

HERITAGE COMMERCE CORP  
Form 10-Q  
May 11, 2009

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

FORM 10-Q  
(MARK ONE)

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

For the quarterly period ended March 31, 2009

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-23877

Heritage Commerce Corp  
(Exact name of Registrant as Specified in its Charter)

California  
(State or Other Jurisdiction of Incorporation or  
Organization)

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

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

95113  
(Zip Code)

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

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

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

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act.  
(Check one): Large accelerated filer [ ] Accelerated filer [X] Non-accelerated filer [ ] 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 [X]

The Registrant had 11,820,509 shares of Common Stock outstanding on April 17, 2009.

---

---

---

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

|   | Page<br>No. |
|---|-------------|
| <b>PART I. FINANCIAL INFORMATION</b>  |             |
| Item 1. Consolidated Financial Statements (unaudited):  | <u>2</u>    |
| Consolidated Balance Sheets   | <u>2</u>    |
| Consolidated Income Statements  | <u>3</u>    |
| Consolidated Statements of Changes in Shareholders' Equity                                    | <u>4</u>    |
| Consolidated Statements of Cash Flows   | <u>5</u>    |
| Notes to Consolidated Financial Statements  | <u>6</u>    |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations | 9           |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk                            | 27          |
| Item 4. Controls and Procedures   | 28          |
| <b>PART II. OTHER INFORMATION</b>   |             |
| Item 1. Legal Proceedings   | 28          |
| Item 1A. Risk Factors   | 28          |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds                           | 28          |
| Item 3. Defaults Upon Senior Securities   | 28          |
| Item 4. Submission of Matters to a Vote of Security Holders                                   | 28          |
| Item 5. Other Information   | 28          |
| Item 6. Exhibits  | 29          |
| <b>SIGNATURES</b>   | 29          |
| <b>EXHIBIT INDEX</b>  | 30          |



## Part I -- FINANCIAL INFORMATION

## ITEM 1 - CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Heritage Commerce Corp  
Consolidated Balance Sheets (Unaudited)

|  | March 31,<br>2009      | December 31,<br>2008 |
|--|------------------------|----------------------|
|  | (Dollars in thousands) |                      |
| Assets   |                        |                      |
| Cash and due from banks  | \$ 30,720              | \$ 29,996            |
| Federal funds sold   | 100                    | 100                  |
| Total cash and cash equivalents  | 30,820                 | 30,096               |
| Securities available-for-sale, at fair value   | 97,340                 | 104,475              |
| Loans, net of deferred costs   | 1,210,571              | 1,248,631            |
| Allowance for loan losses  | (23,900)               | (25,007)             |
| Loans, net   | 1,186,671              | 1,223,624            |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost   | 8,276                  | 7,816                |
| Company owned life insurance   | 41,061                 | 40,649               |
| Premises and equipment, net  | 9,383                  | 9,517                |
| Goodwill   | 43,181                 | 43,181               |
| Intangible assets  | 4,071                  | 4,231                |
| Accrued interest receivable and other assets   | 39,940                 | 35,638               |
| Total assets   | \$ 1,460,743           | \$ 1,499,227         |
| Liabilities and Shareholders' Equity   |                        |                      |
| Liabilities:   |                        |                      |
| Deposits   |                        |                      |
| Demand, noninterest bearing  | \$ 254,823             | \$ 261,337           |
| Demand, interest bearing   | 133,183                | 134,814              |
| Savings and money market   | 358,848                | 344,767              |
| Time deposits, under \$100   | 46,078                 | 45,615               |
| Time deposits, \$100 and over  | 177,308                | 171,269              |
| Brokered time deposits   | 195,763                | 196,248              |
| Total deposits   | 1,166,003              | 1,154,050            |
| Notes payable to subsidiary grantor trusts   | 23,702                 | 23,702               |
| Securities sold under agreement to repurchase  | 30,000                 | 35,000               |
| Note payable   | -                      | 15,000               |
| Other short-term borrowings  | 32,000                 | 55,000               |
| Accrued interest payable and other liabilities   | 28,757                 | 32,208               |
| Total liabilities  | 1,280,462              | 1,314,960            |
| Shareholders' equity:  |                        |                      |
| Preferred stock, \$1,000 par value; 10,000,000 shares authorized; 40,000 shares outstanding (liquidation preference of \$1,000 per share plus accrued dividends) | 39,846                 | 39,846               |
| Discount on preferred stock  | (1,861)                | (1,946)              |
| Common stock, no par value; 30,000,000 shares authorized;  |                        |                      |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|   |              |              |
|---|--------------|--------------|
| 11,820,509 shares outstanding                 | 79,152       | 78,854       |
| Retained earnings                             | 63,028       | 67,804       |
| Accumulated other comprehensive income (loss) | 116          | (291)        |
| Total shareholders' equity                    | 180,281      | 184,267      |
| Total liabilities and shareholders' equity    | \$ 1,460,743 | \$ 1,499,227 |

See notes to consolidated financial statements

Heritage Commerce Corp  
Consolidated Income Statements (Unaudited)  
Three Months Ended  
March 31,

|   | 2009  | 2008      |
|---|---|-----------|
|   | (Dollars in thousands, except per share data) |           |
| Interest income:  |   |           |
| Loans, including fees                                     | \$ 15,030                                     | \$ 18,355 |
| Securities, taxable                                       | 994   | 1,477     |
| Securities, non-taxable                                   | 5   | 24        |
| Interest bearing deposits in other financial institutions | 4   | 7         |
| Federal funds sold  | -   | 32        |
| Total interest income                                     | 16,033  | 19,895    |
| Interest expense:   |   |           |
| Deposits  | 4,030   | 5,717     |
| Notes payable to subsidiary grantor trusts                | 500   | 557       |
| Repurchase agreements                                     | 243   | 156       |
| Note payable  | 82  | 9         |
| Other short-term borrowings                               | 26  | 352       |
| Total interest expense                                    | 4,881   | 6,791     |
| Net interest income before provision for loan losses      | 11,152  | 13,104    |
| Provision for loan losses                                 | 10,420  | 1,650     |
| Net interest income after provision for loan losses       | 732   | 11,454    |
| Noninterest income:                                       |   |           |
| Service charges and fees on deposit accounts              | 571   | 415       |
| Servicing income  | 420   | 479       |
| Increase in cash surrender value of life insurance        | 412   | 398       |
| Other   | 220   | 222       |
| Total noninterest income                                  | 1,623   | 1,514     |
| Noninterest expense:                                      |   |           |
| Salaries and employee benefits                            | 6,458   | 6,059     |
| Professional fees   | 913   | 665       |
| Occupancy   | 771   | 902       |
| Regulatory assessments                                    | 739   | 192       |
| Data processing   | 229   | 245       |
| Low income housing investment losses                      | 214   | 210       |
| Software subscription                                     | 196   | 209       |
| Amortization of intangible assets                         | 160   | 212       |
| Director fees   | 153   | 133       |
| Furniture and equipment                                   | 145   | 217       |
| Client services   | 145   | 224       |
| Advertising and promotion                                 | 118   | 180       |
| Other   | 1,121   | 1,132     |
| Total noninterest expense                                 | 11,362  | 10,580    |
| Income (loss) before income taxes                         | (9,007)                                       | 2,388     |
| Income tax expense (benefit)                              | (5,052)                                       | 684       |
| Net income (loss)   | (3,955)                                       | 1,704     |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|   |           |    |       |
|---|-----------|----|-------|
| Dividends and discount accretion on preferred stock   | (585)     |    | -     |
| Net income (loss) available to common shareholders \$ | (4,540)   | \$ | 1,704 |
| Earnings (loss) per common share:                     |           |    |       |
| Basic   | \$ (0.38) | \$ | 0.14  |
| Diluted   | \$ (0.38) | \$ | 0.14  |

See notes to consolidated financial statements



Heritage Commerce Corp  
Consolidated Statements of Shareholders' Equity (Unaudited)  
Three Months Ended March 31, 2009 and 2008

|   | Preferred Stock |          | Common Stock |           | Retained  | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total<br>Shareholder<br>Equity | Comprehensive<br>Income<br>(Loss) |
|---|-----------------|----------|--------------|-----------|-----------|---|--------------------------------|-----------------------------------|
|   | Amount          | Discount | Shares       | Amount    | Earnings  | (Loss)  |                                | (Loss)                            |
| Balance, January 1, 2008  | \$ -            | \$ -     | 12,774,926   | \$ 92,414 | \$ 73,298 | \$ (888)  | \$ 164,824                     |                                   |
| Cumulative effect adjustment upon adoption of EITF 06-4, net of deferred income taxes   | -               | -        | -            | -         | (3,182)   | -   | (3,182)                        |                                   |
| Net income  |                 |          |              | -         | 1,704     | -   | 1,704                          | \$ 1,704                          |
| Net change in unrealized gain on securities available-for-sale and interest-only-strips, net of reclassification adjustment and deferred income taxes | -               | -        | -            | -         | -         | 729   | 729                            | 729                               |
| Net increase in pension and other post retirement obligations, net of deferred income taxes   | -               | -        | -            | -         | -         | 14  | 14                             | 14                                |
| Total comprehensive income  |                 |          |              |           |           |   |                                | \$ 2,447                          |
| Amortization of restricted stock award  | -               | -        | -            | 38        | -         | -   | 38                             |                                   |
| Cash dividend declared on common stock, \$0.08 per share  | -               | -        | -            | -         | (1,023)   | -   | (1,023)                        |                                   |
| Common stock repurchased  | -               | -        | (613,362)    | (10,765)  | -         | -   | (10,765)                       |                                   |
| Stock option expense  | -               | -        | -            | 342       | -         | -   | 342                            |                                   |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|   |           |            |            |           |           |          |            |            |
|---|-----------|------------|------------|-----------|-----------|----------|------------|------------|
| Stock options exercised, including related tax benefits   | -         | -          | 8,782      | 91        | -         | -        | 91         |            |
| Balance, March 31, 2008   | \$ -      | \$ -       | 12,170,346 | \$ 82,120 | \$ 70,797 | \$ (145) | \$ 152,772 |            |
| Balance, January 1, 2009  | \$ 39,846 | \$ (1,946) | 11,820,509 | \$ 78,854 | \$ 67,804 | \$ (291) | \$ 184,267 |            |
| Net loss  | -         | -          | -          | -         | (3,955)   | -        | (3,955)    | \$ (3,955) |
| Net change in unrealized gain on securities available-for-sale and interest-only-strips, net of reclassification adjustment and deferred income tax | -         | -          | -          | -         | -         | 374      | 374        | 374        |
| Net increase in pension and other post retirement obligations, net of deferred income taxes   | -         | -          | -          | -         | -         | 33       | 33         | 33         |
| Total comprehensive loss  |           |            |            |           |           |          |            | \$ (3,548) |
| Amortization of restricted stock award  | -         | -          | -          | 38        | -         | -        | 38         |            |
| Cash dividends accrued on preferred stock   | -         | -          | -          | -         | (500)     | -        | (500)      |            |
| Accretion of discount on preferred stock  | -         | 85         | -          | -         | (85)      | -        | -          |            |
| Cash dividend declared on common stock, \$0.02 per share  | -         | -          | -          | -         | (236)     | -        | (236)      |            |
| Stock option expense  | -         | -          | -          | 332       | -         | -        | 332        |            |
| Income tax effect of restricted stock award vesting   | -         | -          | -          | (72)      | -         | -        | (72)       |            |
| Balance, March 31, 2009   | \$ 39,846 | \$ (1,861) | 11,820,509 | \$ 79,152 | \$ 63,028 | \$ 116   | \$ 180,281 |            |

