<br/>Ended<br/>September 30,</b> |               | <b>Nine Months<br/>Ended<br/>September 30,</b> |               |
|---|---|---------------|--|---------------|
|   | <b>2010</b>                                     | <b>2009</b>   | <b>2010</b>                                    | <b>2009</b>   |
| <b>(Dollars in thousands, except per share data)</b>        |   |               |  |               |
| <b>Interest income:</b>                                     |   |               |  |               |
| Loans, including fees                                       | \$ 12,041                                       | \$ 14,727     | \$ 37,952                                      | \$ 44,619     |
| Securities, taxable   | 1,247   | 753           | 3,869  | 2,702         |
| Securities, non-taxable                                     |   | 1             |  | 9             |
| Interest-bearing deposits in other financial institutions   | 73  | 14            | 99   | 21            |
| <b>Total interest income</b>                                | <b>13,361</b>                                   | <b>15,495</b> | <b>41,920</b>                                  | <b>47,351</b> |
| <b>Interest expense:</b>                                    |   |               |  |               |
| Deposits  | 1,929   | 3,228         | 6,451  | 10,652        |
| Subordinated debt   | 473   | 476           | 1,407  | 1,463         |
| Repurchase agreements                                       | 97  | 168           | 341  | 638           |
| Short-term borrowings                                       | 31  |               | 93   | 53            |
| Note payable  |   |               |  | 82            |
| <b>Total interest expense</b>                               | <b>2,530</b>                                    | <b>3,872</b>  | <b>8,292</b>                                   | <b>12,888</b> |
| <b>Net interest income before provision for loan losses</b> | <b>10,831</b>                                   | <b>11,623</b> | <b>33,628</b>                                  | <b>34,463</b> |
| <b>Provision for loan losses</b>                            | <b>2,058</b>                                    | <b>7,129</b>  | <b>25,754</b>                                  | <b>28,253</b> |
| <b>Net interest income after provision for loan losses</b>  | <b>8,773</b>                                    | <b>4,494</b>  | <b>7,874</b>                                   | <b>6,210</b>  |
| <b>Noninterest income:</b>                                  |   |               |  |               |
| Gain on sale of securities                                  | 1,492   |               | 1,492  |               |
| Service charges and fees on deposit accounts                | 536   | 557           | 1,664  | 1,665         |
| Servicing income  | 442   | 382           | 1,288  | 1,210         |
| Gain on sale of SBA loans                                   | 429   | 643           | 707  | 643           |
| Loss on sale of other loans                                 | (887)   |               | (887)  |               |
| Increase in cash surrender value of life insurance          | 428   | 420           | 1,249  | 1,248         |
| Other   | 288   | 348           | 777  | 808           |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|   |         |            |             |             |
|---|---------|------------|-------------|-------------|
| Total noninterest income                            | 2,728   | 2,350      | 6,290       | 5,574       |
| Noninterest expense:                                |         |            |             |             |
| Salaries and employee benefits                      | 5,272   | 5,730      | 16,645      | 17,831      |
| Occupancy and equipment                             | 1,081   | 1,005      | 3,023       | 2,893       |
| Writedown of loans held-for-sale                    | 1,080   |            | 1,080       |             |
| FDIC deposit insurance premiums                     | 849     | 598        | 3,059       | 2,490       |
| Professional fees                                   | 780     | 691        | 3,202       | 2,833       |
| Software subscription                               | 261     | 203        | 747         | 616         |
| Insurance expense                                   | 241     | 203        | 765         | 393         |
| Low income housing investment losses                | 214     | 217        | 572         | 642         |
| Data processing                                     | 188     | 196        | 619         | 686         |
| Other real estate owned expense                     | 49      | 60         | 537         | 229         |
| Impairment of goodwill                              |         |            | 43,181      |             |
| Other   | 1,233   | 1,841      | 4,568       | 5,572       |
| Total noninterest expense                           | 11,248  | 10,744     | 77,998      | 34,185      |
| Income (loss) before income taxes                   | 253     | (3,900)    | (63,834)    | (22,401)    |
| Income tax benefit                                  | (398)   | (1,824)    | (6,272)     | (10,990)    |
| Net income (loss)                                   | \$ 651  | \$ (2,076) | \$ (57,562) | \$ (11,411) |
| Dividends and discount accretion on preferred stock | (193)   | (599)      | (1,792)     | (1,776)     |
| Net income (loss) allocable to common shareholders  | \$ 458  | \$ (2,675) | \$ (59,354) | \$ (13,187) |
| Income (loss) per common share:                     |         |            |             |             |
| Basic   | \$ 0.01 | \$ (0.23)  | \$ (4.70)   | \$ (1.12)   |
| Diluted   | \$ 0.01 | \$ (0.23)  | \$ (4.70)   | \$ (1.12)   |

See notes to consolidated financial statements

Table of Contents**Heritage Commerce Corp****Consolidated Statements of Changes in Shareholders' Equity (Unaudited)****Nine Months Ended September 30, 2010 and 2009**

|   | Preferred Stock |           |            | Common Stock |           | Retained Earnings/<br>(Accumulated Deficit) | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Shareholder<br>Equity | Comprehensive<br>Loss |
|---|-----------------|-----------|------------|--------------|-----------|---|---|--------------------------------|-----------------------|
|   | Shares          | Amount    | Discount   | Shares       | Amount    |   |   |                                |                       |
| (Dollars in thousands, except share data)   |                 |           |            |              |           |   |   |                                |                       |
| <b>Balance, January 1, 2009</b>   | 40,000          | \$ 39,846 | \$ (1,946) | 11,820,509   | \$ 78,854 | \$ 70,986                                   | \$ (3,473)                                    | \$ 184,267                     |                       |
| Net loss  |                 |           |            |              |           | (11,411)                                    |   | (11,411)                       | \$ (11,411)           |
| Net change in unrealized gain on securities available-for-sale and interest-only strips, net of deferred income taxes |                 |           |            |              |           |   | 593   | 593                            | 593                   |
| Net increase in pension and other postretirement obligations, net of deferred income taxes                            |                 |           |            |              |           |   | 697   | 697                            | 697                   |
| <b>Total comprehensive loss</b>   |                 |           |            |              |           |   |   |                                | \$ (10,121)           |
| Amortization of restricted stock awards   |                 |           |            |              | 115       |   |   | 115                            |                       |
| Cash dividends accrued on Series A preferred stock  |                 |           |            |              |           | (1,517)                                     |   | (1,517)                        |                       |
| Accretion of discount on Series A preferred stock   |                 |           | 259        |              |           | (259)                                       |   |                                |                       |
| Cash dividend declared on common stock, \$0.02 per share  |                 |           |            |              |           | (236)                                       |   | (236)                          |                       |
| Stock option expense  |                 |           |            |              | 985       |   |   | 985                            |                       |
| Income tax effect of restricted stock award vesting   |                 |           |            |              | (70)      |   |   | (70)                           |                       |
| <b>Balance, September 30, 2009</b>  | 40,000          | \$ 39,846 | \$ (1,687) | 11,820,509   | \$ 79,884 | \$ 57,563                                   | \$ (2,183)                                    | \$ 173,423                     |                       |
| <b>Balance, January 1, 2010</b>   | 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 on securities available-for-sale and interest-only strips, net of deferred income taxes |                 |           |            |              |           |   | 1,026   | 1,026                          | 1,026                 |
| Net increase in pension and other   |                 |           |            |              |           |   | 202   | 202                            | 202                   |



Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

postretirement  
obligations, net of  
deferred income taxes

|  |          |           |            |            |            |            |            |    |  |             |
|--|----------|-----------|------------|------------|------------|------------|------------|----|--|-------------|
| 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 awards  |          |           |            |            | 117        |            |            |    |  | 117         |
| Cash dividends accrued on Series A preferred stock   |          |           |            |            |            |            | (1,516)    |    |  | (1,516)     |
| Accretion of unearned discount on Series A preferred stock   |          |           | 276        |            |            |            | (276)      |    |  |             |
| Stock option expense   |          |           |            |            | 837        |            |            |    |  | 837         |
| Income tax effect of restricted stock award vesting  |          |           |            |            |            |            | (75)       |    |  | (75)        |
| <b>Balance, September 30, 2010</b>   | 61,004   | \$ 59,384 | \$ (1,322) | 26,233,001 | \$ 131,329 | \$ (2,965) | \$ (1,326) | \$ |  | 185,100     |

See notes to consolidated financial statements

Table of Contents**Heritage Commerce Corp****Consolidated Statements of Cash Flows (Unaudited)**

|   | <b>Nine Months Ended</b>      |             |
|---|-------------------------------|-------------|
|   | <b>September 30,</b>          |             |
|   | <b>2010</b>                   | <b>2009</b> |
|   | <b>(Dollars in thousands)</b> |             |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                |                               |             |
| Net loss  | \$ (57,562)                   | \$ (11,411) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                               |             |
| Depreciation and amortization   | 600                           | 604         |
| Gain on sale of securities available-for-sale                               | (1,492)                       |             |
| Provision for loan losses   | 25,754                        | 28,253      |
| Stock option expense  | 837                           | 985         |
| Amortization of other intangible assets                                     | 431                           | 481         |
| Amortization of restricted stock awards                                     | 117                           | 115         |
| Amortization (accretion) of discounts and premiums on securities            | (1,295)                       | (324)       |
| Writedowns and (gains) losses on sale of foreclosed assets, net             | 546                           | (106)       |
| Gain on sale of SBA loans   | (707)                         | (643)       |
| Proceeds from sale of SBA loans originated for sale                         | 17,146                        |             |
| Net change in SBA loans originated for sale                                 | (17,458)                      | (15,056)    |
| Loss on sale of other loans   | 887                           |             |
| Writedowns on other loans held-for-sale                                     | 1,080                         |             |
| Increase in cash surrender value of life insurance                          | (1,249)                       | (1,248)     |
| Goodwill impairment   | 43,181                        |             |
| Effect of changes in:   |                               |             |
| Accrued interest receivable and other assets                                | (2,963)                       | (10,456)    |
| Accrued interest payable and other liabilities                              | (1,234)                       | (1,943)     |
| Net cash provided by (used in) operating activities                         | 6,619                         | (10,749)    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                |                               |             |
| Net change in loans   | 128,960                       | 116,417     |
| Net change in SBA loans previously transferred to held-for-sale             | (320)                         | (1,140)     |
| Proceeds from sale of SBA loans transferred to held-for-sale                | 1,768                         | 15,369      |
| Purchases of securities available-for-sale                                  | (41,434)                      | (69,271)    |
| Maturities/Paydowns/Calls of securities available-for-sale                  | 21,164                        | 69,822      |
| Proceeds from sale of securities available-for-sale                         | 27,245                        | 8,552       |
| Purchase of premises and equipment  | (171)                         | (269)       |
| Changes in Federal Home Loan Bank stock and other investments               | (883)                         | (628)       |
| Proceeds from sale of other loans transferred to held-for-sale              | 10,303                        |             |
| Proceeds from sale of foreclosed assets                                     | 11,595                        | 3,505       |
| Changes in company owned life insurance                                     | 308                           |             |
| Net cash provided by investing activities                                   | 158,535                       | 142,357     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                |                               |             |
| Net change in deposits  | (24,167)                      | (37,676)    |
| Issuance of preferred stock, net of offering costs                          | 69,766                        |             |
| Income tax effect of restricted stock award vesting                         | (75)                          | (70)        |
| Payment of cash dividends common stock                                      |                               | (236)       |
| Payment of cash dividends preferred stock                                   |                               | (1,467)     |
| Net change in short-term borrowings   | (15,685)                      | (55,000)    |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|   |            |           |
|---|------------|-----------|
| Net change in note payable                                  |            | (15,000)  |
| Net change in securities sold under agreement to repurchase | (10,000)   | (10,000)  |
| Net cash provided by (used in) financing activities         | 19,839     | (119,449) |
| Net increase in cash and cash equivalents                   | 184,993    | 12,159    |
| Cash and cash equivalents, beginning of period              | 45,562     | 30,096    |
| Cash and cash equivalents, end of period                    | \$ 230,555 | \$ 42,255 |

Supplemental disclosures of cash flow information:

Cash paid during the period for:

|                   |          |           |
|-------------------|----------|-----------|
| Interest paid     | \$ 7,008 | \$ 13,215 |
| Income taxes paid | \$       | \$ 1,250  |

Supplemental schedule of non-cash investing and financing activities:

|   |           |           |
|---|-----------|-----------|
| Transfer from portfolio loans to loans held-for-sale    | \$ 17,079 | \$ 20,506 |
| Transfer from loans held-for-sale to the loan portfolio | \$ 2,367  | \$        |
| Loans transferred to foreclosed assets                  | \$ 10,593 | \$ 5,856  |
| Due to broker for securities purchased                  | \$ 4,123  | \$        |
| Conversion of Series B preferred stock to common stock  | \$ 50,228 | \$        |

See notes to consolidated financial statements

Table of Contents

**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements**

**September 30, 2010**

**(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, 2009. 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, 2010 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2010.

***Adoption of New Accounting Standards***

In June 2009, the FASB amended previous accounting guidance to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. The new accounting guidance eliminates the concept of a "qualifying special-purpose entity" and changes the requirements for derecognizing financial assets. The new authoritative accounting guidance also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. The provisions from the new accounting guidance became effective on January 1, 2010. The adoption of the new accounting guidance did not have an impact on the prior period financial statements or beginning retained earnings. The new accounting guidance had an impact on the 2010 financial statements by resulting in the deferral of approximately \$351,000 of gains on sale of SBA loans as of September 30, 2010. During the quarter ended September 30, 2010, the Company sold guaranteed portions of SBA loans with a principal balance of \$4.3 million to third parties.

Table of Contents

**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**September 30, 2010**

**(Unaudited)**

**1) Basis of Presentation (Continued)**

However, these loans are subject to a SBA warranty for a period of 90 days, which requires under this new accounting guidance for the Company to treat these as secured borrowings during the warranty period. The warranty periods for these loans expire in the fourth quarter of 2010. Provided the loans remain current through the end of the warranty period, all elements necessary to record the sale and recognize the gain will have been met.

In January 2010, the FASB issued guidance clarifying the accounting for shareholder distributions where the shareholder has the ability to elect to have his or her distribution in the form of cash (up to a pre-determined maximum), stock or a combination of the two. The amendments of the update provide that the stock portion of a distribution where the shareholder had the ability to elect the distribution as stock or cash (up to a pre-determined maximum) should be accounted for as a share issuance and thereby eliminate diversity in practice. The provisions of this update became effective for financial statements dated on or after December 15, 2009. The adoption of this standard did not have a material impact on the Company's financial statements.

In January 2010, the FASB issued guidance requiring increased fair value disclosures. There are two components to the increased disclosure requirements set forth in the update: (1) a description of, as well as the disclosure of, the dollar amount of transfers in or out of level one or level two (2) in the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances and settlements (that is, gross amounts shall be disclosed as opposed to a single net figure). Increased disclosures regarding the transfers in or out of level one and two are required for interim and annual periods beginning after December 15, 2009. The adoption of this portion of the standard did not have a material impact on the Company's financial statements. Increased disclosures regarding the level three fair value reconciliation are required for fiscal years beginning after December 15, 2010.

***Newly Issued, but not yet Effective 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 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 become effective for periods ending on or after December 15, 2010. The

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****September 30, 2010****(Unaudited)****1) Basis of Presentation (Continued)**

increased disclosures for activity within a reporting period become effective for periods beginning on or after December 15, 2010. The provisions of this update will expand the Company's current disclosures with respect to the allowance for loan losses.

**2) Earnings Per Share**

Basic earnings (loss) per common share is computed by dividing net income (loss) allocable to common shareholders by the weighted average common shares outstanding during the period. Diluted earnings (loss) per common share reflects potential dilution from outstanding stock options and common stock warrants, using the treasury stock method. 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<br>September 30, |            | For the Nine Months Ended<br>September 30, |            |
|---|---|------------|--|------------|
|   | 2010  | 2009       | 2010                                       | 2009       |
| Weighted average common shares outstanding                        | 14,230,212                                  | 11,820,509 | 12,623,743                                 | 11,820,509 |
| Effect of convertible preferred stock(1)                          | 17,600,160                                  | N/A        | N/A  | N/A        |
| Shares used in computing basic earnings (loss) per common share   | 31,830,372                                  | 11,820,509 | 12,623,743                                 | 11,820,509 |
| Dilutive effect of stock options and common stock warrants(2)     |   | N/A        | N/A  | N/A        |
| Shares used in computing diluted earnings (loss) per common share | 31,830,372                                  | 11,820,509 | 12,623,743                                 | 11,820,509 |

(1)

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, 2010, 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 for the three months ended September 30, 2010. 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.

(2)

There were 1,613,787 stock options and common stock warrants for the three months ended September 30, 2010 considered to be antidilutive and excluded from the computation of diluted earnings per average common share. Due to the Company's net loss allocable to common

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****September 30, 2010****(Unaudited)****2) Earnings Per Share (Continued)**

shareholders for the three months ended September 30, 2009 and the nine months ended September 30, 2010 and 2009, all stock options and common stock warrants were excluded from the computation of diluted loss per average common share.

**3) Securities**

The amortized cost and estimated fair value of securities at September 30, 2010 and December 31, 2009 were as follows:

| <b>September 30, 2010</b>                       | <b>Amortized<br/>Cost</b>     | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|---|-------------------------------|---------------------------------------|--|-------------------------------------|
|   | <b>(Dollars in thousands)</b> |                                       |  |                                     |
| <b>Securities available-for-sale:</b>           |                               |                                       |  |                                     |
| Mortgage-Backed Securities Residential          | \$ 108,381                    | \$ 2,941                              | \$                                     | \$ 111,322                          |
| Collateralized Mortgage Obligations Residential | 137                           |                                       |  | 137                                 |
| <b>Total securities available-for-sale</b>      | <b>\$ 108,518</b>             | <b>\$ 2,941</b>                       | <b>\$</b>                              | <b>\$ 111,459</b>                   |
| <br>  |                               |                                       |  |                                     |
| <b>December 31, 2009</b>                        | <b>Amortized<br/>Cost</b>     | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|   | <b>(Dollars in thousands)</b> |                                       |  |                                     |
| <b>Securities available-for-sale:</b>           |                               |                                       |  |                                     |
| U.S. Government Sponsored Entities              | \$ 2,000                      | \$                                    | \$ (27)                                | \$ 1,973                            |
| Mortgage-Backed Securities Residential          | 101,356                       | 1,653                                 | (463)                                  | 102,546                             |
| Collateralized Mortgage Obligations Residential | 5,227                         | 220                                   |  | 5,447                               |
| <b>Total securities available-for-sale</b>      | <b>\$ 108,583</b>             | <b>\$ 1,873</b>                       | <b>\$ (490)</b>                        | <b>\$ 109,966</b>                   |

Securities classified as U.S. Government Sponsored Entities as of December 31, 2009 were issued by the Federal National Mortgage Association ("Fannie Mae"). At September 30, 2010 and December 31, 2009, all mortgage backed securities and collateralized mortgage obligations were issued by Fannie Mae, Freddie Mac, or the Government National Mortgage Association ("Ginnie Mae").

At September 30, 2010 and December 31, 2009, 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.

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****September 30, 2010****(Unaudited)****3) Securities (Continued)**

There were no securities with unrealized losses at September 30, 2010. Securities with unrealized losses at December 31, 2009, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

| December 31, 2009                      | Less Than 12 Months    |                   | 12 Months or More |                   | Total      |                   |
|--|------------------------|-------------------|-------------------|-------------------|------------|-------------------|
|  | Fair Value             | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
|  | (Dollars in thousands) |                   |                   |                   |            |                   |
| Securities available-for-sale:         |                        |                   |                   |                   |            |                   |
| U.S. Government Sponsored Entities     | \$ 1,973               | \$ (27)           | \$                | \$                | \$ 1,973   | \$ (27)           |
| Mortgage-Backed Securities Residential | 43,600                 | (463)             |                   |                   | 43,600     | (463)             |
| Total                                  | \$ 45,573              | \$ (490)          | \$                | \$                | \$ 45,573  | \$ (490)          |

At December 31, 2009, the Company held 75 securities, of which 23 had fair values below amortized cost. No securities have 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, 2009.

**4) Loans**

Loans were as follows:

|   | September 30,<br>2010  | December 31,<br>2009 |
|---|------------------------|----------------------|
|   | (Dollars in thousands) |                      |
| Loans held-for-sale:                          |                        |                      |
| Loans held-for-sale SBA                       | \$ 7,967               | \$ 10,742            |
| Loans held-for-sale Other                     | 4,788                  |                      |
| Total loans held-for-sale                     | \$ 12,755              | \$ 10,742            |
| Loans held-for-investment:                    |                        |                      |
| Commercial                                    | \$ 370,939             | \$ 427,177           |
| Real estate mortgage                          | 353,565                | 400,731              |
| Real estate land and construction             | 91,706                 | 182,871              |
| Home equity                                   | 53,772                 | 51,368               |
| Consumer                                      | 15,793                 | 7,181                |
| Total loans held-for-investment               | 885,775                | 1,069,328            |
| Deferred loan origination costs and fees, net | 841                    | 785                  |
| Loans, including deferred costs               | 886,616                | 1,070,113            |
| Allowance for loan losses                     | (25,290)               | (28,768)             |



|            |    |         |    |           |
|------------|----|---------|----|-----------|
| Loans, net | \$ | 861,326 | \$ | 1,041,345 |
|------------|----|---------|----|-----------|

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****September 30, 2010****(Unaudited)****4) Loans (Continued)**

At September 30, 2010, included in the balance of loans held-for-sale are \$4,315,000 of SBA loans that were transferred to third parties during the third quarter. However, because these loans are subject to a SBA warranty for a period of 90 days, the Company must treat these loans as secured borrowings during the warranty period under recent accounting guidance. The secured borrowings are classified as "short-term borrowings" on the consolidated balance sheet. The warranty period for these loans expires in the following quarter. Provided the loans remain current through the end of the warranty period all elements necessary to record the sale will have been met. The Company has deferred gains of \$351,000 associated with these loans, which are included in other liabilities on the consolidated balance sheets.

During the second quarter of 2010, the Company identified \$31,005,000 of problem real estate loans for sale. These loans were written down by \$13,926,000 to reflect the estimated proceeds from the sale, resulting in a net balance of \$17,079,000 which was transferred into the loans held-for-sale portfolio. The following table shows the detail of the problem loans transferred to the loans held-for-sale portfolio at June 30, 2010:

|                                      | <b>Balance<br/>Prior to<br/>Transfer</b> | <b>Amount<br/>Charged-off</b> | <b>Balance<br/>Transferred<br/>to Loans<br/>Held-for-Sale</b> |
|--------------------------------------|--|-------------------------------|---|
| (Dollars in thousands)               |  |                               |   |
| Real estate-mortgage                 | \$ 9,893                                 | \$ (2,781)                    | \$ 7,112  |
| Real estate-land and<br>construction | 21,112                                   | (11,145)                      | 9,967   |
| <b>Total</b>                         | <b>\$ 31,005</b>                         | <b>\$ (13,926)</b>            | <b>\$ 17,079</b>  |

Of the \$17,079,000 loans held-for-sale at June 30, 2010, \$11,211,000 of loans were sold during the third quarter of 2010, which resulted in a loss on sale of other loans of \$887,000. The remaining \$5,868,000 of problem real estate loans held-for-sale were written down by an additional \$1,080,000 during the third quarter of 2010 to \$4,788,000, after obtaining updated bids and broker indications on the estimated value of these loans held-for-sale. Problem loans held-for-sale include commercial real estate loans of \$1,165,000 and land and construction loans of \$3,623,000 at September 30, 2010.

Changes in the allowance for loan losses were as follows:

|                              | <b>Nine Months Ended<br/>September 30,</b> |             |
|------------------------------|--|-------------|
|                              | <b>2010</b>                                | <b>2009</b> |
| (Dollars in thousands)       |  |             |
| Balance, beginning of period | \$ 28,768                                  | \$ 25,007   |
| Loans charged-off            | (30,347)                                   | (25,253)    |
| Recoveries                   | 1,115                                      | 969         |
| Net charge-offs              | (29,232)                                   | (24,284)    |
| Provision for loan losses    | 25,754                                     | 28,253      |
| Balance, end of period       | \$ 25,290                                  | \$ 28,976   |



Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****September 30, 2010****(Unaudited)****4) Loans (Continued)**

Impaired loans were as follows:

|  | September 30,          |                  | December 31, |               |
|--|------------------------|------------------|--------------|---------------|
|  | 2010                   | 2009             | 2009         |               |
|  | (Dollars in thousands) |                  |              |               |
| Period-end loans with no allocated allowance for loan losses | \$ 17,985              | \$ 9,472         | \$           | 13,202        |
| Period-end loans with allocated allowance for loan losses    | 31,011                 | 45,792           |              | 49,173        |
| <b>Total</b>   | <b>\$ 48,996</b>       | <b>\$ 55,264</b> | <b>\$</b>    | <b>62,375</b> |

|  |          |          |    |       |
|--|----------|----------|----|-------|
| Amount of the allowance for loan losses allocated to above at period-end | \$ 6,543 | \$ 9,875 | \$ | 9,103 |
|--|----------|----------|----|-------|

Nonperforming loans include both smaller dollar balance homogeneous loans that are collectively evaluated for impairment and individually classified loans. Nonperforming loans were as follows:

|   | September 30,          |                  | December 31, |               |
|---|------------------------|------------------|--------------|---------------|
|   | 2010                   | 2009             | 2009         |               |
|   | (Dollars in thousands) |                  |              |               |
| Nonaccrual loans held-for-sale                                | \$ 4,552               | \$               | \$           |               |
| Nonaccrual loans held-for-investment                          | 41,757                 | 55,120           |              | 59,480        |
| Restructured and loans past due over 90 days still on accrual | 2,687                  | 144              |              | 2,895         |
| <b>Total</b>  | <b>\$ 48,996</b>       | <b>\$ 55,264</b> | <b>\$</b>    | <b>62,375</b> |

Nonaccrual loans held-for-investment at September 30, 2010, included \$4.5 million related to six loans that were restructured during the third quarter of 2010. Three of the loans were restructured to extend amortization periods at market interest rates and required additional collateral. Nonaccrual restructured loans held-for-investment also included one loan that was bifurcated into two separate loans to provide 1) a fully secured loan for half of the outstanding balance, and 2) an unsecured loan for the other half of the outstanding balance. Principal was not reduced on the two loans and payments are interest only. These two loans have been extended once since they were restructured, and are current in accordance with their modified terms. Additionally, one nonaccrual restructured loan is not current in accordance with the terms of its

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

forbearance agreement, and the forbearance has expired. The borrower under this loan is making monthly payments, but the payments are not sufficient to cure the loan default.

At September 30, 2010, restructured loans still on accrual included three loans totaling \$2.7 million. These restructurings primarily resulted from short term principal deferments and extensions of the amortization periods. The loans are current according to their modified terms and repayment of the remaining contractual payments is expected. The Company has no commitments to

Table of Contents

**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**September 30, 2010**

**(Unaudited)**

**4) Loans (Continued)**

lend any additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

**5) Private Placement**

On June 21, 2010, the Company issued to various institutional investors 53,996 shares of Series B Preferred Stock and 21,004 shares of 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.

Table of Contents

**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**September 30, 2010**

**(Unaudited)**

**5) Private Placement (Continued)**

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 Fixed Rate Cumulative Preferred Stock ("Series A Preferred Stock").

The holders of the Series B Preferred Stock and Series C Preferred Stock were entitled to receive cumulative dividends at a per annum rate of 20%, payable semi-annually in arrears commencing on December 21, 2010, unless shareholder approval was obtained before December 21, 2010. The Company recorded \$411,000 of dividends on the Series B Preferred Stock and Series C Preferred Stock in the three and six months ended June 30, 2010. As a result of the shareholder approval on September 15, 2010, no cumulative dividends will be paid on the Series B Preferred Stock and the Series C Preferred Stock and the previously recognized dividends were reversed in the quarter ended September 30, 2010.

**6) Goodwill and Intangible Assets**

***Goodwill***

Goodwill resulted from the acquisition of Diablo Valley Bank in June 2007 and represented the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill was assessed at least annually, as of November 30, for impairment with the assistance of an independent valuation firm. Goodwill impairment exists when a reporting unit's carrying value exceeds its fair value, which is determined through a two-step impairment test. Step 1 includes the determination of the carrying value of the Company's single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss will be recognized in an amount equal to that excess.

Due to concerns about the Company's stock price, the condition of the banking industry in general, and the pricing of the closed private placement of convertible preferred stock, goodwill was tested for impairment in the second quarter of 2010, with the assistance of an independent valuation firm. Due to the continued depressed economic conditions and the length of time and amount by which

Table of Contents

**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**September 30, 2010**

**(Unaudited)**

**6) Goodwill and Intangible Assets (Continued)**

the Company's book value exceeded market value per share, and the Company's closing of the private placement at a conversion price of \$3.75 per share, the Company determined goodwill related to the acquisition of Diablo Valley Bank of \$43,181,000 was fully impaired during the second quarter of 2010. The method for estimating the value of the reporting unit included a weighted average of the discounted cash flows income approach and publicly traded company approach.

***Intangible Assets***

Intangible assets consist of core deposit and customer relationship intangible assets arising from the acquisition of Diablo Valley Bank in June 2007. These assets are amortized over their estimated useful lives. Impairment testing of these assets is performed at the individual asset level. Impairment exists if the carrying amount of the asset is not recoverable and exceeds its fair value at the date of the impairment test. For intangible assets, estimates of expected future cash flows (cash inflows less cash outflows) that are directly associated with an intangible asset are used to determine the fair value of that asset. Management makes certain estimates and assumptions in determining the expected future cash flows from core deposit and customer relationship intangibles including account attrition, expected lives, discount rates, interest rates, servicing costs and other factors. Significant changes in these estimates and assumptions could adversely impact the valuation of these intangible assets. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset. Based on its assessment, management concluded that there was no impairment of intangible assets at September 30, 2010.