See notes to consolidated financial statements



Heritage Commerce Corp  
Consolidated Statements of Cash Flows (Unaudited)

|  | ThreeMonths Ended<br>March 31, |           |
|--|--------------------------------|-----------|
|  | 2009                           | 2008      |
|  | (Dollars in thousands)         |           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                                |           |
| Net income (loss)  | \$ (3,955)                     | \$ 1,704  |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                                |           |
| Depreciation and amortization  | 199                            | 231       |
| Provision for loan losses  | 10,420                         | 1,650     |
| Stock option expense   | 332                            | 342       |
| Amortization of other intangible assets  | 160                            | 212       |
| Amortization of restricted stock award   | 38                             | 38        |
| Amortization (accretion) of discounts and premiums on securities                         | (40)                           | 67        |
| Gain on sale of foreclosed assets  | (35)                           | -         |
| Increase in cash surrender value of life insurance                                       | (412)                          | (398)     |
| Effect of changes in:  |                                |           |
| Accrued interest receivable and other assets   | (4,345)                        | 4,027     |
| Accrued interest payable and other liabilities   | (3,428)                        | (3,633)   |
| Net cash (used in) provided by operating activities                                      | (1,066)                        | 4,240     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                                |           |
| Net change in loans  | 26,056                         | (95,774)  |
| Purchases of securities available-for-sale   | -                              | (7,141)   |
| Maturities/Paydowns/Calls of securities available-for-sale                               | 7,711                          | 12,872    |
| Purchase of company-owned life insurance   | -                              | (361)     |
| Purchase of premises and equipment   | (65)                           | (116)     |
| Redemption (Purchase) of restricted stock and other investments                          | (460)                          | (138)     |
| Proceeds from sale of foreclosed assets  | 370                            | -         |
| Net cash (used in) provided by investing activities                                      | 33,612                         | (90,658)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                                |           |
| Net change in deposits   | 11,953                         | 107,478   |
| Exercise of stock options  | -                              | 91        |
| Income tax effect of restricted stock award vesting                                      | (72)                           | -         |
| Common stock repurchased   | -                              | (10,765)  |
| Payment of cash dividends - common stock   | (236)                          | (1,023)   |
| Payment of cash dividends - preferred stock  | (467)                          | -         |
| Net change in other short-term borrowings  | (23,000)                       | (50,000)  |
| Net change in note payable   | (15,000)                       | (5,000)   |
| Net change in securities sold under agreement to repurchase                              | (5,000)                        | 25,000    |
| Net cash (used in) provided by financing activities                                      | (31,822)                       | 65,781    |
| Net increase (decrease) in cash and cash equivalents                                     | 724                            | (20,637)  |
| Cash and cash equivalents, beginning of period   | 30,096                         | 49,093    |
| Cash and cash equivalents, end of period   | \$ 30,820                      | \$ 28,456 |

## Supplemental disclosures of cash flow information:

Cash paid during the period for:

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|   |    |       |    |       |
|---|----|-------|----|-------|
| Interest  | \$ | 5,196 | \$ | 7,057 |
| Income taxes  | \$ | 450   | \$ | -     |
| Supplemental schedule of non-cash investing and financing activities: |    |       |    |       |
| Loans transferred to foreclosed assets                                | \$ | 477   | \$ | -     |

See notes to consolidated financial statements

HERITAGE COMMERCE CORP  
Notes to Consolidated Financial Statements  
March 31, 2009  
(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 (“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, 2008. 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. On June 20, 2007, the Company completed its acquisition of Diablo Valley Bank (“DVB”). DVB was merged into HBC on the acquisition date.

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 accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ significantly from these estimates.

The results for the three months ended March 31, 2009 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2009.

#### Adoption of New Accounting Standards

In February 2008, the FASB issued Staff Position (“FSP”) 157-2, “Effective Date of FASB Statement No. 157.” This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Company adopted this accounting standard on January 1, 2009. On October 10, 2008 the FASB issued FSP 157-3, “Determining the Fair Value of a Financial Asset When the Market for that Asset Is Not Active,” which illustrates key considerations in determining the fair value of a financial asset when the market for that asset is not active. FSP 157-3 provides clarification for how to consider various inputs in determining fair value under current market conditions consistent with the principles of FAS 157. FSP 157-3 became effective upon issuance. Adoption of these FSPs has not impacted the Company.

In December 2007, FASB issued Statement 141 (revised 2007), "Business Combinations," which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. This Statement is effective for fiscal years beginning on or after December 15, 2008. Adoption of this standard will affect the Company's pending acquisition of two branch offices of Wachovia Bank, N.A., a subsidiary of Wells Fargo and Company, in that transaction costs such as legal and other professional fees will be charged to expenses as incurred, rather than included in the cost of the business acquired.

In December 2007, FASB issued Statement 160, "Noncontrolling Interests in Consolidated Financial Statements." This statement is intended to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This Statement is effective for fiscal years and interim periods within those fiscal years beginning on or after December 15, 2008. The adoption of this standard did not have a material impact on the Company's financial statements.

In March 2008, FASB issued Statement 161, "Disclosures about Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133." This statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption of this standard did not have a material impact on the Company's financial statements.

In June 2008, the FASB issued FASB Staff Position EITF 03-6-1—Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities. (FSP EITF 03-6-1). This FASB Staff Position (FSP) addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share (EPS) under the two-class method of FASB Statement No. 128, Earnings Per Share. FSP EITF 03-6-1 provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of EPS pursuant to the two-class method. This FSP was effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented were adjusted retrospectively to conform with the provisions of this FSP. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. Upon adoption of FSP EITF 03-6-1 in 2009, the Company began including non vested restricted stock award shares in the computation of basic EPS. Previously, non vested restricted stock awards were excluded from the basic EPS computation and included in the diluted EPS computation. The 2008 EPS data presented were adjusted retrospectively to conform with the provisions of this FSP, although this change in computation did not involve a sufficient number of shares to basic and diluted EPS from the first quarter of 2008.

#### Newly Issued, but not yet Effective Accounting Standards

In April 2009 the FASB issued FSP 115-2 & 124-2 Recognition and Presentation of Other Than Temporary Impairments. The FSP eliminates the requirement for the issuer to evaluate whether it has the intent and ability to hold an impaired investment until maturity. Conversely, the new FSP requires the issuer to recognize an other than temporary impairment (OTTI) in the event that the issuer intends to sell the impaired security or in the event that it is more likely than not that the issuer will sell the security prior to recovery. In the event that the sale of the security in question prior to its maturity is not probable but the entity does not expect to recover its amortized cost basis in that security, then the entity will be required to recognize an OTTI. In the event that the recovery of the security's cost basis prior to maturity is not probable and an OTTI is recognized, the FSP provides that any component of the OTTI relating to a decline in the creditworthiness of the debtor should be reflected in earnings, with the remainder being recognized in Other Comprehensive Income. Conversely, in the event that the issuer determines that sale of the security in question prior to recovery is probable, then the entire OTTI will be recognized in earnings. The FSP is effective for interim and annual reporting periods ending after June 15, 2009. The Company does not expect adoption to have a material impact on the Company's financial statements.

In April 2009 the FASB issued FSP 157-4 Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly. The FSP provides additional guidance for determining fair value based on observable transactions. The FSP provides that if evidence suggests that an observable transaction was not executed orderly that little, if any, weight should be assigned to this indication of an asset's or liability's fair value. Conversely, if evidence suggests that the observable transaction was executed orderly then the transaction price of the observable transaction may be appropriate to use in determining the fair value of the asset/liability in question, with appropriate weighting given to this indication based on facts and circumstances. Finally, if there is no way for the entity to determine whether the observable transaction was executed orderly, relatively less weight should be ascribed to this indicator of fair value. The FSP is effective for interim and annual reporting periods ending after June 15, 2009. The Company does not expect adoption to have a material impact on the Company's financial statements.

In April 2009 the FASB issued FSP 107-1 & APB 28-1 Interim Disclosures about Fair Value of Financial Instruments. The FSP provides that publicly traded companies shall provide information concerning the fair value of its financial instruments whenever it issues summarized financial information for interim reporting periods. In periods after initial adoption this FSP requires comparative disclosures only for periods ending after initial adoption. The FSP is effective for interim reporting periods ending after June 15, 2009.

2)

Earnings Per Share



Basic earnings (loss) per share is computed by dividing net income (loss) less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. Diluted earnings (loss) per share reflects potential dilution from outstanding stock options and common stock warrants, using the treasury stock method. Due to the Company's net loss in 2009, all stock options and warrants were excluded from the computation of diluted earnings (loss) per share. There were 762,341 stock options for three months ended March 31, 2008, considered to be antidilutive and excluded from the computation of diluted earnings (loss) per share. For each of the periods presented, net income (loss) is the same for basic and diluted earnings (loss) per share. Reconciliation of weighted average shares used in computing basic and diluted earnings (loss) per share is as follows:

|   | Three Months Ended |            |
|---|--------------------|------------|
|   | 2009               | 2008       |
| Weighted average common shares<br>outstanding - used<br>in computing basic earnings (loss)<br>per share | 11,820,509         | 12,481,141 |
| Dilutive effect of stock options and<br>warrants outstanding,<br>using the treasury stock method        | -                  | 65,203     |
| Shares used in computing diluted<br>earnings (loss) per share   | 11,820,509         | 12,546,344 |

## 3) Supplemental Retirement Plan

The Company has a supplemental retirement 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 three months ended March 31, 2009 and 2008:

|  | Three Months Ended<br>March 31, |        |
|--|---------------------------------|--------|
|  | 2009                            | 2008   |
| (Dollars in thousands)                         |                                 |        |
| Components of net<br>periodic benefits<br>cost |                                 |        |
| Service cost                                   | \$ 241                          | \$ 203 |
| Interest cost                                  | 191                             | 182    |
| Prior service cost                             | 9                               | 9      |
| Amortization of<br>loss                        | 48                              | 14     |
| Net periodic cost                              | \$ 489                          | \$ 408 |

## 4 Fair Value

Statement 157 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.