**7) Income Taxes**

Under generally accepted accounting principles, a valuation allowance is required if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions. During the second quarter of 2010, the Company determined a partial valuation allowance on the state of California net deferred tax asset was necessary, primarily because of the Company's cumulative loss in the most recent three-year period caused by the provision for loan losses recorded during the period. Management is required to re-evaluate the deferred tax asset and the related valuation allowance quarterly and it has been determined no additions to the valuation allowance were required in the third quarter of 2010. The \$6,272,000 income tax benefit for the nine months ended September 30, 2010 is net of \$3,700,000 of income tax expense in the second quarter of 2010 to establish the partial valuation allowance.

The net recorded deferred tax asset, after the partial valuation allowance of \$3,700,000, was \$25,840,000 at September 30, 2010. The net deferred tax asset was \$22,401,000 at December 31, 2009. The net deferred tax asset includes California and Federal net operating loss carryforwards that will begin to expire in 2019 and 2030, respectively, if not utilized to reduce future taxable income. The remaining deferred tax asset was supported by available tax planning strategies and projected future taxable income.



Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****September 30, 2010****(Unaudited)****8) 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<br>Ended<br>September 30,<br>2010 |        | Nine Months<br>Ended<br>September 30,<br>2010 |          |
|--|--|--------|---|----------|
|  | 2009   | 2010   | 2009  | 2010     |
| (Dollars in thousands)                   |  |        |   |          |
| Components of net periodic benefits cost |  |        |   |          |
| Service cost                             | \$ 244   | \$ 241 | \$ 732  | \$ 723   |
| Interest cost                            | 209  | 191    | 627   | 573      |
| Prior service cost                       | 9  | 9      | 27  | 27       |
| Amortization of loss                     | 17   | 48     | 51  | 144      |
| Net periodic cost                        | \$ 479   | \$ 489 | \$ 1,437                                      | \$ 1,467 |

**9) Fair Value**

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

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

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

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).

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****September 30, 2010****(Unaudited)****9) Fair Value (Continued)**

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 Significant                      |                                   |
|---|------------|--|-----------------------------------|
|   |            | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) |
| (Dollars in thousands)                          |            |  |                                   |
| Assets at September 30, 2010:                   |            |  |                                   |
| Available-for-sale securities                   |            |  |                                   |
| Mortgage-Backed Securities Residential          | \$ 111,322 |  | \$ 111,322                        |
| Collateralized Mortgage Obligations Residential | 137        |  | 137                               |
| I/O strip receivables                           | 2,115      |  | 2,115                             |
| Assets at December 31, 2009:                    |            |  |                                   |
| Available-for-sale securities                   |            |  |                                   |
| U.S. Government Sponsored Entities              | \$ 1,973   |  | \$ 1,973                          |
| Mortgage-Backed Securities Residential          | 102,546    |  | 102,546                           |
| Collateralized Mortgage Obligations Residential | 5,447      |  | 5,447                             |
| I/O strip receivables                           | 2,116      |  | 2,116                             |

**Assets and Liabilities Measured on a Non-Recurring Basis**

The fair value of loans held-for-sale is based upon binding contracts or quotes from third party investment banker valuations, resulting in Level 2 classification of inputs for determining fair value.

The fair value of impaired loans held for investment with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals, brokers' opinion of value, letters of intent, purchase and sale agreements, financial statements and equipment evaluations. Real estate 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.

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

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****September 30, 2010****(Unaudited)****9) Fair Value (Continued)**

classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

|                                     | Balance   | Fair Value Measurements Using   |   |
|-------------------------------------|-----------|---|---|
|                                     |           | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) |
| (Dollars in thousands)              |           |   |   |
| Assets at September 30, 2010:       |           |   |   |
| Impaired loans held-for-sale:       |           |   |   |
| Real estate mortgage                | \$ 1,165  |   | \$ 1,165  |
| Real estate land and construction   | 3,623     |   | 3,623   |
|                                     | \$ 4,788  |   | \$ 4,788  |
| Impaired loans held-for-investment: |           |   |   |
| Commercial                          | \$ 6,593  |   | \$ 6,593  |
| Real estate mortgage                | 2,885     |   | 2,885   |
| Real estate land and construction   | 20,252    |   | 20,252  |
| Consumer                            | 160       |   | 160   |
|                                     | \$ 29,890 |   | \$ 29,890   |
| Other real estate owned             | \$ 657    |   | \$ 657  |
| Assets at December 31, 2009:        |           |   |   |
| Impaired loans                      | \$ 48,410 |   | \$ 48,410   |
| Other real estate owned             | \$ 812    |   | \$ 812  |

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****September 30, 2010****(Unaudited)****9) Fair Value (Continued)**

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

|  | September 30, 2010     |            | December 31, 2009 |
|--|------------------------|------------|-------------------|
|  | (Dollars in thousands) |            |                   |
| <b>Impaired loans held-for-investment:</b>                             |                        |            |                   |
| Book value of impaired loans held-for-investment carried at fair value | \$                     | 36,433     | \$ 57,513         |
| Book value of impaired loans held-for-investment carried at cost       |                        | 8,011      | 4,862             |
| <br>Total impaired loans held-for-investment                           | <br>\$                 | <br>44,444 | <br>\$ 62,375     |
| <b>Impaired loans held-for-investment carried at fair value:</b>       |                        |            |                   |
| Book value of impaired loans held-for-investment carried at fair value | \$                     | 36,433     | \$ 57,513         |
| Specific valuation allowance   |                        | (6,543)    | (9,103)           |
| <br>Impaired loans held-for-investment carried at fair value, net      | <br>\$                 | <br>29,890 | <br>\$ 48,410     |

Of the total provision for loan losses during the nine months ended September 30, 2010 and the year ended December 31, 2009, \$8,124,000 and \$16,574,000 was a result of the decline in the fair value of impaired loans held-for-investment that were carried at fair value at September 30, 2010 and December 31, 2009, respectively.

Total other real estate owned, consisting of two properties, had a fair value of \$657,000 at September 30, 2010.

Total other real estate owned, consisting of two properties, had a carrying value of \$2,241,000 at December 31, 2009. One property was carried at fair value, less costs to sell, of \$812,000 at December 31, 2009. The other property was carried at cost as of December 31, 2009. There were no impairment write downs subsequent to acquisition in 2009.

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****September 30, 2010****(Unaudited)****9) Fair Value (Continued)**

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

|  | September 30, 2010     |                            | December 31, 2009   |                            |
|--|------------------------|----------------------------|---------------------|----------------------------|
|  | Carrying<br>Amounts    | Estimated<br>Fair<br>Value | Carrying<br>Amounts | Estimated<br>Fair<br>Value |
|  | (Dollars in thousands) |                            |                     |                            |
| <b>Assets</b>                                    |                        |                            |                     |                            |
| Cash and cash equivalents                        | \$ 230,555             | \$ 230,555                 | \$ 45,562           | \$ 45,562                  |
| Securities available-for-sale                    | 111,459                | 111,459                    | 109,966             | 109,966                    |
| Loans (including loans held-for-sale), net       | 874,081                | 883,123                    | 1,052,087           | 955,242                    |
| FHLB and FRB stock                               | 9,337                  | N/A                        | 8,454               | N/A                        |
| Accrued interest receivable                      | 2,775                  | 2,775                      | 3,472               | 3,472                      |
| Loan servicing rights and I/O strips receivables | 3,110                  | 5,280                      | 3,183               | 4,972                      |
| <b>Liabilities</b>                               |                        |                            |                     |                            |
| Time deposits                                    | \$ 320,503             | \$ 321,991                 | \$ 386,213          | \$ 389,027                 |
| Other deposits                                   | 744,615                | 744,615                    | 703,072             | 703,072                    |
| Securities sold under agreement to repurchase    | 15,000                 | 15,082                     | 25,000              | 25,341                     |
| Short-term borrowings                            | 4,315                  | 4,315                      | 20,000              | 20,000                     |
| Subordinated debt                                | 23,702                 | 12,970                     | 23,702              | 14,938                     |
| Accrued interest payable                         | 2,478                  | 2,478                      | 1,194               | 1,194                      |

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.

Table of Contents

**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**September 30, 2010**

**(Unaudited)**

**9) Fair Value (Continued)**

***FHLB and FRB Stock***

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

**10) Regulatory Matters**

On February 17, 2010, the Company and HBC entered into a written agreement ("Written Agreement") with the Federal Reserve Bank of San Francisco ("FRB") and the California Department of Financial Institutions ("DFI"). Under the terms of the Written Agreement, the Company must obtain the prior written approval of the Federal Reserve and DFI before it may (i) declare or pay any dividends, (ii) make any distributions of principal or interest on the Company's outstanding trust

Table of Contents

**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**September 30, 2010**

**(Unaudited)**

**10) Regulatory Matters (Continued)**

preferred securities and related subordinated debt, (iii) incur, increase or guarantee any debt, (iv) redeem any outstanding stock, or (v) take dividends or any other form of payment that represents a reduction in capital from HBC. The Written Agreement also requires the Company to (i) submit a written plan to strengthen credit risk management practices, (ii) submit a written capital plan for sufficient capitalization of both the Company and HBC, (iii) submit a written business plan for 2010 to improve the Company's earnings and overall financial condition, (iv) comply with notice and approval requirements related to the appointment of directors and senior executive officers or change in the responsibility of any current senior executive officer, (v) comply with restrictions on paying or agreeing to pay certain indemnification and severance payments without prior written approval, (vi) submit a written plan to improve management of the Company's liquidity position and funds management practices, (vii) notify the Federal Reserve and DFI no more than 30 days after the end of any quarter in which the capital ratios of the Company or HBC fall below approved capital plan's minimum ratios, together with an acceptable written plan to increase capital ratios to or above the approved capital plan's minimum levels, (viii) comply with specified procedures for board (or a committee of the board) approval for the extension, renewal or restructure of any "criticized loan", (ix) submit plans to improve the Company's position on outstanding past due and other problem loans in excess of \$2 million, (x) maintain policies and procedures and submit a plan for the maintenance of an adequate allocation for loan losses, and (xi) provide quarterly progress reports to the Federal Reserve and DFI.

Prior to entering into the Written Agreement in February 2010, the Company had already ceased paying dividends on its common stock (in the second quarter of 2009), suspended interest payments on its trust preferred securities and related subordinated debt (in the fourth quarter of 2009), and suspended dividend payments on its Series A Preferred Stock (also in the fourth quarter of 2009). As a result, the Company has accrued but has not paid approximately \$2.0 million in interest on its subordinated debt, and approximately \$2.3 million in dividends on its Series A Preferred Stock as of September 30, 2010. If the Company fails to pay dividends on the Series A Preferred Stock for a total of six quarters, whether or not consecutive, the U.S. Treasury will have the right to elect two members of the Company's Board of Directors. These directors would serve on the Company's Board of Directors until such time as the Company has paid in full all dividends not previously paid. So long as payment of interest on the subordinated debt and dividends on the Series A Preferred Stock remain suspended, we may not, among other things and with limited exceptions, pay cash dividends on or repurchase our common stock or preferred stock.

The Company is addressing the requirements of the Written Agreement. A new joint compliance committee was formed to oversee the Company's and HBC's response to the Written Agreement. The committee reports monthly to the Board of Directors. The Company submitted specific plans to the FRB and DFI relating to improving asset quality and credit risk management, improving profitability and liquidity management and these plans were accepted as satisfactory by the FRB and DFI. The Company has submitted its capital plan and it is being reviewed by the FRB and DFI.

The Company and HBC believe they are currently in compliance with the requirements of the Written Agreement. Failure to comply with the Written Agreement may subject the Company and HBC to additional supervisory actions and orders.

Table of Contents

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

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources of Heritage Commerce Corp (the "Company") 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.

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, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or Exchange Act, 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. Please see our most recent Annual Report on Form 10-K for the year ended December 31, 2009 and our subsequent Quarterly Reports on Form 10-Q and the other information contained in this Report on Form 10-Q for a further discussion of these and other risks and uncertainties applicable to our business. The forward looking statements could be affected by many factors, including but not limited to:

Our ability to attract new deposits and loans;

Local, regional, and national economic conditions and events and the impact they may have on us and our customers;

Risks associated with concentrations in real estate related loans;

Increasing levels of classified assets, including nonperforming assets, which could adversely affect our earnings and liquidity;

Market interest rate volatility;

Stability of funding sources and continued availability of borrowings;

Changes in legal or regulatory requirements or the results of regulatory examinations that could restrict growth and constrain our activities, including the terms of our Written Agreement entered into by the Company, the Board of Governors of the Federal Reserve System and the Department of Financial Institutions;



Table of Contents

Changes in accounting standards and interpretations;

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

Regulatory limits on the HBC's ability to pay dividends to the Company;

Effectiveness of the Emergency Economic Stabilization Act of 2008, the American Recovery and Reinvestment Act of 2009 and other legislative and regulatory efforts to help stabilize the U.S. financial markets;

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

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; and

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

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

**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, 2010, net income was \$651,000. 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. In the three months ended September 30, 2009, the net loss was \$2.1 million. The net loss allocable to common shareholders was \$2.7 million, or \$(0.23) per average diluted common share for the three months ended September 30, 2009, which included a provision for loan losses of \$7.1 million.



## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

### Table of Contents

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 a \$3.7 million partial valuation allowance on the deferred tax asset. In the nine months ended September 30, 2009, the net loss was \$11.4 million. The net loss allocable to common shareholders was \$13.2 million, or \$(1.12) per average diluted common share for the nine months ended September 30, 2009, including a provision for loan losses of \$28.3 million.

In the third quarter of 2010, the Company's shareholders approved the issuance of common stock upon the conversion of the Series B Preferred Stock and the Series C Preferred Stock. As a result of the shareholder approval, no cumulative dividends at the per annum rate of 20% will be paid on the Series B Preferred Stock and the Series C Preferred Stock. Dividends and accretion on preferred stock decreased to \$193,000 in the third quarter of 2010, compared to \$599,000 in the third quarter of 2009, due to \$411,000 of accrued dividends in the second quarter of 2010 for the Series B Preferred Stock and the Series C Preferred Stock that will not have to be paid.

After receiving shareholder approval, the outstanding Series B Preferred Stock automatically 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.

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

The net interest margin decreased 3 basis points to 3.59% in the third quarter of 2010, from 3.62% in the same quarter a year ago and declined 29 basis points from 3.88% in the second quarter of 2010. The 29 basis point decline in the third quarter of 2010 compared to the previous quarter was primarily due to investment of proceeds from June 2010 capital raise in short-term investments and deposits at the Federal Reserve Bank, partially offset by maturing higher-cost wholesale funding and a more cost-effective blend of core deposits.

The provision for loan losses was \$2.1 million for the third quarter of 2010, compared to \$7.1 million for the third quarter of 2009. The provision for loan losses for the nine months ended September 30, 2010 was \$25.8 million, compared to \$28.3 million for the same period a year ago. The decrease in the provision for loan losses reflects improvement in credit quality.

Noninterest income increased 16% to \$2.7 million in the third quarter of 2010 from \$2.4 million in the third quarter of 2009, and increased 13% to \$6.3 million in the first nine months of 2010 from \$5.6 million in the first nine months of 2009. The increase in noninterest income was primarily due to a \$1.5 million gain on sale of securities, which was partially offset by an \$887,000 loss on sale of other loans.

Noninterest expense was \$11.2 million for the third quarter of 2010, compared to \$10.7 million in the third quarter of 2009. In the first nine months of 2010, noninterest expense, excluding the \$43.2 million impairment of goodwill, was \$34.8 million, compared to \$34.2 million in the first nine months a year ago.

The income tax benefit for the quarter ended September 30, 2010 was \$398,000, compared to \$1.8 million for the quarter ended September 30, 2009. In the first nine months of 2010, the income tax benefit was \$6.3 million, compared to \$11.0 million in the first nine months of 2009. The income tax benefit for the first nine months of 2010 included \$3.7 million of income tax expense in the second quarter of 2010 to establish a partial valuation allowance on the Company's net deferred tax asset. The negative effective income tax rates are due to the loss before income taxes for the nine months ended September 30, 2010 and 2009. 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

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

### Table of Contents

not subject to taxes, and tax credits related to investments in low income housing limited partnerships.

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

Cash, Federal funds sold, interest-bearing deposits in other financial institutions and securities available-for-sale increased 146% to \$342.0 million at September 30, 2010, from \$138.9 million a year ago and increased 120% from \$155.5 million at December 31, 2009. The increase in liquid assets is primarily due to: proceeds from the private placement; proceeds from loan sales; loan paydowns; and an increase in customer deposits.

During the third quarter of 2010, the sale of \$11.2 million of the \$17.1 million of problem real estate loans held-for-sale resulted in net proceeds of \$10.3 million, with a loss on sale of \$887,000. The remaining \$5.9 million of problem real estate loans held-for-sale were written down by an additional \$1.1 million during the third quarter of 2010 to \$4.8 million. Problem real estate loans held-for-sale included commercial real estate loans of \$1.2 million and land and construction loans of \$3.6 million at September 30, 2010.

Total loans, excluding loans held-for-sale, decreased \$195.0 million, or 18%, to \$886.6 million at September 30, 2010, compared to \$1.08 billion at September 30, 2009, and decreased \$183.5 million, or 17%, from \$1.07 billion at December 31, 2009. Land and construction loans decreased \$105.7 million, or 54%, to \$91.7 million at September 30, 2010, compared to \$197.4 million at September 30, 2009, and decreased \$91.2 million, or 50%, from \$182.9 million at December 31, 2009.

Classified assets decreased to \$115.9 million at September 30, 2010, compared to \$172.9 million at September 30, 2009, and \$164.1 million at December 31, 2009.

The allowance for loan losses at September 30, 2010 was \$25.3 million, or 2.85% of total loans, and represented 51.62% of nonperforming loans, and 56.90% of nonperforming loans excluding nonaccrual loans in the loans held-for-sale portfolio. The allowance for loan losses a year ago was \$28.9 million, or 2.68% of total loans and 52.43% of nonperforming loans. The allowance for loan losses at December 31, 2009, was \$28.8 million, or 2.69% of total loans and 46.12% of nonperforming loans.

Nonperforming assets decreased to \$49.7 million, or 3.73% of total assets at September 30, 2010, which included \$4.6 million of real estate loans classified as substandard or substandard-nonaccrual in the loans held-for-sale portfolio. Nonperforming assets were \$58.2 million, or 4.26% of total assets at September 30, 2009, and \$64.6 million, or 4.74% of total assets at December 31, 2009.

Net charge-offs were \$3.5 million in the third quarter of 2010, compared to \$9.6 million in the third quarter of 2009, and \$5.9 million in the fourth quarter of 2009.

Brokered deposits decreased to \$132.4 million at September 30, 2010, compared to \$181.8 million at September 30, 2009, and \$178.0 million at December 31, 2009.

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 23% at September 30, 2010, compared to 28% at September 30, 2009, and 29% at December 31, 2009.

The liquidity position improved with a loan to deposit ratio of 83.24% at September 30, 2010, compared to 96.88% at September 30, 2009, and 98.24% at December 31, 2009.



Table of Contents

The \$75 million of new capital raised in June 2010 increased tangible equity to \$181.9 million at September 30, 2010, from \$126.5 million at September 30, 2009, and \$125.5 million at December 31, 2009.

Capital ratios substantially exceed regulatory requirements for a well-capitalized financial institution, both on a consolidated basis and at HBC on a stand-alone basis. The leverage ratio of the Company was 14.17%, with a tier 1 risk-based capital ratio of 18.83% and a total risk-based capital ratio of 20.10% at September 30, 2010. HBC's leverage ratio was 11.95%, tier 1 risk-based capital ratio was 15.89%, and a total risk-based capital ratio was 17.16% at September 30, 2010.

***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 \$132.4 million in brokered deposits at September 30, 2010, compared to \$181.8 million at September 30, 2009, and \$178.0 million at December 31, 2009. 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, 2010 were \$1.07 billion, compared to \$1.12 billion at September 30, 2009, and \$1.09 billion at December 31, 2009. Increases in core deposit balances allowed the Company to decrease higher-cost wholesale funding.

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 \$16.3 million at September 30, 2010, compared to \$41.4 million at September 30, 2009, and \$38.2 million at December 31, 2009.

HBC is a participant in the Federal Deposit Insurance Corporation's ("FDIC") Transaction Account Guarantee ("TAG") Program, which provides HBC's depositors with unlimited FDIC insurance coverage for certain noninterest-bearing transaction accounts. The TAG Program will expire on December 31, 2010, which could have an adverse effect on HBC's deposit base. However, in September 2010, the FDIC Board of Directors issued a proposed rule to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act to provide depositors at all FDIC-insured institutions unlimited deposit insurance coverage on noninterest-bearing transaction accounts beginning December 31, 2010 through December 31, 2012. Unlike the FDIC's voluntary TAG Program, the Dodd-Frank provision will apply at all FDIC-insured institutions and it will cover only traditional checking accounts that do not pay interest. The proposed rule emphasizes that, starting January 1, 2011, low-interest consumer checking accounts and Interest on Lawyer Trust Accounts (currently protected under the TAG Program) will no longer be eligible for an unlimited guarantee.

***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. We believe that our liquidity position is more than sufficient to meet our operating expenses, borrowing needs and other obligations for 2010. Our liquidity has been significantly enhanced from the proceeds from the June 2010 private placement, proceeds from loan sales, loan paydowns, and an increase in customer deposit balances. At September 30, 2010, we had \$230.6 million in cash and cash equivalents and approximately

Table of Contents

\$199.0 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 \$48.2 million in unpledged securities available at September 30, 2010. The loan to deposit ratio improved to 83.24% at September 30, 2010, compared to 96.88% at September 30, 2009, and 98.24% at December 31, 2009.

***Lending***

Our lending business originates primarily through our branch offices located in our primary market. The Company also has SBA loan production offices in Sacramento, Oakland and Santa Rosa, California. As a result of the weakened economy in our primary service area throughout 2009 and the first nine months of 2010 and loan payoffs, we have seen a contraction in our loan portfolio during the last two years. At September 30, 2010, commercial and industrial loans accounted for 42% of the total loan portfolio. Commercial real estate loans accounted for 40% of the total loan portfolio at September 30, 2010, of which 57% were owner occupied by businesses. Land and construction loans continued to decrease and accounted for 10% of the total loan portfolio, and consumer and home equity loans accounted for the remaining 8% of total loans at September 30, 2010. The year to date decline in gross loans is primarily due to loans transferred to loans held-for-sale, several large pay-downs during the first nine months of 2010 and scheduled amortizations of balances which were off-set by lower volume of loan originations relative to historical periods. 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*.

From January 22, 2008 through December 16, 2008, the Board of Governors of the Federal Reserve System reduced short-term interest rates by 325 basis points. This decrease in short-term rates immediately affected the rates applicable to the majority of the Company's loans. While the decrease in interest rates also lowered the cost of interest bearing deposits, which represents the Company's primary funding source, these deposits tend to price more slowly than floating rate loans, which resulted in compression of the Company's net interest margin. The Company's net interest margin expanded in the first half of 2010, as the costs of deposits and borrowings have continued to decline. However, the net interest margin decreased 3 basis points to 3.59% in the third quarter of 2010, from 3.62% in the same quarter a year ago and declined 29 basis points from 3.88% in the second quarter of 2010. The 29 basis point decline in the third quarter of 2010 compared to the previous quarter was primarily due to investment of proceeds from the June 2010 capital raise in short-term investments and

Table of Contents

deposits at the Federal Reserve Bank, partially offset by maturing higher-cost wholesale funding and a more cost-effective blend of core deposits.

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

***Management of Credit Risk***

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

The Company sold \$25.7 million of investment securities for total gross proceeds of \$27.2 million resulting in a \$1.5 million gain on sale of securities for the third quarter and first nine months of 2010, compared to no gain on sale of securities for the same periods in 2009.

Prior to the third quarter of 2007, a significant percentage of the Company's noninterest income was 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. From the third quarter of 2007 through the second quarter of 2009, the Company retained its SBA production. In the third quarter of 2009, the Company began to again sell loans in the secondary market. When the Company sells SBA loans to third parties, the loans are subject to a 90 day SBA warranty. The Company adopted new accounting guidance in the first quarter of 2010 that requires the Company to treat the SBA loans sold as secured borrowings during the warranty period. The warranty period for loans transferred in the second quarter of 2010 expired in the third quarter of 2010, and resulted in a gain on sale of SBA loans of \$230,000, recognized in the third quarter of 2010. SBA loans sold in the third quarter of 2010, without a warranty period, resulted in a gain on sale of SBA loans of \$199,000, which was immediately recognized. Additionally, \$4.3 million of SBA loans have been transferred to third parties during the third quarter of 2010. Provided the loans remain current through the end of the warranty period, all



Table of Contents

elements necessary to record the sale will have been met. The Company has deferred gains of \$351,000 associated with these loans, which are included in other liabilities on the consolidated balance sheet. During the third quarter of 2010, the sale of \$11.2 million of problem real estate loans held-for-sale resulted in net proceeds of \$10.3 million, with a loss on sale of \$887,000.

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

***Noninterest Expense***

Management considers the control of operating expenses to be a critical element of the Company's performance. Over the last several quarters the Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. Operating expenses increased \$632,000 in the first nine months of 2010, compared to the first nine months of 2009, primarily due to a \$1.1 million writedown of loans held-for-sale. Total noninterest expenses in the first nine months of 2010 increased over the comparable period in 2009, as a result of the goodwill impairment recorded in the second quarter of 2010. Noninterest expense, including the \$43.2 million impairment of goodwill, was \$78.0 million for the nine months of 2010, compared to \$34.2 million for the nine months of 2009.

***Capital Management***

As part of its asset and liability 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 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.

At September 30, 2010, HBC's total risk-based capital ratio was 17.16%, compared to the 10% regulatory requirement for well-capitalized banks under the regulatory framework for prompt corrective actions. HBC's tier 1 risk-based capital ratio of 15.89% and leverage ratio of 11.95% at September 30, 2010 also exceeded regulatory guidelines for well-capitalized banks under the prompt corrective actions framework of 6% and 5%, respectively. On a consolidated basis, the Company has a leverage ratio of 14.17%, a tier 1 risk-based capital ratio of 18.83%, and a total risk-based capital ratio of 20.10% at September 30, 2010.

Under the Written Agreement we are required to obtain the prior approval of the Federal Reserve Bank of San Francisco and the Director of the Division of Banking Supervision and Regulation of the Federal Reserve to make any interest payments on our outstanding trust preferred securities and related subordinate debt, or to pay any dividends on our common stock or preferred stock.

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

Table of Contents

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. As a result, the Company has accrued but has not paid approximately \$2.3 million in dividends on its Series A Preferred Stock as of September 30, 2010. If the Company fails to pay dividends on the Series A Preferred Stock for a total of six quarters, whether or not consecutive, the U.S. Treasury will have the right to elect two members of the Company's Board of Directors. These directors would serve on the Company's Board of Directors until such time as the Company has paid in full all dividends not previously paid. So long as payment of dividends on the Series A Preferred Stock remain suspended, we may not, among other things and with limited exceptions, pay cash dividends on or repurchase our common stock or preferred stock.

We have supported our growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt that we issued to the trusts is senior to our shares of common stock, 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. As a result the Company has accrued but has not paid approximately \$2.0 million in interest on its subordinated debt as of September 30, 2010. So long as interest payments remain deferred, we may not pay cash dividends on or repurchase our common stock or preferred stock.

At such time as we become current with the dividends payable on our preferred stock and interest payments on our trust preferred securities and related subordinated debt, the decision whether to pay dividends will be made by our board of directors in light of conditions then existing, including factors such as our results of operations, financial condition, business conditions, regulatory capital requirements and covenants under any applicable contractual arrangements, including agreements with regulatory authorities.

## **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<br>NET INTEREST MARGIN               | For the Three Months Ended<br>September 30, 2010 |                                |                           | For the Three Months Ended<br>September 30, 2009 |                                |                           |
|--|--|--------------------------------|---------------------------|--|--------------------------------|---------------------------|
|  | Average<br>Balance                               | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate | Average<br>Balance                               | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate |
| (Dollars in thousands)                                       |  |                                |                           |  |                                |                           |
| <b>Assets:</b>   |  |                                |                           |  |                                |                           |
| Loans, gross(1)  | \$ 936,917                                       | \$ 12,041                      | 5.10%                     | \$ 1,149,250                                     | \$ 14,727                      | 5.08%                     |
| Securities   | 146,061  | 1,247                          | 3.39%                     | 100,439  | 754                            | 2.98%                     |
| Federal funds sold   | 100  |                                | 0.00%                     | 21,347   | 14                             | 0.26%                     |
| Interest-bearing deposits in other<br>financial institutions | 112,881  | 73                             | 0.26%                     | 1,305  |                                | 0.00%                     |
| Total interest earning assets                                | 1,195,959  | 13,361                         | 4.43%                     | 1,272,341  | 15,495                         | 4.83%                     |
| Cash and due from banks                                      | 44,904   |                                |                           | 24,665   |                                |                           |
| Premises and equipment, net                                  | 8,677  |                                |                           | 9,276  |                                |                           |
| Goodwill and other intangible<br>assets                      | 3,249  |                                |                           | 47,028   |                                |                           |
| Other assets   | 69,470   |                                |                           | 58,644   |                                |                           |
| Total assets   | \$ 1,322,259                                     |                                |                           | \$ 1,411,954                                     |                                |                           |
| <b>Liabilities and shareholders'<br/>equity:</b>             |  |                                |                           |  |                                |                           |
| <b>Deposits:</b>   |  |                                |                           |  |                                |                           |
| Demand, interest-bearing                                     | \$ 157,501                                       | 87                             | 0.22%                     | \$ 133,301                                       | 74                             | 0.22%                     |
| Savings and money market                                     | 290,711  | 343                            | 0.47%                     | 332,922  | 589                            | 0.70%                     |
| Time deposits under \$100                                    | 38,316   | 125                            | 1.29%                     | 43,527   | 240                            | 2.19%                     |
| Time deposits \$100 and over                                 | 135,204  | 470                            | 1.38%                     | 141,401  | 646                            | 1.81%                     |
| Time deposits CDARS  | 17,624   | 32                             | 0.72%                     | 37,048   | 103                            | 1.10%                     |
| Time deposits brokered                                       | 151,359  | 872                            | 2.29%                     | 197,376  | 1,576                          | 3.17%                     |
| Subordinated debt  | 23,702   | 473                            | 7.92%                     | 23,702   | 476                            | 7.97%                     |
| Securities sold under agreement to<br>repurchase             | 17,663   | 97                             | 2.18%                     | 27,663   | 168                            | 2.41%                     |
| Short-term borrowings  | 3,601  | 31                             | 3.42%                     | 272  |                                | 0.00%                     |
| Total interest-bearing liabilities                           | 835,681  | 2,530                          | 1.20%                     | 937,212  | 3,872                          | 1.64%                     |
| Demand, noninterest bearing                                  | 266,190  |                                |                           | 267,528  |                                |                           |
| Other liabilities  | 32,794   |                                |                           | 31,016   |                                |                           |
| Total liabilities  | 1,134,665  |                                |                           | 1,235,756  |                                |                           |
| Shareholders' equity   | 187,594  |                                |                           | 176,198  |                                |                           |
| Total liabilities and shareholders'<br>equity                | \$ 1,322,259                                     |                                |                           | \$ 1,411,954                                     |                                |                           |
| Net interest income / margin                                 |  | \$ 10,831                      | 3.59%                     |  | \$ 11,623                      | 3.62%                     |