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' relationship to other benchmark quoted securities (Level 2 inputs).

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

## Assets and Liabilities Measured on a Recurring Basis

|  | Fair Value Measurements Using |                                    |                             |
|--|-------------------------------|------------------------------------|-----------------------------|
|  | Quoted Prices in              | Significant<br>Other<br>Observable | Significant<br>Unobservable |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|                               | Balance    | Active Markets<br>for<br>Identical Assets<br>(Level 1)<br>(Dollars in thousands) | Inputs<br>(Level 2) | Inputs<br>(Level 3) |
|-------------------------------|------------|--|---------------------|---------------------|
| Assets:                       |            |  |                     |                     |
| March 31, 2009                |            |  |                     |                     |
| Available for sale securities | \$ 97,340  | \$ 15,491  | \$ 81,849           | \$ -                |
| I/O strip receivables         | \$ 2,283   | \$ -   | \$ 2,283            | \$ -                |
| December 31, 2008             |            |  |                     |                     |
| Available for sale securities | \$ 104,475 | \$ 19,496  | \$ 84,979           | \$ -                |
| I/O strip receivables         | \$ 2,248   | \$ -   | \$ 2,248            | \$ -                |

8

---

## Assets and Liabilities Measured on a Recurring Basis

|                   | Balance   | Fair Value Measurements Using Significant   |   |  |
|-------------------|-----------|---|---|--|
|                   |           | Quoted Prices<br>in<br>Active Markets<br>for<br>Identical Assets<br>(Level 1)<br>(Dollars in thousands) | Other<br>Obeservable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets:           |           |   |   |  |
| March 31 ,2009    |           |   |   |  |
| Impaired loans    | \$ 54,715 | \$ -  | \$ 54,715                                   | \$ -   |
| December 31, 2008 |           |   |   |  |
| Impaired loans    | \$ 40,224 | \$ -  | \$ 40,224                                   | \$ -   |

Impaired loans, which are measured primarily for impairment using the fair value of the collateral were \$62.7 million, with an allowance for loan losses of \$8.0 million at March 31, 2009, compared to loans of \$46.7 million, with an allowance for loan losses of \$6.5 million at December 31, 2008, resulting in a provision for loan losses of \$1.5 million for the quarter ended March 31, 2009.

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

Discussions of certain matters in this Report on Form 10-Q may constitute forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and as such, may involve risks and uncertainties. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies, and expectations, are generally identifiable by the use of words such as "believe", "expect", "intend", "anticipate", "estimate", "project", "assume", "plan", "p", "forecast" or similar expressions. These forward-looking statements relate to, among other things, expectations of the business environment in which the Company operates, projections of future performance, potential future performance, potential future credit experience, perceived opportunities in the market, and statements regarding the Company's mission and vision. The Company's actual results, performance, and achievements may differ materially from the results, performance, and achievements expressed or implied in such forward-looking statements due to a wide range of factors. These factors include (1) difficult and adverse conditions in the global and domestic capital and credit markets, (2) continued volatility and further deterioration of the capital and credit markets, (3) significant changes in banking laws or regulations, including, without limitation, as a result of the Emergency Economic Stabilization Act, the American Reinvestment and Recovery Act, and possible amendments to the Troubled Asset Relief Program (TARP), including the Capital Purchase Program and related executive compensation requirements, (4) continued uncertainty about the impact of TARP and other recent federal programs on the financial markets including levels of volatility and credit availability, (5) a more adverse than expected decline or continued weakness in general business and economic conditions, either nationally, regionally or locally in areas where the Company conducts its business, which may affect, among other things, the level of nonperforming assets, charge-offs and provision expense, (6) changes in interest rates, reducing interest rate margins or increasing interest rate risks, (7) changes in market liquidity which may reduce interest margins and impact funding sources, (8) increased competition in the Company's markets, (9) changes in the financial performance and/or condition of the Company's borrowers, (10) current and further deterioration in the housing and commercial real estate markets particularly in California, and (11) increases in Federal Deposit Insurance Corporation premiums due to market developments and regulatory changes. In addition, acts and threats of terrorism or the impact of military conflicts have increased the uncertainty related to the national and California economic outlook and could have an effect on the future operations of the

Company or its customers, including borrowers. See “Item 1A – Risk Factors” in this Report on Form 10-Q and in “Item 1A- Risk Factors” in our Annual Report on Form 10-K for the Year ended December 31, 2008 for further discussions of factors that could cause actual results to differ from forward looking statements. The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

#### 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.

### First Quarter Developments

- Since the November 2008 sale of \$40 million in preferred shares to the U.S. Department of the Treasury's through its Capital Purchase Program, the Company has made \$66.0 million in new loan commitments and \$126.4 million in renewed loan commitments through March 31, 2009. Of those, \$34.4 million in new loan commitments and \$80.4 million in renewed loan commitments were made during the first quarter of 2009.
- Capital ratios exceed regulatory well-capitalized standards, including a consolidated leverage ratio of 10.4% at March 31, 2009.
- Total assets were \$1.46 billion, an increase of 3% from March 31, 2008 and a 3% decrease from December 31, 2008.
- Loans increased 7% to \$1.21 billion from \$1.13 billion a year ago, but decreased from \$1.25 billion at December 31, 2008.
- Reflecting the difficult economic environment, nonperforming assets increased to \$56.9 million, or 3.89% of total assets. Consequently, the provision for loan losses was \$10.4 million in the first quarter of 2009.
- Heritage Bank of Commerce signed an agreement to purchase the deposits of Wachovia Bank branches in Santa Cruz and Monterey, California. At December 31, 2008, the deposits at the two branches were approximately \$463 million. No loans will be purchased as part of the transaction, which is subject to bank regulatory approval and customary closing conditions and is expected to close during the third quarter of 2009.
- In the first quarter of 2006, Heritage Commerce Corp commenced the payment of cash dividends to common stock shareholders. Although the Company remains "well-capitalized" as of March 31, 2009, the Board of Directors has approved a suspension of the payment of cash dividends in view of its desire to preserve the capital of the Company to support its banking activities in the markets it serves during this challenging economy. The Board of Directors will periodically review its position throughout 2009 and into 2010.

### Performance Overview

For the three months ended March 31, 2009, net loss was \$4.0 million. Net loss available to common shareholders was \$4.5 million, or \$(0.38) per diluted common share for the first quarter ended March 31, 2009, which included a \$10.4 million provision for loan losses and \$585,000 in dividends and discount accretion on preferred stock. In the quarter ended March 31, 2008, net income was \$1.7 million, or \$0.14 per diluted common share, including a provision of \$1.7 million and no dividends or discount accretion on preferred stock. The Company's return on average assets was -1.08% and return on average equity was -8.65% for the first quarter of 2009 compared to 0.50% and 4.33% a year ago.

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

- Net interest income decreased 15% to \$11.2 million in the first quarter of 2009 from \$13.1 million in the first quarter of 2008, primarily due to a decrease in market interest rates.
- Net interest margin was 3.35%, compared with 4.32% for the first quarter a year ago, and 3.64% for the fourth quarter of 2008. Reversals of accrued interest on loans placed on nonaccrual status totaled \$428,000 in the first quarter of 2009, reducing net interest margin by 13 basis points.
- Provision for loan losses increased to \$10.4 million for the first quarter of 2009, compared to \$1.7 million in the first quarter of 2008, primarily due to the increase in nonperforming loans.

- Noninterest income increased 7% to \$1.6 million in the first quarter of 2009 from \$1.5 million in the first quarter of 2008, primarily due to increased service charges on deposit accounts.
- The efficiency ratio was 88.9% in the first quarter of 2009, compared to 72.4% in the first quarter of 2008, primarily due to a lower net interest margin and higher noninterest expense.
- The income tax benefit for the quarter ended March 31, 2009 was \$5.1 million, as compared to income tax expense of \$684,000 in the first quarter of 2008. The negative effective income tax rate for the quarter ended March 31, 2009 was due to reduced pre-tax earnings.

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

- Total assets increased \$45 million, or 3%, to \$1.46 billion at March 31, 2009 from \$1.41 billion at March 31, 2008, primarily due to loans and deposits generated by additional relationship managers hired in the past year, and a new office in Walnut Creek.
- Total loans increased \$80 million, or 7%, at March 31, 2009 compared to \$1.13 billion at March 31, 2008, but decreased from \$1.25 billion at December 31, 2008.
- Total deposits remained the same at \$1.2 billion at March 31, 2009, compared to March 31, 2008, and increased from \$1.15 billion at December 31, 2008.
- The Company's noncore funding (which consists of time deposits \$100,000 and over, brokered deposits, securities under agreement to repurchase, notes payable and other short-term borrowings) to total assets ratio was 30% at March 31, 2009, compared to 19% at March 31, 2008, and 32% at December 31, 2008.
- The Company's loan to deposit ratio was 104% at March 31, 2009, compared to 97% at March 31, 2008, and 108% at December 31, 2008.

## 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 \$195.8 million in brokered deposits at March 31, 2009. The increase in brokered deposits of \$129.9 million from March 31, 2008 was primarily to fund loan growth. The Company also seeks deposits from title insurance companies, escrow accounts and real estate exchange facilitators, which were \$40.4 million at March 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 for the first quarter of 2009 remained the same at \$1.2 billion, compared to the first quarter of 2008. The Company has not experienced any increased demand outside its ordinary course of business from its customers to withdraw deposits as a result of recent developments in the financial institution industry.

## 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 2009. As of March 31, 2009, we had \$31 million in cash and cash equivalents and approximately \$332.5 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.

## Lending

Our lending business originates primarily through our branch offices located in our primary market. The economy in our primary service area has weakened throughout 2008 and the first quarter of 2009, causing the Company to experience loan contraction in the first quarter of 2009. Commercial and land and construction loans decreased from December 31, 2008, as a result of the weakening economy. We will continue to use and improve existing products to expand market share at current locations. Total loans increased to \$1.2 billion at March 31, 2009 compared to \$1.1 billion at March 31, 2008.