(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

|  | For the Nine Months Ended<br>September 30, 2010 |                                |                           | For the Nine Months Ended<br>September 30, 2009 |                                |                           |
|--|---|--------------------------------|---------------------------|---|--------------------------------|---------------------------|
|  | Average<br>Balance                              | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate | Average<br>Balance                              | Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate |
| (Dollars in thousands, unaudited)                            |   |                                |                           |   |                                |                           |
| <b>Assets:</b>   |   |                                |                           |   |                                |                           |
| Loans, gross(1)  | \$ 1,000,791                                    | \$ 37,952                      | 5.07%                     | \$ 1,197,039                                    | \$ 44,619                      | 4.98%                     |
| Securities   | 140,843   | 3,869                          | 3.67%                     | 105,886   | 2,711                          | 3.42%                     |
| Federal funds sold   | 101   |                                | 0.00%                     | 11,130  | 21                             | 0.25%                     |
| Interest-bearing deposits in<br>other financial institutions | 52,485  | 99                             | 0.25%                     | 544   |                                | 0.00%                     |
| Total interest earning assets                                | 1,194,220                                       | 41,920                         | 4.69%                     | 1,314,599                                       | 47,351                         | 4.82%                     |
| Cash and due from banks                                      | 33,981  |                                |                           | 24,138  |                                |                           |
| Premises and equipment, net                                  | 8,818   |                                |                           | 9,374   |                                |                           |
| Goodwill and other intangible<br>assets                      | 31,858  |                                |                           | 47,188  |                                |                           |
| Other assets   | 67,392  |                                |                           | 55,660  |                                |                           |
| Total assets   | \$ 1,336,269                                    |                                |                           | \$ 1,450,959                                    |                                |                           |
| <b>Liabilities and shareholders'<br/>equity:</b>             |   |                                |                           |   |                                |                           |
| <b>Deposits:</b>   |   |                                |                           |   |                                |                           |
| Demand, interest-bearing                                     | \$ 152,505                                      | 256                            | 0.22%                     | \$ 134,576                                      | 252                            | 0.25%                     |
| Savings and money market                                     | 295,617   | 1,105                          | 0.50%                     | 342,156   | 2,043                          | 0.80%                     |
| Time deposits under \$100                                    | 38,794  | 407                            | 1.40%                     | 44,740  | 794                            | 2.37%                     |
| Time deposits \$100 and<br>Over                              | 133,223   | 1,438                          | 1.44%                     | 162,601   | 2,239                          | 1.84%                     |
| Time deposits CDARS  | 18,609  | 133                            | 0.96%                     | 20,096  | 192                            | 1.28%                     |
| Time deposits brokered                                       | 168,559   | 3,112                          | 2.47%                     | 192,692   | 5,132                          | 3.56%                     |
| Subordinated debt  | 23,702  | 1,407                          | 7.94%                     | 23,702  | 1,463                          | 8.25%                     |
| Securities sold under<br>agreement to repurchase             | 20,110  | 341                            | 2.27%                     | 30,110  | 638                            | 2.83%                     |
| Note payable   |   |                                | N/A                       | 3,388   | 82                             | 3.24%                     |
| Short-term borrowings  | 9,867   | 93                             | 1.26%                     | 27,520  | 53                             | 0.26%                     |
| Total interest-bearing<br>liabilities                        | 860,986   | 8,292                          | 1.29%                     | 981,581   | 12,888                         | 1.76%                     |
| Demand, noninterest bearing                                  | 259,879   |                                |                           | 258,725   |                                |                           |
| Other liabilities  | 35,504  |                                |                           | 29,678  |                                |                           |
| Total liabilities  | 1,156,369                                       |                                |                           | 1,269,984                                       |                                |                           |
| Shareholders' equity   | 179,900   |                                |                           | 180,975   |                                |                           |
| Total liabilities and<br>shareholders' equity                | \$ 1,336,269                                    |                                |                           | \$ 1,450,959                                    |                                |                           |
| Net interest income / margin                                 |   | \$ 33,628                      | 3.76%                     |   | \$ 34,463                      | 3.51%                     |

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

**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

Table of Contents

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.

| <b>Three Months Ended<br/>September 30,<br/>2010 vs. 2009<br/>Increase (Decrease)<br/>Due to Change In:</b> |                           |                         |                       |
|---|---------------------------|-------------------------|-----------------------|
|   | <b>Average<br/>Volume</b> | <b>Average<br/>Rate</b> | <b>Net<br/>Change</b> |
| <b>(Dollars in thousands)</b>   |                           |                         |                       |
| <b>Income from interest earning assets:</b>   |                           |                         |                       |
| Loans, gross  | \$ (2,732)                | \$ 46                   | \$ (2,686)            |
| Securities  | 389                       | 104                     | 493                   |
| Interest-bearing deposits in other financial institutions   | 72                        | (13)                    | 59                    |
| <b>Total interest income from interest earnings assets</b>  | <b>\$ (2,271)</b>         | <b>\$ 137</b>           | <b>\$ (2,134)</b>     |
| <b>Expense on interest-bearing liabilities:</b>   |                           |                         |                       |
| Demand, interest-bearing  | \$ 13                     | \$                      | \$ 13                 |
| Savings and money market  | (51)                      | (195)                   | (246)                 |
| Time deposits under \$100   | (17)                      | (98)                    | (115)                 |
| Time deposits \$100 and over  | (22)                      | (154)                   | (176)                 |
| Time deposits CDARS   | (35)                      | (36)                    | (71)                  |
| Time deposits brokered  | (267)                     | (437)                   | (704)                 |
| Subordinated debt   |                           | (3)                     | (3)                   |
| Securities sold under agreement to repurchase   | (55)                      | (16)                    | (71)                  |
| Short-term borrowings   | 29                        | 2                       | 31                    |
| <b>Total interest expense on interest-bearing liabilities</b>   | <b>\$ (405)</b>           | <b>\$ (937)</b>         | <b>\$ (1,342)</b>     |
| <b>Net interest income</b>  | <b>\$ (1,866)</b>         | <b>\$ 1,074</b>         | <b>\$ (792)</b>       |

Table of Contents

|   | <b>Nine Months Ended<br/>September 30,<br/>2010 vs. 2009<br/>Increase (Decrease)<br/>Due to Change In:</b> |                         |                       |
|---|--|-------------------------|-----------------------|
|   | <b>Average<br/>Volume</b>  | <b>Average<br/>Rate</b> | <b>Net<br/>Change</b> |
|   | <b>(Dollars in thousands)</b>  |                         |                       |
| <b>Income from interest earning assets:</b>                   |  |                         |                       |
| Loans, gross  | \$ (7,441)   | \$ 774                  | \$ (6,667)            |
| Securities  | 962  | 196                     | 1,158                 |
| Interest-bearing deposits in other financial institutions     | 98   | (20)                    | 78                    |
| <b>Total interest income from interest earnings assets</b>    | <b>\$ (6,381)</b>  | <b>\$ 950</b>           | <b>\$ (5,431)</b>     |
| <b>Expense on interest-bearing liabilities:</b>               |  |                         |                       |
| Demand, interest-bearing                                      | \$ 35  | \$ (31)                 | \$ 4                  |
| Savings and money market                                      | (175)  | (763)                   | (938)                 |
| Time deposits under \$100                                     | (61)   | (326)                   | (387)                 |
| Time deposits \$100 and over                                  | (313)  | (488)                   | (801)                 |
| Time deposits CDARS   | (11)   | (48)                    | (59)                  |
| Time deposits brokered  | (448)  | (1,572)                 | (2,020)               |
| Subordinated debt   |  | (56)                    | (56)                  |
| Securities sold under agreement to repurchase                 | (170)  | (127)                   | (297)                 |
| Note payable  | (82)   |                         | (82)                  |
| Short-term borrowings   | (166)  | 206                     | 40                    |
| <b>Total interest expense on interest-bearing liabilities</b> | <b>\$ (1,391)</b>  | <b>\$ (3,205)</b>       | <b>\$ (4,596)</b>     |
| <b>Net interest income</b>                                    | <b>\$ (4,990)</b>  | <b>\$ 4,155</b>         | <b>\$ (835)</b>       |

The Company's net interest margin, expressed as a percentage of average earning assets, was 3.59% for the third quarter of 2010, a decrease of 3 basis points from 3.62% for the third quarter a year ago and down 29 basis points from 3.88% for the second quarter of 2010. The 29 basis point decline in the third quarter of 2010 compared to the previous quarter was primarily due to investment of proceeds from the June 2010 capital raise in short-term investments and deposits at the Federal Reserve Bank, partially offset by maturing higher-cost wholesale funding and a more cost-effective blend of core deposits. In the third quarter of 2010, the Company had \$113 million of average balances deposited with the Federal Reserve Bank compared to \$27 million of average balances deposited with the Federal Reserve Bank in the second quarter of 2010. The Company's relatively short-term investments allow the Company to maximize yields on excess liquidity while providing cash flow to support potential loan growth in future periods. For the nine months ended September 30, 2010, the net interest increased to 3.76% compared to 3.51% for the same period in 2009, primarily as a result of lower deposit and borrowing costs.

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.

Net interest income in the third quarter of 2010 decreased to \$10.8 million, or 7%, from \$11.6 million in the third quarter of 2009, primarily due to a decrease in average loan volume, including loans held-for-sale, of \$212.3 million. Net interest income in the first nine months of 2010 decreased by \$835,000 to \$33.6 million from \$34.5 million for the first nine months of 2009, primarily due to a decrease in average loan volume, including loans held-for-sale, of \$196.2 million.





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

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

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 Company had a provision for loan losses of \$7.1 million for the quarter ended September 30, 2009 and \$28.3 million for the nine months ended September 30, 2009.

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<br>Three Months<br>Ended<br>September 30, |                 | Increase (decrease)<br>2010 versus 2009 |            |
|--|---|-----------------|---|------------|
|  | 2010  | 2009            | Amount                                  | Percent    |
| (Dollars in thousands)                             |   |                 |   |            |
| Noninterest income:                                |   |                 |   |            |
| Gain on sale of securities                         | \$ 1,492  | \$              | \$ 1,492                                | N/A        |
| Service charges and fees on deposit accounts       | 536   | 557             | (21)                                    | -4%        |
| Servicing income                                   | 442   | 382             | 60                                      | 16%        |
| Gain on sale of SBA loans                          | 429   | 643             | (214)                                   | -33%       |
| Loss on sale of other loans                        | (887)   |                 | (887)                                   | N/A        |
| Increase in cash surrender value of life insurance | 428   | 420             | 8                                       | 2%         |
| Other  | 288   | 348             | (60)                                    | -17%       |
| <b>Total noninterest income</b>                    | <b>\$ 2,728</b>                                   | <b>\$ 2,350</b> | <b>\$ 378</b>                           | <b>16%</b> |

Table of Contents

|   | For the<br>Nine Months<br>Ended<br>September 30, |                 | Increase (decrease)<br>2010 versus 2009 |            |
|---|--|-----------------|---|------------|
|   | 2010   | 2009            | Amount                                  | Percent    |
| (Dollars in thousands)                                |  |                 |   |            |
| Noninterest income:                                   |  |                 |   |            |
| Gain on sale of securities                            | \$ 1,492   |                 | \$ 1,492                                | N/A        |
| Service charges and fees on<br>deposit accounts       | 1,664  | 1,665           | (1)                                     | 0%         |
| Servicing income                                      | 1,288  | 1,210           | 78                                      | 6%         |
| Gain on sale of SBA loans                             | 707  | 643             | 64                                      | 10%        |
| Loss on sale of other loans                           | (887)  |                 | (887)                                   | N/A        |
| Increase in cash surrender value<br>of life insurance | 1,249  | 1,248           | 1                                       | 0%         |
| Other   | 777  | 808             | (31)                                    | -4%        |
| <b>Total noninterest income</b>                       | <b>\$ 6,290</b>                                  | <b>\$ 5,574</b> | <b>\$ 716</b>                           | <b>13%</b> |

The increase in noninterest income in the third quarter and first nine months of 2010 compared to the same periods in 2009 was primarily attributable to a \$1.5 million gain on sale of securities, partially offset by a loss on sale of other loans of \$887,000. Other sources of noninterest income include loan servicing fees, service charges and fees, and the cash surrender value from company owned life insurance policies.

The Company sold \$25.7 million of investment securities for total gross proceeds of \$27.2 million resulting in a \$1.5 million gain on sale of securities for the third quarter and first nine months of 2010, compared to no gain on sale of securities for the same periods in 2009.

Historically, a significant percentage of the Company's noninterest income has been associated with its SBA lending activity, as gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. During the third quarter of 2010, SBA loan sales resulted in a \$429,000 gain, compared to a \$643,000 gain on sale of SBA loans in the third quarter of 2009. During the first nine months of 2010, SBA loans sales resulted in a \$707,000 gain, compared to a \$643,000 gain on sale of SBA loans in the first nine months of 2009.

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.

During the third quarter of 2010, the sale of \$11.2 million of the \$17.1 million problem real estate loans held-for-sale for proceeds of \$10.3 million, resulted in a loss on sale of other loans of \$887,000 for the third quarter and first nine months of 2010.

The increase in cash surrender value of life insurance approximates a 4.01% 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<br>Three Months<br>Ended<br>September 30, |           | Increase (decrease)<br>2010 versus 2009 |         |
|--------------------------------------|---|-----------|---|---------|
|                                      | 2010  | 2009      | Amount                                  | Percent |
| (Dollars in thousands)               |   |           |   |         |
| <b>Noninterest Expense:</b>          |   |           |   |         |
| Salaries and employee benefits       | \$ 5,272  | \$ 5,730  | \$ (458)                                | -8%     |
| Occupancy and equipment              | 1,081   | 1,005     | 76                                      | 8%      |
| Writedown of loans held-for-sale     | 1,080   |           | 1,080                                   | N/A     |
| FDIC deposit insurance premiums      | 849   | 598       | 251                                     | 42%     |
| Professional fees                    | 780   | 691       | 89                                      | 13%     |
| Software subscription                | 261   | 203       | 58                                      | 29%     |
| Insurance expense                    | 241   | 203       | 38                                      | 19%     |
| Low income housing investment losses | 214   | 217       | (3)                                     | -1%     |
| Data processing                      | 188   | 196       | (8)                                     | -4%     |
| Other real estate owned expense      | 49  | 60        | (11)                                    | -18%    |
| Impairment of goodwill               |   |           |   | N/A     |
| Other                                | 1,233   | 1,841     | (608)                                   | -33%    |
| <br>                                 |   |           |   |         |
| Total noninterest expense            | \$ 11,248   | \$ 10,744 | \$ 504                                  | 5%      |

|                                      | For the<br>Nine Months<br>Ended<br>September 30, |           | Increase (decrease)<br>2010 versus 2009 |         |
|--------------------------------------|--|-----------|---|---------|
|                                      | 2010   | 2009      | Amount                                  | Percent |
| (Dollars in thousands)               |  |           |   |         |
| <b>Noninterest Expense:</b>          |  |           |   |         |
| Salaries and employee benefits       | \$ 16,645  | \$ 17,831 | \$ (1,186)                              | -7%     |
| Occupancy and equipment              | 3,023  | 2,893     | 130                                     | 4%      |
| Writedown of loans held-for-sale     | 1,080  |           | 1,080                                   | N/A     |
| FDIC deposit insurance premiums      | 3,059  | 2,490     | 569                                     | 23%     |
| Professional fees                    | 3,202  | 2,833     | 369                                     | 13%     |
| Software subscription                | 747  | 616       | 131                                     | 21%     |
| Insurance expense                    | 765  | 393       | 372                                     | 95%     |
| Low income housing investment losses | 572  | 642       | (70)                                    | -11%    |
| Data processing                      | 619  | 686       | (67)                                    | -10%    |
| Other real estate owned expense      | 537  | 229       | 308                                     | 134%    |
| Impairment of goodwill               | 43,181   |           | 43,181                                  | N/A     |
| Other                                | 4,568  | 5,572     | (1,004)                                 | -18%    |
| <br>                                 |  |           |   |         |
| Total noninterest expense            | \$ 77,998  | \$ 34,185 | \$ 43,813                               | 128%    |

Salaries and employee benefits, the single largest component of noninterest expense, decreased \$458,000, or 8%, for the third quarter of 2010 and \$1.2 million, or 7%, for the first nine months of 2010, compared to the same periods in 2009, primarily due to a reduction in workforce implemented in the fourth quarter of 2009. Full-time equivalent employees were 203 and 213 at September 30, 2010 and 2009, respectively.



## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

### Table of Contents

Noninterest expense for the third quarter of 2010 and first nine months of 2010 included the \$1.1 million write-down of loans held-for-sale.

FDIC deposit insurance premiums increased \$251,000, or 42%, for the quarter ended September 30, 2010 and \$569,000, or 23% for the nine months ended September 30, 2010, compared to the same periods in 2009, mainly due to an increase in the FDIC deposit assessment rate.

Professional fees increased \$89,000, or 13%, for the quarter ended September 30, 2010 and \$369,000 or 13% for the nine months ended September 30, 2010, from the same periods a year ago. The increase in professional fees for the third quarter and the first nine months of 2010 compared to the same periods in 2009 was primarily due to legal fees related to loan workouts and increased expenses for bank regulatory compliance.

Insurance expense increased \$38,000, or 19%, for the quarter ended September 30, 2010 and increased \$372,000, or 95%, for the nine months ended September 30, 2010 from the same periods in 2009, primarily due to an increase in the directors and officers' insurance premiums.

OREO expense in the third quarter of 2010 decreased \$11,000, or 18% compared to the third quarter of 2009. For the nine months ended September 30, 2010, OREO expense increased \$308,000, or 134%, compared to the same period in 2009, primarily due to the write-down of an OREO property in the first quarter of 2010.

Due to the continued depressed economic conditions and the length of time and amount by which the Company's book value exceeded market value per share, and the Company's closing of the private placement at a conversion price of \$3.75 per share, the Company determined the entire \$43.2 million of goodwill related to the acquisition of Diablo Valley Bank was impaired during the second quarter of 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 third quarter and nine months ended 2010 was \$398,000 and \$6.3 million, respectively. The \$6.3 million income tax benefit for the nine months ended September 30, 2010 included \$3.7 million of additional income tax expense in the second quarter of 2010 to establish a partial valuation allowance on the Company's net deferred tax asset. The income tax benefit was \$1.8 million and \$11.0 million for the same periods in 2009. The following table shows the effective income tax rates for the third quarter and first nine months of 2010 and 2009:

|                           | <b>For the<br/>Three Months<br/>Ended<br/>September 30,</b> |             | <b>For the<br/>Nine Months<br/>Ended<br/>September 30,</b> |             |
|---------------------------|---|-------------|--|-------------|
|                           | <b>2010</b>   | <b>2009</b> | <b>2010</b>  | <b>2009</b> |
| Effective income tax rate | -157.3%   | -46.8%      | -9.8%  | -49.1%      |

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 and the effect of the \$3.7 million valuation allowance on deferred tax assets.

Table of Contents

The Company has total investments of \$4.9 million in low-income housing limited partnerships as of September 30, 2010. These investments have generated annual tax credits of approximately \$1.1 million in each of the years ended December 31, 2009 and 2008.

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. At September 30, 2010, the Company had a net deferred tax asset of approximately \$25.8 million, compared to \$20.9 million at September 30, 2009, and \$22.4 million at December 31, 2009.

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. During the second quarter of 2010, the Company determined a partial valuation allowance on the state of California net deferred tax asset was necessary, largely based on the negative evidence represented by a cumulative loss in the Company's most recent three-year period caused by the provisions for loan losses recorded during the periods. Management is required to re-evaluate the deferred tax asset and the related valuation allowance quarterly and it has been determined no additions to the valuation allowance were required in the third quarter of 2010. The \$6.3 million income tax benefit for the nine months ended September 30, 2010 is net of \$3.7 million of income tax expense in the second quarter of 2010 to establish the partial valuation allowance.

The net deferred tax asset, after the partial valuation allowance, was \$25.8 million at September 30, 2010. The remaining deferred tax asset was supported by available tax planning strategies and projected future taxable income.

**FINANCIAL CONDITION**

As of September 30, 2010, total assets were \$1.33 billion, compared to \$1.37 billion as of September 30, 2009 and \$1.36 billion as of December 31, 2009. Total securities available-for-sale (at fair value) were \$111.5 million, an increase of 15% from \$96.6 million the year before and an increase of 1% from \$110.0 million at December 31, 2009. The total loan portfolio (excluding loans held-for-sale) was \$886.6 million at September 30, 2010, a decrease of 18% from \$1.08 billion at September 30, 2009, and a decrease of 17% from \$1.07 billion at December 31, 2009. Total deposits decreased 5% to \$1.07 billion at September 30, 2010, from \$1.12 billion at September 30, 2009, and decreased 2% from \$1.09 billion at December 31, 2009. Securities sold under agreement to repurchase decreased \$10 million, or 40%, to \$15.0 million at September 30, 2010, from \$25.0 million at September 30, 2009 and December 31, 2009. In addition, short-term borrowings were \$4.3 million at September 30, 2010. There were no short-term borrowings at September 30, 2009. Short-term borrowings decreased \$15.7 million, or 78%, at September 30, 2010, from \$20.0 million at December 31, 2009.

Table of Contents**Securities Portfolio**

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

|  | September 30,<br>2010  |           | December 31,<br>2009 |         |
|--|------------------------|-----------|----------------------|---------|
|  | (Dollars in thousands) |           |                      |         |
| Securities available-for-sale<br>(at fair value)   |                        |           |                      |         |
| U.S. Treasury                                      | \$                     | \$ 39,999 | \$                   |         |
| U.S. Government Sponsored<br>Entities              |                        | 2,018     |                      | 1,973   |
| Mortgage-Backed<br>Securities Residential          | 111,322                | 48,944    |                      | 102,546 |
| Collateralized Mortgage<br>Obligations Residential | 137                    | 5,657     |                      | 5,447   |
| Total  | \$ 111,459             | \$ 96,618 | \$                   | 109,966 |

The following table summarizes the weighted average life and weighted average yields of securities at September 30, 2010:

|   | Within<br>One Year     |       | After One<br>and Within<br>Five Years |       | Weighted Average Life<br>After Five<br>and Within<br>Ten Years |       | After<br>Ten Years |       | Total      |       |
|---|------------------------|-------|---------------------------------------|-------|--|-------|--------------------|-------|------------|-------|
|   | Amount                 | Yield | Amount                                | Yield | Amount   | Yield | Amount             | Yield | Amount     | Yield |
|   | (Dollars in thousands) |       |                                       |       |  |       |                    |       |            |       |
| Securities<br>available-for-sale<br>(at fair value)   |                        |       |                                       |       |  |       |                    |       |            |       |
| Mortgage-Backed<br>Securities Residential             | 111,322                | 5.20% | \$ 70,854                             | 3.41% | \$ 37,718  | 3.55% | \$ 1,299           | 4.34% | \$ 111,322 | 3.49% |
| Collateralized<br>Mortgage<br>Obligations Residential | 137                    | 2.31% |                                       | 0.00% |  | 0.00% |                    | 0.00% | 137        | 2.31% |
| Total   | \$ 1,588               | 4.95% | \$ 70,854                             | 3.41% | \$ 37,718  | 3.55% | \$ 1,299           | 4.34% | \$ 111,459 | 3.49% |

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 weak or when deposits grow more rapidly than loans.

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

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





Table of Contents

In the third quarter of 2010, the securities portfolio increased by \$14.8 million, or 15%, and increased to 8% of total assets at September 30, 2010 from 7% at September 30, 2009, and increased by \$1.5 million, or 1%, from December 31, 2009. The Company increased its holding of mortgage-back securities by \$62.4 million to \$111.3 million at September 30, 2010, from \$48.9 million at September 30, 2009, and increased \$8.8 million from \$102.5 million at December 31, 2009 to take advantage of higher yields and offset a portion of the contraction in the loan portfolio. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities to otherwise mitigate interest rate risk.

**Loans**

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

Gross loans, excluding loans held-for-sale, represented 67% of total assets at September 30, 2010, compared to 79% of total assets at September 30, 2009, and 78% of total assets at December 31, 2009. The ratio of loans to deposits decreased to 83.24% at September 30, 2010 from 96.88% at September 30, 2009 and from 98.24% at December 31, 2009. Demand for loans has weakened within the Company's markets due to the current economic environment.

During the second quarter of 2010, the Company identified \$31.0 million of problem real estate loans for sale. These loans were written down by \$13.9 million to reflect the estimated proceeds from the sale, resulting in a net balance of \$17.1 million which was transferred into the loans held-for-sale portfolio. The following table shows the detail of the problem loans transferred to the loans held-for-sale portfolio at June 30, 2010:

|                                      | <b>Balance<br/>Prior to<br/>Transfer</b> | <b>Amount<br/>Charged-off</b> | <b>Balance<br/>Transferred<br/>to Loans<br/>Held-for-Sale</b> |
|--------------------------------------|--|-------------------------------|---|
| (Dollars in thousands)               |  |                               |   |
| Real estate-mortgage                 | \$ 9,893                                 | \$ (2,781)                    | \$ 7,112  |
| Real estate-land and<br>construction | 21,112                                   | (11,145)                      | 9,967   |
| <b>Total</b>                         | <b>\$ 31,005</b>                         | <b>\$ (13,926)</b>            | <b>\$ 17,079</b>  |

Of the \$17.1 million loans held-for-sale at June 30, 2010, \$11.2 million of loans were sold during the third quarter of 2010, which resulted in a loss on sale of other loans of \$887,000. The remaining \$5.9 million of problem real estate loans held-for-sale were written down by an additional \$1.1 million during the third quarter of 2010 to \$4.8 million, after obtaining updated bids and broker indications on the estimated value of these loans held-for-sale. Problem loans held-for-sale include commercial real estate loans of \$1.2 million and land and construction loans of \$3.6 million at September 30, 2010.

Table of Contents**Loan Distribution**

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

|                                   | September 30, 2010 |            | September 30, 2009 |            | December 31, 2009 |            |
|-----------------------------------|--------------------|------------|--------------------|------------|-------------------|------------|
|                                   | Balance            | % to Total | Balance            | % to Total | Balance           | % to Total |
| (Dollars in thousands)            |                    |            |                    |            |                   |            |
| Commercial                        | \$ 370,939         | 42%        | \$ 414,441         | 38%        | \$ 427,177        | 40%        |
| Real estate mortgage              | 353,565            | 40%        | 405,486            | 38%        | 400,731           | 37%        |
| Real estate land and construction | 91,706             | 10%        | 197,374            | 18%        | 182,871           | 17%        |
| Home equity                       | 53,772             | 6%         | 51,768             | 5%         | 51,368            | 5%         |
| Consumer                          | 15,793             | 2%         | 11,476             | 1%         | 7,181             | 1%         |
| Total loans                       | 885,775            | 100%       | 1,080,545          | 100%       | 1,069,328         | 100%       |
| Deferred loan costs               | 841                |            | 1,023              |            | 785               |            |
| Loans, including deferred costs   | 886,616            | 100%       | 1,081,568          | 100%       | 1,070,113         | 100%       |
| Allowance for loan losses         | (25,290)           |            | (28,976)           |            | (28,768)          |            |
| Loans, net                        | \$ 861,326         |            | \$ 1,052,592       |            | \$ 1,041,345      |            |

The Company's loan portfolio is concentrated in commercial loans, primarily manufacturing, wholesale, and services, and real estate mortgage loans, with the balance in land development, construction and home equity and consumer loans. The decrease in the Company's loan portfolio in 2010 is due to diminished loan demand, and loan payoffs exceeding draw downs of loan commitments. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 56% of its gross loans were secured by real property as of September 30, 2010, compared to 61% as of September 30, 2009, and 59% as of December 31, 2009. 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 first nine months of 2010, loans were sold resulting in a gain on sale of SBA loans of \$707,000.

As of September 30, 2010, real estate mortgage loans of \$353.6 million consist primarily of adjustable and fixed rate loans secured by deeds of trust on commercial property. The real estate mortgage loans at September 30, 2010 consist of \$200.3 million, or 57%, of owner occupied properties, and \$153.3 million, or 43%, of investment properties. Properties securing the commercial real estate mortgage loans are primarily located in the Company's primary market, which is the Greater San Francisco Bay Area.

Table of Contents

The Company's real estate mortgage 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 normally restricts real estate term loans to generally 75%, or less, 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 \$105.7 million to \$91.7 million, or 10% of total loans at September 30, 2010, from \$197.4 million, or 18% of total loans at September 30, 2009, and decreased \$91.2 million from \$182.9 million, or 17% of total loans at December 31, 2009.

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.

Additionally, the Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten 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.

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 \$30.2 million and \$50.3 million at September 30, 2010, respectively.