## 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 scenario.

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 September 18, 2007 through December 16, 2008, the Board of Governors of the Federal Reserve System reduced short-term interest rates by 500 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. The rapid, substantial drop in the short-term interest rates, including the prime rate, has significantly compressed the Company's net interest margin.

#### Management of Credit Risk

Because of our focus on business banking, loans to single borrowing entities are often larger than would be found in a more consumer oriented bank with many smaller, more homogeneous loans. The average size of our loan relationships makes the Company more susceptible to larger losses. As a result of this concentration of larger risks, the Company has maintained an allowance for loan losses which is higher than might be indicated by its actual historic loss experience. In setting the loan loss allowance, management takes into consideration many factors including loan growth, changes in the composition of the loan portfolio, the general economic condition in the Company's market area, and the impact on the industrial sectors the Company services, as well as management's overall assessment of the quality of the loan portfolio and the lending staff and managers who service the portfolio. A complete 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. 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. However, beginning in the third quarter of 2007, the Company decided to change its strategy regarding its SBA loan business. The Company now retains most of its SBA production, which allows us to generate more interest income rather than noninterest income. Other sources of noninterest income include the increase in cash surrender value of life insurance and service charges on deposits. Noninterest income will continue to be affected by the Company's strategic decision to retain rather than sell its loans.

## Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company's performance. Over the last three years the Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. Nonetheless, noninterest expense increased in the first quarter of 2009 compared to the first quarter of 2008, due to lower deferred cost related to lower loan volume, severance pay resulting from a reduction in the number of full-time equivalent employees, increased professional fees due to problem loan expense and the pending acquisition of two branch offices, and a substantial increase in FDIC insurance costs. Management monitors progress in reducing noninterest expense through review of the Company's efficiency ratio. The Company's efficiency ratio was 88.9% in the first quarter of 2009 compared with 72.4% in the first quarter of 2008. The efficiency ratio increased in 2009 primarily due to compression of the Company's net interest margin and higher noninterest expense.

## Capital Management and Share Repurchases

Heritage Commerce Corp and Heritage Bank of Commerce meet the regulatory definition of "well-capitalized" at March 31, 2009. 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.

Our capital position has been considerably strengthened. As of March 31, 2009, our consolidated total risk-based capital ratio was 12.7%, or \$165.1 million, more than the 10% regulatory requirement for well-capitalized banks. Our Tier 1 risk-based capital ratio of 11.4% and our Tier 1 leverage ratio of 10.4% as of March 31, 2009 also significantly exceeded regulatory guidelines for well-capitalized banks. On November 21, 2008, the Company issued to the U.S. Treasury under its Capital Purchase Program 40,000 shares of Series A Preferred Stock and warrants to purchase 462,963 shares of common stock at an exercise price of \$12.96 for \$40 million. The terms of the U.S. Treasury TARP Capital Purchase Program could reduce investment returns to our shareholders by restricting dividends to common shareholders, diluting existing shareholders' interests, and restricting capital management practices.

In July, 2007, the board of directors authorized the repurchase of up to \$30 million of common stock through July, 2009. From August 13, 2007 through May 27, 2008, the Company purchased 1,645,607 shares for a total of \$29.9 million to complete the repurchase plan.

Starting in 2006, the Company initiated the payment of quarterly cash dividends. The Company paid cash dividends of \$3.8 million or \$0.32 per common share in 2008 representing 217% of 2008 earnings. The Company accrued \$500,000 of dividends in the first quarter of 2009 on the preferred stock issued to the U.S. Treasury under the TARP Capital Purchase Program. However, to preserve the capital of the Company in support of its banking activities during this challenging economy, the Board of Directors suspended common stock dividends, beginning in the second quarter of 2009.

## 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 loan servicing fees, customer service charges and fees, and Company-owned life insurance income. 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

In the first quarter of 2009, net interest income was \$11.2 million, compared to \$13.1 million in the first quarter of 2008. 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.

12

---

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Distribution, Rate and Yield

|  | For the Three Months Ended<br>March 31, 2009 |                                |                           | For the Three Months Ended<br>March 31, 2008 |                                |                           |
|--|--|--------------------------------|---------------------------|--|--------------------------------|---------------------------|
|  | 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 |
| NET INTEREST INCOME AND<br>NET INTEREST MARGIN<br>(Dollars in thousands) |  |                                |                           |  |                                |                           |
| Assets:  |  |                                |                           |  |                                |                           |
| Loans, gross   | \$ 1,236,361                                 | \$ 15,030                      | 4.93%                     | \$ 1,075,605                                 | \$ 18,355                      | 6.86%                     |
| Securities   | 110,169                                      | 999                            | 3.68%                     | 137,810                                      | 1,501                          | 4.38%                     |
| Interest bearing deposits in other<br>financial institutions             | 5,215  | 4                              | 0.31%                     | 1,065  | 7                              | 2.64%                     |
| Federal funds sold   | 176  | -                              | 0.00%                     | 4,408  | 32                             | 2.92%                     |
| Total interest earning assets  | 1,351,921                                    | 16,033                         | 4.81%                     | 1,218,888                                    | 19,895                         | 6.56%                     |
| Cash and due from banks  | 24,481                                       |                                |                           | 38,559                                       |                                |                           |
| Premises and equipment, net  | 9,468  |                                |                           | 9,272  |                                |                           |
| Goodwill and other intangible assets                                     | 47,349                                       |                                |                           | 48,084                                       |                                |                           |
| Other assets   | 51,325                                       |                                |                           | 61,414                                       |                                |                           |
| Total assets   | \$ 1,484,544                                 |                                |                           | \$ 1,376,217                                 |                                |                           |
| Liabilities and shareholders' equity:                                    |  |                                |                           |  |                                |                           |
| Deposits:  |  |                                |                           |  |                                |                           |
| Demand, interest bearing   | \$ 136,317                                   | 99                             | 0.29%                     | \$ 148,469                                   | 601                            | 1.63%                     |
| Savings and money market   | 346,857                                      | 792                            | 0.93%                     | 476,592                                      | 2,889                          | 2.44%                     |
| Time deposits, under \$100   | 46,108                                       | 296                            | 2.60%                     | 34,625                                       | 320                            | 3.72%                     |
| Time deposits, \$100 and over  | 176,837                                      | 874                            | 2.00%                     | 146,732                                      | 1,389                          | 3.81%                     |
| Brokered time deposits   | 203,952                                      | 1,969                          | 3.92%                     | 47,115                                       | 518                            | 4.42%                     |
| Notes payable to subsidiary grantor<br>trusts                            | 23,702                                       | 500                            | 8.56%                     | 23,702                                       | 557                            | 9.45%                     |
| Securities sold under agreement to<br>repurchase                         | 32,722                                       | 243                            | 3.01%                     | 22,164                                       | 156                            | 2.83%                     |
| Note payable   | 10,278                                       | 82                             | 3.24%                     | 1,154  | 9                              | 3.14%                     |
| Other short-term borrowings  | 39,622                                       | 26                             | 0.27%                     | 39,945                                       | 352                            | 3.54%                     |
| Total interest bearing liabilities                                       | 1,016,395                                    | 4,881                          | 1.95%                     | 940,498                                      | 6,791                          | 2.90%                     |
| Demand, noninterest bearing  | 253,481                                      |                                |                           | 249,173                                      |                                |                           |
| Other liabilities  | 29,244                                       |                                |                           | 28,118                                       |                                |                           |
| Total liabilities  | 1,299,120                                    |                                |                           | 1,217,789                                    |                                |                           |
| Shareholders' equity   | 185,424                                      |                                |                           | 158,428                                      |                                |                           |
| Total liabilities and shareholders'<br>equity                            | \$ 1,484,544                                 |                                |                           | \$ 1,376,217                                 |                                |                           |
| Net interest income / margin   |  | \$ 11,152                      | 3.35%                     |  | \$ 13,104                      | 4.32%                     |

Note: Yields and amounts earned on loans include loan fees and costs. Nonaccrual loans are included in the average balance calculation above.

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

to the increase or decrease in the average balance times the prior period rate, and rate variances are equal to the increase or decrease in the average rate times the prior period average balance. Variances attributable to both rate and volume changes are equal to the change in rate times the change in average balance and are included below in the average volume column.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Volume and Rate Variances

|   | For the Three Months Ended March 31,<br>2009 vs. 2008 |                 |               |
|---|---|-----------------|---------------|
|   | Increase (Decrease) Due to Change In:                 |                 |               |
|   | Average<br>Volume                                     | Average<br>Rate | Net<br>Change |
|   | (Dollars in thousands)                                |                 |               |
| Income from the interest earning assets:                  |   |                 |               |
| Loans, gross  | \$ 1,955  | \$ (5,280)      | \$ (3,325)    |
| Securities  | (251)   | (251)           | (502)         |
| Interest bearing deposits in other financial institutions | (3)   | (6)             | (3)           |
| Federal funds sold  | -   | (32)            | (32)          |
| Total interest income from interest earnings assets       | \$ 1,706  | \$ (5,568)      | \$ (3,862)    |
| Expense from the interest bearing liabilities:            |   |                 |               |
| Demand, interest bearing                                  | \$ (7)  | \$ (495)        | \$ (502)      |
| Savings and money market                                  | (301)   | (1,796)         | (2,097)       |
| Time deposits, under \$100                                | 74  | (98)            | (24)          |
| Time deposits, \$100 and over                             | 150   | (665)           | (515)         |
| Brokered time deposits                                    | 1,514   | (63)            | 1,451         |
| Notes payable to subsidiary grantor trusts                | -   | (57)            | (57)          |
| Securities sold under agreement to repurchase             | 79  | 8               | 87            |
| Note payable  | 73  | -               | 73            |
| Other short-term borrowings                               | (1)   | (325)           | (326)         |
| Total interest expense on interest bearing liabilities    | \$ 1,581  | \$ (3,490)      | \$ (1,910)    |
| Net interest income                                       | \$ 126  | \$ (2,078)      | \$ (1,952)    |

The Company's net interest margin, expressed as a percentage of average earning assets, was 3.35% in the first quarter of 2009 compared to 4.32% in the first quarter of 2008. 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. The prime rate and the Federal Reserve's federal funds target rate decreased 200 basis points from March 31, 2008. The average prime rate during the first quarters of 2009 and 2008 were 3.25% and 6.22%, respectively. Reversals of interest income on loans placed on nonaccrual status totaled \$428,000 in the first quarter of 2009, reducing net interest margin by 13 basis points.