***Loan Maturities***

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale) as of September 30, 2010. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

Street Journal. As of September 30, 2010, approximately 70% of the Company's loan portfolio consisted of floating interest rate loans.

|                                    | Due in<br>One Year<br>or Less | Over One<br>Year But<br>Less than<br>Five Years | Over<br>Five Years | Total      |
|------------------------------------|-------------------------------|---|--------------------|------------|
| (Dollars in thousands)             |                               |   |                    |            |
| Commercial                         | \$ 329,804                    | \$ 40,385                                       | \$ 750             | \$ 370,939 |
| Real estate mortgage               | 120,991                       | 190,379   | 42,195             | 353,565    |
| Real estate land and construction  | 82,805                        | 8,901   |                    | 91,706     |
| Home equity                        | 51,972                        |   | 1,800              | 53,772     |
| Consumer                           | 14,888                        | 905   |                    | 15,793     |
| <br>                               |                               |   |                    |            |
| Loans                              | \$ 600,460                    | \$ 240,570                                      | \$ 44,745          | \$ 885,775 |
| <br>                               |                               |   |                    |            |
| Loans with variable interest rates | \$ 542,079                    | \$ 76,310                                       | \$ 699             | \$ 619,088 |
| Loans with fixed interest rates    | 58,381                        | 164,260   | 44,046             | 266,687    |
| <br>                               |                               |   |                    |            |
| Loans                              | \$ 600,460                    | \$ 240,570                                      | \$ 44,745          | \$ 885,775 |

**Loan Servicing**

As of September 30, 2010 and 2009, there were \$170.2 million and \$149.1 million, respectively, in SBA loans were serviced by the Company for others. Activity for loan servicing rights was as follows:

|                             | For the<br>Three Months<br>Ended<br>September 30, |        | For the<br>Nine Months<br>Ended<br>September 30, |          |
|-----------------------------|---|--------|--|----------|
|                             | 2010  | 2009   | 2010   | 2009     |
| (Dollars in thousands)      |   |        |  |          |
| Beginning of period balance | \$ 956  | \$ 745 | \$ 1,067   | \$ 1,013 |
| Additions                   | 153   | 233    | 281  | 233      |
| Amortization                | (115)   | (116)  | (354)  | (384)    |
| <br>                        |   |        |  |          |
| End of period balance       | \$ 994  | \$ 862 | \$ 994   | \$ 862   |

Loan servicing rights are included in Accrued Interest Receivable and Other Assets on the consolidated balance sheets and reported net of amortization. There was no valuation allowance as of September 30, 2010 and 2009, as the fair market value of the assets was greater than the carrying value.

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

|                             | For the<br>Three Months<br>Ended<br>September 30, |          | For the<br>Nine Months<br>Ended<br>September 30, |          |
|-----------------------------|---|----------|--|----------|
|                             | 2010  | 2009     | 2010   | 2009     |
| (Dollars in thousands)      |   |          |  |          |
| Beginning of period balance | \$ 2,060  | \$ 2,111 | \$ 2,116   | \$ 2,247 |
| Amortization                | (61)  | (75)     | (189)  | (264)    |
| Unrealized holding gain     | 116   | 48       | 188  | 101      |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

End of period balance                    \$ 2,115   \$ 2,084   \$ 2,115   \$ 2,084

Table of Contents

*Nonperforming Assets*

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, 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 means that management is offering or will offer for sale. Total OREO was \$657,000 at September 30, 2010, compared to \$3.0 million at September 30, 2009, and \$2.2 million at December 31, 2009.

Table of Contents

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

|  | September 30,          |                  | December 31,     |
|--|------------------------|------------------|------------------|
|  | 2010                   | 2009             | 2009             |
|  | (Dollars in thousands) |                  |                  |
| Nonaccrual loans held-for-sale                             | \$ 4,552               | \$               | \$               |
| Nonaccrual loans held-for-investment                       | 41,757                 | 55,120           | 59,480           |
| Restructured and loans 90 days past due and still accruing | 2,687                  | 144              | 2,895            |
| <b>Total nonperforming loans</b>                           | <b>48,996</b>          | <b>55,264</b>    | <b>62,375</b>    |
| Other real estate owned                                    | 657                    | 2,973            | 2,241            |
| <b>Total nonperforming assets</b>                          | <b>\$ 49,653</b>       | <b>\$ 58,237</b> | <b>\$ 64,616</b> |

|   |       |       |       |
|---|-------|-------|-------|
| Nonperforming assets as a percentage of total loans and other real estate owned | 5.60% | 5.37% | 6.03% |
|---|-------|-------|-------|

At September 30, 2010, nonperforming loans, including \$4.6 million in the loans held-for-sale portfolio, decreased \$6.3 million, or 11%, from September 30, 2009, and decreased by \$13.4 million, or 21%, compared to December 31, 2009. The following table provides nonperforming loans by loan type as of September 30, 2010:

|                                   | Nonaccrual             | Restructured and<br>Loans Over 90 Days<br>Past Due and<br>Still Accruing | Total            |
|-----------------------------------|------------------------|--|------------------|
|                                   | (Dollars in thousands) |  |                  |
| Commercial                        | \$ 12,052              | \$ 1,024   | \$ 13,076        |
| Real estate mortgage              | 6,292                  | 1,663  | 7,955            |
| Real estate land and construction | 27,037                 |  | 27,037           |
| Consumer                          | 928                    |  | 928              |
| <b>Total</b>                      | <b>\$ 46,309</b>       | <b>\$ 2,687</b>  | <b>\$ 48,996</b> |

Nonaccrual loans held-for-investment at September 30, 2010, included \$4.5 million related to six loans that were restructured during the third quarter of 2010. Three of the loans were restructured to extend amortization periods at market interest rates and required additional collateral. Nonaccrual restructured loans held-for-investment also included one loan that was bifurcated into two separate loans to provide 1) a fully secured loan for half of the outstanding balance, and 2) an unsecured loan for the other half of the outstanding balance. Principal was not reduced on the two loans and payments are interest only. These two loans have been extended once since they were restructured, and are current in accordance with their modified terms. Additionally, one nonaccrual restructured loan is not current in accordance with the terms of its forbearance agreement, and the forbearance has expired. The borrower under this loan is making monthly payments, but the payments are not sufficient to cure the loan default.

At September 30, 2010, restructured loans still on accrual included three loans totaling \$2.7 million. These restructurings primarily resulted from short term principal deferments and extensions of the amortization periods. The loans are current according to their modified terms and repayment of the remaining contractual payments is expected. The Company has no commitments to lend any additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.



Table of Contents

*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 loans include all loans considered as substandard, substandard-nonaccrual, and doubtful and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate). The principal balance of classified loans, net of SBA guarantees, was \$115.9 million at September 30, 2010, \$172.9 million at September 30, 2009, and \$164.1 million at December 31, 2009. Included in the \$115.9 million of classified assets at September 30, 2010, were \$4.6 million of loans held-for-sale. Management of the level of classified loans 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. On an ongoing basis, 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

Table of Contents

result in an increase in the level of nonperforming loans and increased loan losses, which could adversely affect the Company's future growth and profitability. No assurance of the ultimate level of credit losses can be given with any certainty.

The following 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:

|   | For the<br>Nine Months<br>Ended<br>September 30, |           | For the Year<br>Ended<br>December 31, |
|---|--|-----------|---------------------------------------|
|   | 2010   | 2009      | 2009                                  |
| (Dollars in thousands)  |  |           |                                       |
| Balance, beginning of period  | \$ 28,768  | \$ 25,007 | \$ 25,007                             |
| Net charge-offs   | (29,232)   | (24,284)  | (30,167)                              |
| Provision for loan losses   | 25,754   | 28,253    | 33,928                                |
| Balance, end of period  | \$ 25,290  | \$ 28,976 | \$ 28,768                             |
| <b>RATIOS:</b>  |  |           |                                       |
| Net charge-offs to average loans(1)   | -3.97%   | -2.73%    | -2.59%                                |
| Allowance for loan losses to total loans(1)   | 2.85%  | 2.68%     | 2.69%                                 |
| Allowance for loan losses to nonperforming loans  | 51.62%   | 52.43%    | 46.12%                                |
| Allowance for loan losses to nonperforming loans,<br>excluding nonaccrual loans loans held-for-sale | 56.90%   | 52.43%    | 46.12%                                |

(1) Average loans and total loans exclude loans 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.

**Goodwill**

Goodwill resulted from the acquisition of Diablo Valley Bank in June 2007 and represented the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill was assessed at least annually, as of November 30, for impairment with the assistance of an independent valuation firm. Goodwill impairment exists when a reporting unit's carrying value exceeds its fair value, which is determined through a two-step impairment test. Step 1 includes the determination of the carrying value of the Company's single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss will be recognized in an amount equal to that excess.

Due to concerns about the Company's stock price, the condition of the banking industry in general, and the closing of the private placement of convertible preferred stock in June 2010, goodwill was tested for impairment in the second quarter of 2010, with the assistance of an independent valuation firm. Due to the continued depressed economic conditions and the length of time and amount by which the Company's book value exceeded market value per share, and the Company's closing of the private placement at a conversion price of \$3.75 per share, the Company determined goodwill related to the acquisition of Diablo Valley Bank of \$43.2 million was fully impaired during the second quarter of 2010.

Table of Contents**Intangible Assets**

Intangible assets consist of core deposit and customer relationship intangible assets arising from the acquisition of Diablo Valley Bank in June 2007. These assets are amortized over their estimated useful lives. Impairment testing of these assets is performed at the individual asset level. Impairment exists if the carrying amount of the asset is not recoverable and exceeds its fair value at the date of the impairment test. For intangible assets, estimates of expected future cash flows (cash inflows less cash outflows) that are directly associated with an intangible asset are used to determine the fair value of that asset. Management makes certain estimates and assumptions in determining the expected future cash flows from core deposit and customer relationship intangibles including account attrition, expected lives, discount rates, interest rates, servicing costs and other factors. Significant changes in these estimates and assumptions could adversely impact the valuation of these intangible assets. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset. Based on its assessment, management concluded that there was no impairment of intangible assets at September 30, 2010.

**Deposits**

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

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

|                                     | September 30, 2010 |            | September 30, 2009 |            | December 31, 2009 |            |
|-------------------------------------|--------------------|------------|--------------------|------------|-------------------|------------|
|                                     | Balance            | % to Total | Balance            | % to Total | Balance           | % to Total |
| (Dollars in thousands)              |                    |            |                    |            |                   |            |
| Demand Deposits Noninterest Bearing | \$ 269,482         | 25%        | \$ 250,515         | 22%        | \$ 260,840        | 24%        |
| Demand Deposits Interest Bearing    | 156,912            | 15%        | 139,919            | 13%        | 146,828           | 13%        |
| Savings and Money Market            | 318,221            | 30%        | 324,611            | 29%        | 295,404           | 27%        |
| Time Deposits under \$100           | 38,909             | 4%         | 43,559             | 4%         | 40,197            | 4%         |
| Time Deposits \$100 and over        | 132,862            | 12%        | 134,533            | 12%        | 129,831           | 12%        |
| Time Deposits CDARS                 | 16,297             | 2%         | 41,418             | 4%         | 38,154            | 4%         |
| Time Deposits brokered              | 132,435            | 12%        | 181,819            | 16%        | 178,031           | 16%        |
| Total deposits                      | \$ 1,065,118       | 100%       | \$ 1,116,374       | 100%       | \$ 1,089,285      | 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, 2010 and 2009, less than 1% of deposits were from public sources, respectively.

Noninterest-bearing and low interest-bearing demand deposit accounts increased \$36.0 million, or 9%, at September 30, 2010 from September 30, 2009, and increased \$18.7 million, or 5%, from December 31, 2009. At September 30, 2010, brokered deposits decreased \$49.4 million, or 27%, to



## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

### Table of Contents

\$132.4 million, compared to \$181.8 million at September 30, 2009, decreased \$45.6 million, or 26%, and from \$178.0 million at December 31, 2009.

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, 2010:

|                                       | Balance                | % of Total  |
|---------------------------------------|------------------------|-------------|
|                                       | (Dollars in thousands) |             |
| Three months or less                  | \$ 124,506             | 44%         |
| Over three months through six months  | 69,477                 | 25%         |
| Over six months through twelve months | 70,187                 | 25%         |
| Over twelve months                    | 17,424                 | 6%          |
| <b>Total</b>                          | <b>\$ 281,594</b>      | <b>100%</b> |

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

### *Return (Loss) on Equity and Assets*

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

|  | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |         |
|--|-------------------------------------|--------|------------------------------------|---------|
|  | 2010                                | 2009   | 2010                               | 2009    |
| Annualized return (loss) on average assets             | 0.20%                               | -0.58% | -5.76%                             | -1.05%  |
| Annualized return (loss) on average tangible assets    | 0.20%                               | -0.60% | -5.90%                             | -1.09%  |
| Annualized return (loss) on average equity(1)          | 1.38%                               | -4.67% | -42.78%                            | -8.43%  |
| Annualized return (loss) on average tangible equity(1) | 1.40%                               | -6.38% | -51.99%                            | -11.40% |
| Dividend payout ratio(2)                               | N/A                                 | N/A    | N/A                                | -2.07%  |
| Average equity to average assets ratio(1)              | 14.19%                              | 12.48% | 13.46%                             | 12.47%  |

(1) The three months and nine months ended September 30, 2010 ratios reflect the \$70 million net proceeds from the private placement completed in the second quarter of 2010.

(2) Percentage is calculated based on dividends paid on common stock divided by net income (loss) available to common shareholders.

### *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 \$288.0 million at September 30, 2010, as compared to \$346.1 million at September 30, 2009 and \$328.2 million at December 31, 2009.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted, because there is no certainty that



Table of Contents

lines of credit and letters of credit will ever be fully utilized. The following table presents the Company's commitments to extend credit for the periods indicated:

|  | September 30, |               |            |               | December 31, |               |
|--|---------------|---------------|------------|---------------|--------------|---------------|
|  | 2010          |               | 2009       |               | 2009         |               |
|  | Fixed Rate    | Variable Rate | Fixed Rate | Variable Rate | Fixed Rate   | Variable Rate |
| Unused lines of credit and commitments to make loans | \$ 4,846      | \$ 262,938    | \$ 17,966  | \$ 306,068    | \$ 10,540    | \$ 297,900    |
| Standby letters of credit                            | 407           | 19,815        | 2,996      | 19,076        | 557          | 19,218        |
|  | \$ 5,253      | \$ 282,753    | \$ 20,962  | \$ 325,144    | \$ 11,097    | \$ 317,118    |

**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, 2010, the Company had loan contraction, including loans held-for-sale, of \$204.2 million from September 30, 2009, and loan contraction, including loans held-for-sale, of \$181.5 million from December 31, 2009, 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 83.24% at September 30, 2010, compared to 96.88% at September 30, 2009, and 98.24% at December 31, 2009.

**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. At September 30, 2010 and September 30, 2009, the Company had no overnight borrowings from the FHLB. At December 31, 2009, the Company had \$20.0 million of overnight borrowings from the FHLB, bearing interest at 0.04%. The Company had \$183.6 million of loans pledged to the FHLB as collateral on an available line of credit of \$119.8 million at September 30, 2010.

The Company can also borrow from FRB's discount window. The Company had \$105.4 million of loans pledged to the FRB as collateral on an available line of credit of \$49.2 million at September 30, 2010, none of which was outstanding.

## Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

### Table of Contents

At September 30, 2010, the Company had Federal funds purchase arrangements available of \$30.0 million. There were no Federal funds purchased outstanding at September 30, 2010, September 30, 2009, and December 31, 2009.