Net interest income for 2009 decreased \$1.9 million, or 15% from first quarter of 2008. The decrease in 2009 was primarily due to the variable rate loan yields decreasing by 193 basis points while the cost of total interest-bearing liabilities only decreased by 95 basis points. Average interest earning assets increased 11% in the first quarter of 2009 from the first quarter of 2008. Average loans outstanding increased \$161 million in the first quarter of 2009 over the average in the first quarter of 2008. Average Federal funds sold decreased \$4.2 million in the first quarter of 2009 from the first quarter of 2008. Average interest bearing liabilities increased 8% in the first quarter of 2009 from the first quarter of 2008. The Company's average rate paid on interest bearing liabilities decreased to 1.95% in the first quarter of 2009 from 2.90% in the first quarter of 2008.

Provision for Loan Losses

Credit risk is inherent in the business of making loans. The Company sets aside an allowance for loan losses through charges to earnings, which are shown in the income statement as the provision for loan losses. Specifically identifiable and quantifiable losses are immediately charged off against the allowance. The loan loss provision 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 loan loss provision 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.

In the first quarter of 2009, the Company had a provision for loan losses of \$10.4 million compared to \$1.7 million in the first quarter of 2008. The increase in the provision for loan losses was primarily due to a \$15.8 million increase in nonperforming assets in the first quarter of 2009. The provision for loan losses in the first quarter of 2009 included loss allocations for a commercial loan, a construction loan and a real estate development loan. The total loss allocation for these three loans was \$4.5 million. The allowance for loan losses represented 1.97%, and 1.19% of total loans at March 31, 2009 and 2008, respectively. See additional discussion under the caption "Allowance for Loan Losses."

## Noninterest Income

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

|  | For the Three Months   |          | Increase (decrease) |         |
|--|------------------------|----------|---------------------|---------|
|  | Ended                  |          | 2009 versus 2008    |         |
|  | March 31,              |          | Amount              | Percent |
|  | 2009                   | 2008     |                     |         |
|  | (Dollars in thousands) |          |                     |         |
| Service charges and fees on deposit accounts       | \$ 571                 | \$ 415   | \$ 156              | 38%     |
| Servicing income                                   | 420                    | 479      | (59)                | -12%    |
| Increase in cash surrender value of life insurance | 412                    | 398      | 14                  | 4%      |
| Other  | 220                    | 222      | (2)                 | -1%     |
| Total noninterest income                           | \$ 1,623               | \$ 1,514 | \$ 110              | 7%      |

Service charges and fees on deposit accounts were higher in the first quarter of 2009 compared to 2008, due to fewer waived fees and higher fees from accounts that are service charged by analysis of services provided less an earnings credit on the account balance as a result of lower interest rates. Lower interest rates generally result in lower earnings credits and higher net fees for services provided to clients.

Historically, a significant percentage of the Company's noninterest income has been associated with its SBA lending activity, as gain on the sale of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. However, beginning in the third quarter of 2007, the Company changed its strategy regarding its SBA loan business by retaining new SBA production in lieu of selling the loans. Reflecting the strategic shift to retain SBA loan production, there were no gains from sales of loans in 2009 or 2008.

The servicing assets that resulted 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 will continue to decline as the respective loans are repaid. This reduction in noninterest income should be offset with higher interest income, as a result of retaining SBA loan production.

The increase in cash surrender value of life insurance approximates a 4.11% tax exempt yield on the policies. To realize this tax advantaged yield, the policies must be held until death of the insured individuals, who are current and former officers and directors of the Company.

## Noninterest Expense

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

|                                | For the Three Months   |          | Increase (decrease) |         |
|--------------------------------|------------------------|----------|---------------------|---------|
|                                | Ended                  |          | 2009 versus 2008    |         |
|                                | March 31,              |          | Amount              | Percent |
|                                | 2009                   | 2008     |                     |         |
|                                | (Dollars in thousands) |          |                     |         |
| Salaries and employee benefits | \$ 6,458               | \$ 6,059 | \$ 399              | 7%      |
| Professional fees              | 913                    | 665      | 248                 | 37%     |
| Occupancy                      | 771                    | 902      | (131)               | -15%    |
| Regulatory assessments         | 739                    | 192      | 547                 | 285%    |



Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|                                      |           |           |        |      |
|--------------------------------------|-----------|-----------|--------|------|
| Data processing                      | 229       | 245       | (16)   | -7%  |
| Low income housing investment losses | 214       | 210       | 4      | 2%   |
| Software subscription                | 196       | 209       | (13)   | -6%  |
| Amortization of intangible assets    | 160       | 212       | (52)   | -25% |
| Director fees                        | 153       | 133       | 20     | 15%  |
| Furniture and equipment              | 145       | 217       | (72)   | -33% |
| Client services                      | 145       | 224       | (79)   | -35% |
| Advertising and promotion            | 118       | 180       | (62)   | -34% |
| Other                                | 1,121     | 1,132     | (11)   | -1%  |
| Total noninterest expense            | \$ 11,362 | \$ 10,580 | \$ 782 | 7%   |

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

|   | For The Three Months Ended March 31, |   |           |                     |
|---|--------------------------------------|---|-----------|---------------------|
|   | 2009                                 | Percent<br>of Total<br>(Dollars in thousands) | 2008      | Percent<br>of Total |
| Salaries and employee benefits          | \$ 6,458                             | 57%   | \$ 6,059  | 57%                 |
| Professional fees                       | 913                                  | 8%  | 665       | 6%                  |
| Occupancy                               | 771                                  | 7%  | 902       | 9%                  |
| Regulatory assessments                  | 739                                  | 7%  | 192       | 2%                  |
| Data processing                         | 229                                  | 2%  | 245       | 2%                  |
| Low income housing investment<br>losses | 214                                  | 2%  | 210       | 2%                  |
| Software subscription                   | 196                                  | 2%  | 209       | 2%                  |
| Amortization of intangible assets       | 160                                  | 1%  | 212       | 2%                  |
| Director fees                           | 153                                  | 1%  | 133       | 1%                  |
| Furniture and equipment                 | 145                                  | 1%  | 217       | 2%                  |
| Client services                         | 145                                  | 1%  | 224       | 2%                  |
| Advertising and promotion               | 118                                  | 1%  | 180       | 2%                  |
| Other                                   | 1,121                                | 10%   | 1,132     | 11%                 |
| Total noninterest expense               | \$ 11,362                            | 100%  | \$ 10,580 | 100%                |

Salaries and employee benefits, the single largest component of noninterest expense, increased \$399,000 for the three months ended March 31, 2009 from the same period in 2008. The increase was primarily attributable to higher severance expense and less capitalized loan origination costs in the first quarter of 2009. Compensation costs related to successful loan originations are deferred and amortized over the lives of the respective loans as a yield adjustment. Compensation capitalized as loan origination costs was \$642,000 and \$1,128,000 in the first quarter of 2009 and 2008, respectively, reflecting substantially less new loan volume in 2009. Full-time equivalent employees were 220 and 229 at March 31, 2009 and 2008, respectively. Employee severance expense was \$397,000 in the first quarter of 2009 compared to \$5,000 in the first quarter of 2008.

Occupancy, furniture and equipment decreased \$203,000 in the first quarter of 2009, compared to the first quarter of 2008 primarily due to the consolidation of our two offices in Los Altos in the third quarter of 2008.

Professional fees increased to \$248,000 for the three months ended March 31, 2009 from the same period in 2008. The increase in professional fees were due to higher legal fees related to the pending acquisition of the two Wachovia branches and the increase in nonperforming assets. Regulatory assessments increased \$547,000 for the three months ended March 31, 2009 from the same period in 2008, primarily due to \$542,000 of increased FDIC insurance premiums.

Client services decreased \$79,000 in the first quarter of 2009, compared to the first quarter of 2008 primarily due to a reduction in deposit balances for these accounts. Advertising and promotion decreased \$62,000 in the first quarter of 2009, compared to the first quarter of 2008 as result of management's effort to control costs.

#### 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 in the first quarter of 2009 was \$5.1 million, as compared to its income tax expense of \$684,000 in the first quarter of 2008. The negative effective income tax rate for the quarter ended March 31, 2009 was primarily due to the pre-tax loss. The effective income tax rates for the first quarter of 2009 and 2008 were (56.1%) and 28.6%, respectively. 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, tax credits related to investments in low income housing limited partnerships and investments in tax-free municipal loans and securities. The effective tax rate in the first quarter of 2009 is lower compared to the first quarter of 2008 because pre-tax income decreased substantially while benefits from tax advantaged investments did not.

Tax-exempt interest income is generated primarily by the Company's investments in state, county and municipal loans and securities, which provided \$78,000 and \$53,000 in federal tax-exempt income in the first quarter of 2009 and 2008, respectively. Although not reflected in the investment portfolio, the Company also has total investments of \$6.2 million in low-income housing limited partnerships as of March 31, 2009. These investments have generated annual tax credits of approximately \$1.1 million in each of the years ended December 31, 2008 and 2007. The investments are expected to generate an additional \$5.2 million in aggregate tax credits from 2009 through 2016; however, the amount of the credits are dependent upon the occupancy level of the housing projects and income of the tenants and cannot be projected with certainty.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles. These temporary differences comprise the “deferred” portion of the Company’s tax expense, which is accumulated on the Company’s books as a deferred tax asset or deferred tax liability until such time as they reverse. As of March 31, 2009, the Company had a net deferred tax asset of approximately \$17.8 million.

FINANCIAL CONDITION

As of March 31, 2009, total assets were \$1.46 billion, compared to \$1.41 billion as of March 31, 2008. Total securities available-for-sale (at fair value) were \$97.3 million, a decrease of 26% from \$131 million the year before. The total loan portfolio was \$1.21 billion, an increase of 7% from \$1.13 billion at March 31, 2008. Total deposits remained constant at \$1.17 billion. Securities sold under agreement to repurchase decreased \$5.9 million, or 16%, to \$30 million at March 31, 2009, from \$35.9 million at March 31, 2008.

Securities Portfolio

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

|   | March 31,<br>2009      |            | December 31,<br>2008 |  |
|---|------------------------|------------|----------------------|--|
|   | (Dollars in thousands) |            |                      |  |
| Securities available-for-sale (at fair value) |                        |            |                      |  |
| U.S. Treasury                                 | \$ 15,491              | \$ 12,173  | \$ 19,496            |  |
| U.S. Government Sponsored Entities            | 8,638                  | 26,847     | 8,696                |  |
| Mortgage-Backed Securities                    | 66,027                 | 80,185     | 69,036               |  |
| Municipals - Tax Exempt                       | 698                    | 4,143      | 701                  |  |
| Collateralized Mortgage Obligations           | 6,486                  | 7,436      | 6,546                |  |
| Total   | \$ 97,340              | \$ 130,784 | \$ 104,475           |  |

The following table summarizes the maturities or weighted average life and weighted average yields of securities at March 31, 2009:

|   | March 31, 2009                   |        |                                    |        |                                    |        |                 |        |           |       |
|---|----------------------------------|--------|------------------------------------|--------|------------------------------------|--------|-----------------|--------|-----------|-------|
|   | Maturity / Weighted Average Life |        |                                    |        |                                    |        |                 |        |           |       |
|   | Within One Year                  |        | After One and<br>Within Five Years |        | After Five and<br>Within Ten Years |        | After Ten Years |        | Total     |       |
| Amount  | Yield                            | Amount | Yield                              | Amount | Yield                              | Amount | Yield           | Amount | Yield     |       |
| (Dollars in thousands)                        |                                  |        |                                    |        |                                    |        |                 |        |           |       |
| Securities available-for-sale (at fair value) |                                  |        |                                    |        |                                    |        |                 |        |           |       |
| U.S. Treasury                                 | \$ 15,491                        | 1.68%  | \$ -                               | -      | \$ -                               | -      | \$ -            | -      | \$ 15,491 | 1.68% |
| U.S. Government Sponsored Entities            | 8,638                            | 4.98%  | -                                  | -      | -                                  | -      | -               | -      | 8,638     | 4.98% |
| Mortgage Backed Securities                    | 1,236                            | 2.81%  | 48,619                             | 4.33%  | 10,383                             | 4.98%  | 5,789           | 5.11%  | 66,027    | 4.47% |
| Municipals - Tax Exempt                       | 698                              | 3.87%  | -                                  | -      | -                                  | -      | -               | -      | 698       | 3.87% |
| Collateralized Mortgage Obligations           | -                                | -      | 4,660                              | 5.61%  | 1,826                              | 3.23%  | -               | -      | 6,486     | 4.94% |
|   | \$ 26,063                        | 2.89%  | \$ 53,279                          | 4.45%  | \$ 12,209                          | 4.72%  | \$ 5,789        | 5.11%  | \$ 97,340 | 4.10% |

Total  
available-for-sale

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 can be readily reduced in size to provide liquidity for loan balance increases or deposit decreases; (ii) 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; (iii) it can be used as an interest rate risk management tool, since it provides a large base of assets, the maturity and interest rate characteristics of which can be changed more readily than the loan portfolio to better match changes in the deposit base and other funding sources of the Company; (iv) it is an alternative interest-earning use of funds when loan demand is weak or when deposits grow more rapidly than loans; and (v) it can enhance the Company's tax position by providing partially tax exempt income.

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. FASB Statement 115 requires available-for-sale securities to be marked to fair value with an offset to accumulated other comprehensive income, 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 currently composed primarily of: (i) U.S. Treasury securities and 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.

Except for U.S. Treasury securities and debt obligations of U.S. Government sponsored entities, no securities of a single issuer exceeded 10% of shareholders' equity at March 31, 2009. The Company has no direct exposure to so-called subprime loans or securities, nor does it own any Fannie Mae or Freddie Mac equity securities. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities to otherwise mitigate interest rate risk.

In the first quarter of 2009, the securities portfolio declined by \$33.4 million, or 26%, and decreased to 7% of total assets at March 31, 2009 from 9% at March 31, 2008. U.S. Treasury and U.S. Government Sponsored Entity securities decreased to 25% of the portfolio at March 31, 2009 from 30% at March 31, 2008. The decrease was primarily due to maturities of U.S. Government Sponsored Entity securities. Municipal securities, mortgage-backed securities and collateralized mortgage obligations remained fairly constant in the first quarter of 2009 compared to the first quarter of 2008. The Company invests in securities with available cash based on market conditions and the Company's cash flow.

### 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 represented 83% of total assets at March 31, 2009, as compared to 80% at March 31, 2008. The ratio of net loans to deposits increased to 102% at March 31, 2009 from 95% at March 31, 2008. Demand for loans remains relatively strong within the Company's markets. To help ensure that we remain competitive, we make every effort to be flexible and creative in our approach to structuring loans.

The Loan Distribution table that follows sets forth the Company's gross loans outstanding and the percentage distribution in each category at the dates indicated.

### Loan Distribution

|                                     | March 31,<br>2009 |            | March 31,<br>2008 |            | December 31,<br>2008 |            |
|-------------------------------------|-------------------|------------|-------------------|------------|----------------------|------------|
|                                     |                   | % to Total |                   | % to Total |                      | % to Total |
| (Dollars in thousands)              |                   |            |                   |            |                      |            |
| Commercial                          | \$ 500,616        | 41%        | \$ 468,540        | 41%        | \$ 525,080           | 42%        |
| Real estate - mortgage              | 406,182           | 34%        | 384,060           | 34%        | 405,530              | 33%        |
| Real estate - land and construction | 244,181           | 20%        | 233,073           | 21%        | 256,567              | 21%        |
| Home equity                         | 54,011            | 5%         | 42,194            | 4%         | 55,490               | 4%         |
| Consumer                            | 4,025             | 0%         | 2,848             | 0%         | 4,310                | 0%         |
| Total loans                         | 1,209,015         | 100%       | 1,130,715         | 100%       | 1,246,977            | 100%       |
| Deferred loan costs                 | 1,556             | -          | 1,090             | -          | 1,654                | -          |
| Loans, net of deferred costs        | 1,210,571         | 100%       | 1,131,805         | 100%       | 1,248,631            | 100%       |
| Allowance for loan losses           | (23,900)          |            | (13,434)          |            | (25,007)             |            |
| Loans, net                          | \$ 1,186,671      |            | \$ 1,118,371      |            | \$ 1,223,624         |            |

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 and construction and home equity and consumer loans. The increase in the Company's loan portfolio in the first quarter of 2009 from the first quarter of 2008 is due to loan production and increased draw down of loan commitments. Loan production increased in all categories, except for land and construction loans. Aggregate loan fundings increased to 75% at March 31, 2009, compared to 69% at

March 31, 2008, with increases in all loan categories. Loans decreased in the first quarter of 2009, compared to the fourth quarter of 2008, as a result of loan payoffs and paydowns, and \$11.5 million in net charge-offs during the quarter. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 59% of its net loans were secured by real property as of March 31, 2009 and 2008. 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. Such 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 Small Business Administration ("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"). Prior to third quarter of 2007, the guaranteed portion of these loans were sold in the secondary market depending on market conditions. Once it was determined that these loans would be sold, these loans were classified as held for sale and carried at the lower of cost or market. When the guaranteed portion of an SBA loan was sold, the Company retained the servicing rights for the sold portion. In the beginning of the third quarter of 2007, the Company changed its strategy regarding its SBA loan business by retaining new SBA production in lieu of selling the loans.

As of March 31, 2009, real estate mortgage loans of \$406 million consist primarily of adjustable and fixed rate loans secured by deeds of trust on commercial property. The real estate mortgage loans at March 31, 2009 consist of \$206 million, or 51%, of owner occupied properties, \$196 million, or 48%, of investment properties, and \$4 million, or 1% in other properties. Properties securing the commercial real estate mortgage loans are primarily located in the Company's market, which is the Greater San Francisco Bay Area. Real estate values in the Greater San Francisco Bay Area have declined significantly in the residential market in 2008 and the first quarter of 2009. Other areas in California and the U.S. have experienced even greater declines. While the commercial real estate market has not seen the same level of declines as the residential market in the Greater San Francisco Bay Area, it has started to decline. The Company's borrowers will be impacted by a further downturn in these sectors of the economy, which could adversely impact the borrowers' ability to repay their loans and reduce demand for loans. Based on the general economic conditions, we anticipate our borrowers will continue to be affected in 2009.

The Company's real estate term loans consist primarily of loans based on the borrower's cash flow and are secured by deeds of trust on commercial and residential property to provide a secondary source of repayment. The Company generally restricts real estate term loans to no more than 80% 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 such 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 permanent mortgage financing prior to making the construction loan.

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 clientele. 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 loan that were underwritten from mid 2005 through 2008, when real estate values were at the peak in the cycle. The Company takes measures to work with customers to reduce line commitments and minimize potential losses. There have been no adverse classifications to date as a result of the review.

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 \$33 million and \$55 million at March 31, 2009.

#### Loan Maturities

The following table presents the maturity distribution of the Company's loans as of March 31, 2009. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the western edition of The Wall Street Journal. As of March 31, 2009, approximately 72% of the Company's loan portfolio consisted of floating interest rate loans.

|        |          |
|--------|----------|
|        | Over One |
| Due in | Year But |



Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|                                     | One Year<br>or Less    | Less than<br>Five Years | Over<br>Five Years | Total        |
|-------------------------------------|------------------------|-------------------------|--------------------|--------------|
|                                     | (Dollars in thousands) |                         |                    |              |
| Commercial                          | \$ 375,622             | \$ 38,339               | \$ 86,655          | \$ 500,616   |
| Real estate - mortgage              | 143,817                | 209,462                 | 52,903             | 406,182      |
| Real estate - land and construction | 225,451                | 18,730                  | -                  | 244,181      |
| Home equity                         | 50,516                 | 235                     | 3,260              | 54,011       |
| Consumer                            | 3,913                  | 112                     | -                  | 4,025        |
| Loans                               | \$ 799,319             | \$ 266,878              | \$ 142,818         | \$ 1,209,015 |
| Loans with variable interest rates  | \$ 715,641             | \$ 79,030               | \$ 80,038          | \$ 874,709   |
| Loans with fixed interest rates     | 83,678                 | 187,848                 | 62,780             | 334,306      |
| Loans                               | \$ 799,319             | \$ 266,878              | \$ 142,818         | \$ 1,209,015 |

## Loan Servicing

As of March 31, 2009 and 2008, \$144 million and \$170 million, respectively, in SBA loans were serviced by the Company for others. Because of the Company's decision in 2007 to retain rather than sell SBA loan production, the portfolio of serviced loans should continue to decline.

Activity for loan servicing rights was as follows:

|   | For the Three Months<br>Ended<br>March 31,<br>2009      2008<br>(Dollars in thousands) |          |
|---|--|----------|
| Beginning of<br>period balance at<br>January 1, | \$ 1,013   | \$ 1,754 |
| Additions                                       | -  | -        |
| Amortization                                    | (145)  | (204)    |
| End of period<br>balance                        | \$ 868   | \$ 1,550 |

Loan servicing rights are included in Accrued Interest and Other Assets on the balance sheet and reported net of amortization. There was no valuation allowance as of March 31, 2009 and 2008, 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 Three Months<br>Ended<br>March 31,<br>2009      2008<br>(Dollars in thousands) |          |
|---|--|----------|
| Beginning of<br>period balance at<br>January 1, | \$ 2,248   | \$ 2,332 |
| Additions                                       | -  | -        |
| Amortization                                    | (103)  | (163)    |
| Unrealized<br>holding gain                      | 108  | (78)     |
| End of period<br>balance                        | \$ 2,253   | \$ 2,247 |

## 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 which have brought about declines in overall property values. 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.