The Company also had a \$4.3 million secured borrowing at September 30, 2010. Secured borrowings represent the guaranteed portions of SBA 7a loans transferred to third parties subject to a SBA warranty for a period of 90 days. This requires the Company to treat these loans as secured borrowings during the warranty period. The warranty period for these loans expires in the following quarter. Provided the loans remain current through the end of the warranty period all elements necessary to record the sale will have been met.

The Company also utilizes securities sold under repurchase agreements to manage our liquidity position. Repurchase agreements are accounted for as collateralized financial transactions and are secured by mortgage-backed securities carried at an amortized cost of approximately \$18.8 million at September 30, 2010, and approximately \$30.0 million at September 30, 2009. Securities sold under agreements to repurchase totaled \$15.0 million at September 30, 2010, compared to \$25.0 million at September 30, 2009, and \$25.0 million at December 31, 2009.

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, |        |
|---|------------------------|-----------|--------------|--------|
|   | 2010                   | 2009      | 2009         | 2009   |
|   | (Dollars in thousands) |           |              |        |
| Average balance year-to-date                | \$ 26,952              | \$ 61,018 | \$           | 56,269 |
| Average interest rate year-to-date          | 1.74%                  | 2.56%     | 1.65%        |        |
| Maximum month-end balance during the period | \$ 23,246              | \$ 30,000 | \$           | 50,000 |
| Average rate during the period              | 1.53%                  | 2.38%     | 1.32%        |        |

### **Capital Resources**

On June 21, 2010, the Company completed a private placement of Series B Preferred Stock and Series C Preferred Stock to a limited number of institutional investors for gross proceeds of \$75 million. HCC downstreamed \$40 million of the proceeds from the private placement to HBC as Tier 1 capital for regulatory purposes. The Company's shareholders approved the conversion of the Series B Preferred Stock and Series C Preferred Stock in September 2010, and as a result the proceeds from the private placement constitute Tier 1 capital for regulatory purposes at the holding company level. As discussed below, the proceeds from the private placement have significantly improved the Company's regulatory ratios.

Tangible equity increased to \$181.9 million at September 30, 2010, from \$126.5 million at September 30, 2009, and \$125.5 million at December 31, 2009.

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.



Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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

|                                      | September 30,  |                  | December 31,     |  |       |
|--------------------------------------|----------------|------------------|------------------|--|-------|
|                                      | 2010           | 2009             | 2009             | 2009   |       |
| (Dollars in thousands)               |                |                  |                  |  |       |
| <b>Capital components:</b>           |                |                  |                  |  |       |
| Tier 1 capital                       | \$ 182,852     | \$ 135,827       | \$ 134,833       |  |       |
| Tier 2 capital                       | 12,303         | 14,880           | 14,720           |  |       |
| <br>Total risk-based capital         | <br>\$ 195,155 | <br>\$ 150,707   | <br>\$ 149,553   |  |       |
| <br>Risk-weighted assets             | <br>\$ 970,922 | <br>\$ 1,175,791 | <br>\$ 1,163,125 |  |       |
| Average assets (regulatory purposes) | \$ 1,290,706   | \$ 1,347,329     | \$ 1,341,670     |  |       |
|                                      |                |                  |                  | <b>Minimum<br/>Regulatory<br/>Requirements</b> |       |
| <b>Capital ratios:</b>               |                |                  |                  |  |       |
| Total risk-based capital             | 20.1%          | 12.8%            | 12.9%            |  | 8.00% |
| Tier 1 risk-based capital            | 18.8%          | 11.6%            | 11.6%            |  | 4.00% |
| Leverage(1)                          | 14.2%          | 10.1%            | 10.1%            |  | 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.

Table of Contents

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

|                                      | September 30, |              | December 31, |        |       |  |
|--------------------------------------|---------------|--------------|--------------|--------|-------|--|
|                                      | 2010          | 2009         | 2009         | 2009   |       |  |
| (Dollars in thousands)               |               |              |              |        |       |  |
| <b>Capital components:</b>           |               |              |              |        |       |  |
| Tier 1 capital                       | \$ 154,283    | \$ 132,483   | \$ 133,216   |        |       |  |
| Tier 2 capital                       | 12,305        | 14,911       | 14,743       |        |       |  |
| Total risk-based capital             | \$ 166,588    | \$ 147,394   | \$ 147,959   |        |       |  |
| Risk-weighted assets                 | \$ 971,050    | \$ 1,178,355 | \$ 1,165,014 |        |       |  |
| Average assets (regulatory purposes) | \$ 1,290,776  | \$ 1,349,655 | \$ 1,344,407 |        |       |  |
| <b>Capital ratios:</b>               |               |              |              |        |       |  |
| Total risk-based capital             | 17.2%         | 12.5%        | 12.7%        | 10.00% | 8.00% |  |
| Tier 1 risk-based capital            | 15.9%         | 11.2%        | 11.4%        | 6.00%  | 4.00% |  |
| Leverage(1)                          | 12.0%         | 9.8%         | 9.9%         | 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. In July 2010, we submitted a written plan for sufficient capitalization of both HBC and the Company (on a consolidated basis), based on their respective risk profiles to the Federal Reserve and DFI.

At September 30, 2010 and 2009, and December 31, 2009, HCC's and HBC's capital met all minimum regulatory requirements. As of September 30, 2010, HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under the prompt corrective action provisions.

At September 30, 2010, the Company had total shareholders' equity of \$185.1 million, including \$58.1 million in preferred stock, and \$(1.3) million of accumulated other comprehensive loss.

***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 10.875% 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

Table of Contents

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. We believe, therefore, that 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. The Company will continue to accrue the cost and recognize the expense of the interest at the normal rate on a compounded basis until such time as the deferred arrearage has been paid current. As a result the Company has accrued but has not paid approximately \$2.0 million in interest on its subordinated debt as of September 30, 2010.

***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. The Company accrues the cumulative unpaid dividends at the compounded dividend rate. As a result of the Company has accrued but has not paid approximately \$2.3 million in dividends on its Series A Preferred Stock as of September 30, 2010.

***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

Table of Contents

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.

The holders of the Series B Preferred Stock and Series C Preferred Stock were entitled to receive cumulative dividends at a per annum rate of 20%, payable semi-annually in arrears commencing on December 21, 2010, unless shareholder approval was obtained before December 21, 2010. The Company recorded \$411,000 of dividends on the Series B Preferred Stock and Series C Preferred Stock in the three and six months ended June 30, 2010. As a result of the shareholder approval on September 15, 2010, no cumulative dividends will be paid on the Series B Preferred Stock and the Series C Preferred Stock and the previously recognized dividends were reversed in the quarter ended September 30, 2010.

**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

Table of Contents

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 Company applies a market value ("MV") methodology to gauge its interest rate risk exposure as derived from its simulation model. Generally, MV is the discounted present value of the difference between incoming cash flows on interest-earning assets and other investments and outgoing cash flows on interest-bearing liabilities and other liabilities. The application of the methodology attempts to quantify interest rate risk as the change in the MV which would result from a theoretical 100 and 200 basis point (1 basis point equals 0.01%) change in market interest rates. Both a 100 and 200 basis point increase and a 100 and 200 basis point decrease in market rates are considered.

At September 30, 2010, it was estimated that the Company's MV would increase 21.3% in the event of a 200 basis point increase in market interest rates. In the event of a 100 point increase in market interest rate, the Company's MV would increase 12.2% at the same date. The Company's MV at the same date would decrease 25.2% in the event of a 200 basis point decrease in applicable interest rates. In the event of a 100 point decrease in market interest rate, the Company's MV would decrease 16.9% at the same date.

Presented below, as of September 30, 2010 and 2009, is an analysis of the Company's interest rate risk as measured by changes in MV for instantaneous and sustained parallel shifts of 100 and 200 basis points in applicable interest rates:

|                            | September 30, 2010              |   |             |                | September 30, 2009              |   |             |                |
|----------------------------|---------------------------------|---|-------------|----------------|---------------------------------|---|-------------|----------------|
|                            |                                 | Market Value as a %<br>of<br>Present Value of<br>Assets |             |                |                                 | Market Value as a %<br>of<br>Present Value of<br>Assets |             |                |
|                            | \$ Change<br>in Market<br>Value | %<br>Change<br>in<br>Market<br>Value                    | MV<br>Ratio | Change<br>(bp) | \$ Change<br>in Market<br>Value | %<br>Change<br>in<br>Market<br>Value                    | MV<br>Ratio | Change<br>(bp) |
|                            | (Dollars in thousands)          |   |             |                |                                 |   |             |                |
| <b>Change<br/>in rates</b> |                                 |   |             |                |                                 |   |             |                |
| +200 bp                    | \$ 32,745                       | 21.3%   | 14.0%       | 247            | \$ 33,019                       | 16.5%   | 17.1%       | 241            |
| +100 bp                    | \$ 18,722                       | 12.2%   | 13.0%       | 141            | \$ 18,076                       | 9.0%  | 16.0%       | 132            |
| 0 bp                       | \$                              | 0.0%  | 11.6%       |                | \$                              | 0.0%  | 14.7%       |                |
| -100 bp                    | \$ (25,865)                     | -16.9%  | 9.6%        | (195)          | \$ (24,841)                     | -12.4%  | 12.8%       | (181)          |
| -200 bp                    | \$ (43,315)                     | -25.2%  | 8.3%        | (327)          | \$ (44,925)                     | -22.4%  | 11.4%       | (328)          |

Management believes that the MV methodology overcomes three shortcomings of the typical maturity gap methodology. First, it does not use arbitrary repricing intervals and accounts for all expected future cash flows. Second, because the MV method projects cash flows of each financial instrument under different interest rate environments, it can incorporate the effect of embedded options on an institution's interest rate risk exposure. Third, it allows interest rates on different

Table of Contents

instruments to change by varying amounts in response to a change in market interest rates, resulting in more accurate estimates of cash flows.

However, as with any method of gauging interest rate risk, there are certain shortcomings inherent to the MV methodology. 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 MV methodology 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, 2009. There are no changes to these policies as of September 30, 2010.

**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, 2010. 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, 2010, the period covered by this report on Form 10-Q.

During the nine months ended September 30, 2010, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to affect, our internal controls over financial reporting.

Table of Contents

**Part II OTHER INFORMATION**

**ITEM 1 LEGAL PROCEEDINGS**

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

**ITEM 1A RISK FACTORS**

In addition to the other information contained in this Report on Form 10-Q, the following significant risks may affect the Company and update the risk factors contained in Part I, Item A "Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2009. The risk factors identified below 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.

*We have a significant deferred tax asset and cannot assure that it will be fully realized.*

Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between the carrying amounts and tax basis of assets and liabilities computed using enacted tax rates. If we determine that we will not achieve sufficient future taxable income to realize our net deferred tax asset, we are required under generally accepted accounting principles to establish a full or partial valuation allowance. If we determine that a valuation allowance is necessary, we are required to incur a charge to operations. We regularly assess available positive and negative evidence to determine whether it is more likely than not that our net deferred tax asset will be realized. Realization of a deferred tax asset requires us to apply significant judgment and is inherently speculative because it requires estimates that cannot be made with certainty. At September 30, 2010, we had a net deferred tax asset of \$25.8 million. For the nine months ended September 30, 2010, we established a partial valuation allowance of \$3.7 million. If we were to determine at some point in the future that we will not achieve sufficient future taxable income to realize our net deferred tax asset, we would be required under generally accepted accounting principles to establish a full or increase our partial valuation allowance which would require us to incur a charge to operations for the period in which the determination was made.

*The Dodd-Frank Wall Street Reform and Consumer Protection Act may affect our business activities, financial position and profitability by increasing our regulatory compliance burden and associated costs, placing restrictions on certain products and services, and limiting our future capital raising strategies.*

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which implements significant changes in the financial regulatory landscape and will impact all financial institutions, including HCC and HBC. The Act is likely to increase our regulatory compliance burden. However, it is too early for us to fully assess the impact of the Act on our business, financial condition or results of operations in part because many of the Act's provisions require subsequent regulatory rulemaking.

Among the Act's significant regulatory changes, it creates a new financial consumer protection agency, known as the Bureau of Consumer Financial Protection (the "Bureau"), that is empowered to promulgate new consumer protection regulations and revise existing regulations in many areas of consumer compliance, which will increase our regulatory compliance burden and costs and may restrict the financial products and services we offer to our customers. Moreover, the Act permits states to adopt stricter consumer protection laws and state attorney generals may enforce consumer protection rules issued by the Bureau. The Act also imposes more stringent capital requirements on bank holding companies by, among other things, imposing leverage ratios on bank holding companies and prohibiting

Table of Contents

new trust preferred issuances from counting as Tier 1 capital. These restrictions will limit future capital strategies. Although we do not use derivative transactions, the Act also increases regulation of derivatives and hedging transactions, which could limit our ability in the future to enter into, or increase the costs associated with, interest rate and other hedging transactions.

Although certain provisions of the Act, such as direct supervision by the Bureau, will not apply to banking organizations with less than \$10 billion of assets, such as Heritage Commerce Corp and Heritage Bank of Commerce, the changes resulting from the legislation will impact our business. These changes will require us to invest significant management attention and resources to evaluate and make necessary changes.

*The recent agreements reached by the Basel Committee on Banking Supervision may result in the potential regulatory capital deduction of our deferred tax asset.*

On September 12, 2010, the Group of Governors and Heads of Supervisors of the Basel Committee on Banking Supervision, the oversight body of the Basel Committee, published its "calibrated" capital standards for major banking institutions ("Basel III"). Under these standards when fully phased in on January 1, 2019, banking institutions will be required to maintain heightened Tier 1 common equity, Tier 1 capital and total capital ratios, as well as maintaining a "capital conservation buffer." The Tier 1 common equity and Tier 1 capital ratio requirements will be phased in incrementally between January 1, 2013 and January 1, 2015. These standards provide for the capital reduction of certain assets including deferred tax assets. The deductions from common equity made in calculating Tier 1 common equity for deferred tax assets will be phased in incrementally over a four-year period commencing on January 1, 2014 with the full impact implemented by January 1, 2018. The final package of Basel III reforms will be considered by the G20 leaders, and then will be subject to individual adoption by member nations, including the United States. We will continue to monitor the development and potential impact of these standards and their implementation by United States regulatory authorities.

**ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None

**ITEM 3 DEFAULTS UPON SENIOR SECURITIES**

As of September 30, 2010, the Company has deferred four dividend payments on its Series A Preferred Stock totaling approximately \$2.3 million.

**ITEM 4 RESERVED**

**ITEM 5 OTHER INFORMATION**

None



Table of Contents

**ITEM 6 EXHIBITS**

| <b>Exhibit</b> | <b>Description</b>  |
|----------------|---|
| 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 16, 2009)   |
| 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 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 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  |

Table of Contents

**SIGNATURES**

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

|                        |  |
|------------------------|--|
|                        | Heritage Commerce Corp (Registrant)                    |
| Date: November 9, 2010 | <u>/s/ WALTER T. KACZMAREK</u>                         |
|                        | Walter T. Kaczmarek<br><i>Chief Executive Officer</i>  |
| Date: November 9, 2010 | <u>/s/ LAWRENCE D. MCGOVERN</u>                        |
|                        | Lawrence D. McGovern<br><i>Chief Financial Officer</i> |

Table of Contents

**EXHIBIT INDEX**

| <b>Exhibit</b> | <b>Description</b>   |
|----------------|--|
| 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 16, 2009)  |
| 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 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   |