To help minimize credit quality concerns, we have established a sound approach to credit that includes well-defined goals and objectives and well-documented credit policies and procedures. The 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 a multi-community independent bank serving a specific geographic area, the Company must contend with the unpredictable changes of the general California and, particularly, primary local markets. The Company's asset quality has suffered in the past from the impact of national and regional economic recessions, consumer bankruptcies, and depressed real estate values.

Nonperforming assets are comprised of the following: loans for which the Company is no longer accruing interest; loans 90 days or more past due and still accruing interest (although they are generally placed on non-accrual when they become 90 days past due, unless they are both well secured and in the process of collection); and other real estate owned ("OREO") from foreclosures. Management's classification of a loan as "non-accrual" 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, and begins recognizing interest income only as cash interest payments are received as long as 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.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

|  | March 31,              |          | December 31, |
|--|------------------------|----------|--------------|
|  | 2009                   | 2008     | 2008         |
|  | (Dollars in thousands) |          |              |
| Nonaccrual loans   | \$ 54,291              | \$ 4,580 | \$ 39,981    |
| Loans 90 days past due and still accruing  | 1,774                  | -        | 460          |
| Total nonperforming loans  | 56,065                 | 4,580    | 40,441       |
| Other real estate owned  | 802                    | 792      | 660          |
| Total nonperforming assets   | \$ 56,867              | \$ 5,372 | \$ 41,101    |
| Nonperforming assets as a percentage of total loans plus other real estate owned | 4.70%                  | 0.47%    | 3.30%        |

Primarily due to the general economic slowdown and a softening of the real estate market, which is expected to continue well into 2009, nonperforming assets at March 31, 2009 increased \$51.5 million, from March 31, 2008 levels. Nonperforming assets increased by \$15.8 million or 38%, compared to December 31, 2008. The increase in nonperforming assets in the first quarter of 2009 was primarily in commercial real estate and land and construction loans. Three large loan relationships significantly increased nonperforming loans during the first quarter of 2009: 1) an \$8.2 million participation in a syndicated real estate loan for a retail center; 2) two construction loans to one borrower totaling \$4.2 million; and 3) a \$3.8 million land development loan.

#### Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses in our loan portfolio. The allowance is based on two basic principles of accounting: (1) Statement of Financial Accounting Standards ("Statement") No. 5 "Accounting for Contingencies," which requires that losses be accrued when they are probable of occurring and estimable and (2) Statement No. 114, "Accounting by Creditors for Impairment of a Loan," which requires that losses be accrued based on the differences between the impaired loan balance and value of collateral, if the loan is collateral dependent, or present value of future cash flows or values that are observable in the secondary market.

Management conducts a critical evaluation of the loan portfolio at least quarterly. This evaluation includes periodic loan by loan review for certain loans to evaluate the level of impairment, as well as reviews of other loans (either individually or in pools) based on an assessment of the following factors: past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, collateral values, loan volumes and concentrations, size and complexity of the loans, recent loss experience in particular segments of the portfolio, bank regulatory examination and independent loan review results, and current economic conditions in the Company's marketplace, in particular the state of the technology industry and the real estate market. This process attempts to assess the risk of loss inherent in the portfolio by segregating loans into the following categories for purposes of determining an appropriate level of the allowance: loans graded "Pass through Special Mention," "Substandard," and "Substandard Non-Accrual," "Doubtful" and "Loss".

Loans are charged against the allowance when management believes that the uncollectibility of the loan balance is confirmed. The Company's methodology for assessing the appropriateness of the allowance consists of several key elements, which include the formula allowance and specific allowances.

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 note agreement. When a loan is considered to be impaired, the amount of impairment is measured based on the fair value of the collateral if the loan is collateral dependent, less costs to sell, or on the present value of expected future cash flows.

The formula portion of the allowance is calculated by applying loss factors to pools of outstanding loans. Loss factors are based on the Company's historical loss experience, adjusted for significant factors that, in management's judgment, affect the collectability of the portfolio as of the evaluation date. The adjustment factors for the formula allowance may include existing general economic and business conditions affecting the key lending areas of the Company, in particular the real estate market, credit quality trends, collateral values, loan volumes and concentrations, the technology industry and specific industry conditions within portfolio segments, recent loss experience in particular segments of the portfolio, duration of the current business cycle, and bank regulatory examination results. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty.

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, doubtful, and loss and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate). The principal balance of classified loans was \$155.7 million at March 31, 2009, \$134.7 million at December 31, 2008, and \$25.3 million at March 31, 2008. The \$21.0 million net increase in classified loans from December 31, 2008 consists primarily of \$26.0 million in land and construction loans, which was offset by a \$6.0 million decrease in commercial real estate loans, and a \$1.0 million increase in other loans. With a continuing downturn in the economic environment, the level of classified loans will continue to be a challenge.

In adjusting the historical loss factors applied to the respective segments of the loan portfolio, management considered the following factors:

- Levels and trends in delinquencies, non-accruals, charge offs and recoveries
  - Trends in volume and loan terms
  - Lending policy or procedural changes
- Experience, ability, and depth of lending management and staff
  - National and local economic trends and conditions
  - Concentrations of credit

There can be no assurance that the adverse impact of any of these conditions on HBC will not be in excess of the current level of estimated losses.

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

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 Three Months Ended<br>March 31, |           | For the Year<br>Ended<br>December 31, |
|-------------------------------------|---|-----------|---------------------------------------|
|                                     | 2009                                    | 2008      | 2008                                  |
|                                     | (Dollars in thousands)                  |           |                                       |
| Balance, beginning of period / year | \$ 25,007                               | \$ 12,218 | \$ 12,218                             |
| Net (charge-offs) recoveries        | (11,527)                                | (434)     | (2,748)                               |
| Provision for loan losses           | 10,420                                  | 1,650     | 15,537                                |
| Balance, end of period / year       | \$ 23,900                               | \$ 13,434 | \$ 25,007                             |

RATIOS:

|  |        |        |       |
|--|--------|--------|-------|
| Net (charge-offs) recoveries to average loans    | -0.93% | -0.16% | 0.23% |
| Allowance for loan losses to total loans         | 1.98%  | 1.19%  | 2.00% |
| Allowance for loan losses to nonperforming loans | 43%    | 293%   | 62%   |

Net charge-offs were \$11.5 million in the first quarter of 2009, as compared to net charge-offs of \$434,000 in the first quarter of 2008. Of the net charge-offs in the first quarter, \$3.3 million was for the remaining loans to William J. (“Boots”) Del Biaggio III, and \$4.1 million was for two construction loans and two commercial loans. 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 and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually as of November 30, for impairment with the assistance of a valuation firm. Any such impairment will be recognized in the period identified. Goodwill is tested for impairment at the reporting unit level. A reporting unit is an operating segment or one level below an operating segment for which discrete financial information is available and regularly reviewed by management. If the fair value of the reporting unit including goodwill is determined to be less than the carrying amount of the reporting unit, a further test is required to measure the amount of impairment. If an impairment loss exists, the carrying amount of the goodwill is adjusted to a new cost basis. For purposes of the goodwill impairment test, the valuation of the Company is based on a weighted blend of the income method (discounted cash flows), market approach considering key pricing multiples of similar control transactions, and market price analysis of the Company’s stock. Management believes the multiples and other assumptions used in these calculations are consistent with current industry practice for valuing similar types of companies. Because of concerns about declining stock prices in the banking industry, goodwill was tested for impairment as of March 31, 2009, with the assistance of a valuation firm. Based on this assessment, management concluded that there was no impairment of goodwill at March 31, 2009.

## 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. Our net interest margin is improved to the extent that growth in deposits can be concentrated in historically lower-cost deposits such as non-interest-bearing demand, NOW accounts, savings accounts and money market deposit accounts. The Company's liquidity is impacted by the volatility of deposits or other funding instrument, 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:

## Deposits

|                               | March 31, 2009         |            | March 31, 2008 |            | December 31, 2008 |            |
|-------------------------------|------------------------|------------|----------------|------------|-------------------|------------|
|                               | Balance                | % to Total | Balance        | % to Total | Balance           | % to Total |
|                               | (Dollars in thousands) |            |                |            |                   |            |
| Demand, noninterest bearing   | \$ 254,823             | 22%        | \$ 254,938     | 22%        | \$ 261,337        | 22%        |
| Demand, interest bearing      | 133,183                | 11%        | 159,046        | 14%        | 134,814           | 12%        |
| Savings and money market      | 358,848                | 31%        | 494,912        | 42%        | 344,767           | 30%        |
| Time deposits, under \$100    | 46,078                 | 4%         | 35,095         | 3%         | 45,615            | 4%         |
| Time deposits, \$100 and over | 177,308                | 15%        | 161,840        | 14%        | 171,269           | 15%        |
| Brokered time deposits        | 195,763                | 17%        | 65,873         | 5%         | 196,248           | 17%        |
| Total deposits                | \$ 1,166,003           | 100%       | \$ 1,171,704   | 100%       | \$ 1,154,050      | 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 March 31, 2009 and 2008, less than 3% and 2% of deposits were from public sources, respectively.

The decreases in savings and money market deposits were primarily due to lower balances in title insurance company, escrow, and real estate exchange facilitators' accounts. At March 31, 2009, title insurance company, escrow, and real estate exchange facilitators' accounts decreased \$55.5 million, or 58% of such deposits at March 31, 2008.

The following table indicates the maturity schedule of the Company's time deposits of \$100,000 or more as of March 31, 2009:

|                      | March 31, 2009         |            |
|----------------------|------------------------|------------|
|                      | Balance                | % of Total |
|                      | (Dollars in thousands) |            |
| Three months or less | \$ 139,091             | 38%        |



|  |            |      |
|--|------------|------|
| Over three months through<br>six months  | 56,780     | 15%  |
| Over six months through<br>twelve months | 85,462     | 23%  |
| Over twelve months                       | 89,389     | 24%  |
| Total                                    | \$ 370,722 | 100% |

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

## Return on Equity and Assets

The following table indicates the ratios for return on average assets and average equity, dividend payout, and average equity to average assets for the first quarter of 2009 and 2008:

|  | Three Months Ended |        |
|--|--------------------|--------|
|  | March 31,          |        |
|  | 2009               | 2008   |
| Return on average assets                           | -1.08%             | 0.50%  |
| Return on average tangible assets                  | -1.12%             | 0.52%  |
| Return on average equity                           | -8.65%             | 4.33%  |
| Return on average tangible equity                  | -11.62%            | 6.21%  |
| Dividend payout ratio (1)                          | -5.20%             | 60.04% |
| Average tangible equity to average tangible assets | 11.49%             | 11.51% |

(1) 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 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 \$407.1 million at March 31, 2009, as compared to \$465.3 million at March 31, 2008. Unused commitments represented 34% and 41% of outstanding gross loans at March 31, 2009 and 2008, respectively.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted, because there is no certainty that lines of credit and letters of credit will ever be fully utilized. The following table presents the Company's commitments to extend credit as of March 31, 2009, and December 31, 2008:

|                              | December          |             |
|------------------------------|-------------------|-------------|
|                              | March 31,<br>2009 | 31,<br>2008 |
| (Dollars in thousands)       |                   |             |
| Commitments to extend credit | \$ 388,009        | \$ 444,172  |
| Standby letters of credit    | 19,151            | 21,143      |
|                              | \$ 407,160        | \$ 465,315  |

## 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 with correspondent banks, 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 the FRB. In addition, the Company can raise cash for temporary needs by selling securities under agreements to repurchase and selling securities available-for-sale.

During 2008, the Company experienced a tightening in its liquidity position as a result of significant loan growth, which was partially funded by an increase in brokered deposits. Since December 31, 2008, the Company had loan contraction of \$38 million and it has experienced a slight improvement in its liquidity position.

#### 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 March 31, 2009, the Company had \$32.0 million of overnight borrowings from the FHLB, bearing interest at 0.21%. There were no FHLB advances at March 31, 2008. The Company had \$275.0 million of loans pledged to the FHLB as collateral on an available line of credit of \$144.0 million at March 31, 2009.

During the first quarter of 2009, HBC made an arrangement with the FRB to borrow from the discount window. The Company had \$214.0 million of loans pledged to the FRB as collateral on an available line of credit of \$160.5 million at March 31, 2009, none of which was outstanding.

At March 31, 2009 and 2008, HBC had Federal funds purchase arrangements available of \$60.0 million and \$50.0 million, respectively.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

The Company also had a \$15 million line of credit with a correspondent bank, which was repaid and closed in March 2009.

Securities sold under agreements to repurchase are secured by mortgage-backed securities carried at amortized cost of approximately \$33.7 million at March 31, 2009. The repurchase agreements were \$30.0 million at March 31, 2009.

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

|                            | March 31,              |           |
|----------------------------|------------------------|-----------|
|                            | 2009                   | 2008      |
|                            | (Dollars in thousands) |           |
| Average balance            |                        |           |
| year-to-date               | \$ 82,622              | \$ 63,263 |
| Average interest rate      |                        |           |
| year-to-date               | 1.73%                  | 3.29%     |
| Maximum month-end          |                        |           |
| balance during the quarter | \$ 101,000             | \$ 40,900 |
| Average rate at March 31,  | 1.42%                  | 2.94%     |

Because most of the growth in loans in 2008 was funded with deposits, other liquidity ratios tracked by the Company, such as unfunded loan commitments to secondary reserves ratio, have been slightly outside of policy guidelines for several months. We continue to watch these ratios closely, and expect that these ratios will revert back within guidelines.

#### Capital Resources

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

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

|                                     | March 31,              |              | December 31, |
|-------------------------------------|------------------------|--------------|--------------|
|                                     | 2009                   | 2008         | 2008         |
|                                     | (Dollars in thousands) |              |              |
| Capital components:                 |                        |              |              |
| Tier 1 Capital                      | \$ 148,788             | \$ 127,816   | \$ 160,146   |
| Tier 2 Capital                      | 16,359                 | 13,659       | 16,989       |
| Total risk-based capital            | \$ 165,147             | \$ 141,475   | \$ 177,135   |
| Risk-weighted assets                | \$ 1,300,876           | \$ 1,258,695 | \$ 1,350,823 |
| Average assets for capital purposes | \$ 1,428,747           | \$ 1,327,612 | \$ 1,449,380 |

|                           |       |       |       | Minimum<br>Regulatory<br>Requirements |
|---------------------------|-------|-------|-------|---------------------------------------|
| Capital ratios            |       |       |       |                                       |
| Total risk-based capital  | 12.7% | 11.2% | 13.1% | 8.00%                                 |
| Tier 1 risk-based capital | 11.4% | 10.2% | 11.9% | 4.00%                                 |
| Leverage (1)              | 10.4% | 9.6%  | 11.0% | 4.00%                                 |

Leverage ratio is equal to Tier 1 capital divided by (1) quarterly average assets (excluding goodwill and other intangible assets).

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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

|                                     | March 31,<br>2009      |           | March 31,<br>2008 |           | December 31,<br>2008                           |                                       |
|-------------------------------------|------------------------|-----------|-------------------|-----------|--|---------------------------------------|
|                                     | (Dollars in thousands) |           |                   |           |  |                                       |
| Capital components:                 |                        |           |                   |           |  |                                       |
| Tier 1 Capital                      | \$                     | 144,447   | \$                | 130,730   | \$   | 149,493                               |
| Tier 2 Capital                      |                        | 16,408    |                   | 13,659    |  | 16,973                                |
| Total risk-based capital            | \$                     | 160,855   | \$                | 144,389   | \$   | 166,466                               |
| Risk-weighted assets                | \$                     | 1,304,914 | \$                | 1,257,403 | \$   | 1,349,471                             |
| Average assets for capital purposes | \$                     | 1,432,871 | \$                | 1,323,472 | \$   | 1,449,158                             |
| Capital ratios                      |                        |           |                   |           |  |                                       |
| Total risk-based capital            |                        | 12.3%     |                   | 11.5%     |  | 12.3%                                 |
| Tier 1 risk-based capital           |                        | 11.1%     |                   | 10.4%     |  | 11.1%                                 |
| Leverage (1)                        |                        | 10.1%     |                   | 9.9%      |  | 10.3%                                 |
|                                     |                        |           |                   |           | Well-Capitalized<br>Regulatory<br>Requirements | Minimum<br>Regulatory<br>Requirements |
|                                     |                        |           |                   |           | 10.00%   | 8.00%                                 |
|                                     |                        |           |                   |           | 6.00%  | 4.00%                                 |
|                                     |                        |           |                   |           | 5.00%  | 4.00%                                 |

Leverage ratio is equal to Tier 1 capital divided by (1) quarterly average assets (excluding goodwill and other intangible assets).

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

At March 31, 2009 and 2008, and December 31, 2008, the Company's and HBC's capital met all minimum regulatory requirements. As of March 31, 2009, HBC was considered "Well Capitalized" under the prompt corrective action provisions.

#### U.S. Treasury TARP 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 TARP Capital Purchase Program. The Series A Preferred qualifies as a component of Tier 1 capital.

#### Market Risk

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

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

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

The Company uses modeling software for asset/liability management in order to simulate the effects of potential interest rate changes on the Company's net interest margin, and to calculate the estimated fair values of the Company's financial instruments under different interest rate scenarios. The program imports current balances, interest rates, maturity dates and repricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company's interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Company's investment, loan, deposit and borrowed funds portfolios. These rate projections can be shocked (an immediate and parallel change in all base rates, up or down), ramped (an incremental increase or decrease in rates over a specified time period), based on current trends and econometric models or economic conditions stable (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 200 basis point (1 basis point equals 0.01%) change in market interest rates. Both a 200 basis point increase and a 200 basis point decrease in market rates are considered.

At March 31, 2009, it was estimated that the Company's MV would increase 15.7% in the event of a 200 basis point increase in market interest rates. The Company's MV at the same date would decrease 10.8% in the event of a 200 basis point decrease in applicable interest rates.

Presented below, as of March 31, 2009 and 2008, is an analysis of the Company's interest rate risk as measured by changes in MV for instantaneous and sustained parallel shifts of 200 basis points in applicable interest rates:

|                 | March 31, 2009         |                 |  |                | March 31, 2008  |                 |  |                |
|-----------------|------------------------|-----------------|--|----------------|-----------------|-----------------|--|----------------|
|                 | \$ Change              | % Change        | Market Value as a % of Present Value of Assets | MV Change (bp) | \$ Change       | % Change        | Market Value as a % of Present Value of Assets | MV Change (bp) |
|                 | in Market Value        | in Market Value | MV Ratio                                       | (bp)           | in Market Value | in Market Value | MV Ratio                                       | (bp)           |
|                 | (Dollars in thousands) |                 |  |                |                 |                 |  |                |
| Change in rates |                        |                 |  |                |                 |                 |  |                |
| + 200 bp        | \$ 26,074              | 12.8%           | 15.7%  | 179            | \$ 43,222       | 19.8%           | 18.6%  | 307            |
| 0 bp            | \$ -                   | -%              | 14.0%  | -              | \$ -            | -%              | 15.5%  | -              |
| - 200 bp        | \$ (46,649)            | -22.9%          | 10.8%  | (320)          | \$ (60,074)     | -27.5%          | 11.2%  | (427)          |

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 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, 2008. There are no changes to these policies as of March 31, 2009.

#### ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

## ITEM 4 – CONTROLS AND PROCEDURES

### Disclosure Control and Procedures

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of March 31, 2009. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded the Company's disclosure controls were effective as of March 31, 2009, the period covered by this report on Form 10-Q.

During the three months ended March 31, 2009, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to affect, our internal controls over financial reporting.

## Part II — OTHER INFORMATION

### ITEM 1 – LEGAL PROCEEDINGS

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

### ITEM 1A – RISK FACTORS

A description of the risk factors associated with our business is contained in Part I, Item 1A, "Risk Factors," of our Annual Report on Form 10-K for the fiscal year ended December 31, 2008 filed with the Securities and Exchange Commission. These cautionary statements are to be used as a reference in connection with any forward-looking statements. The factors, risks and uncertainties identified in these cautionary statements 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. There are no material changes in the "Risk Factors" previously disclosed in the Annual Report on Form 10-K for the year ended December 31, 2008.

### ITEM 2 – UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

### ITEM 3 – DEFAULTS UPON SENIOR SECURITIES

None

### ITEM 4 – SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There was no submission of matters to a vote of security holders during the three months ended March 31, 2009.

ITEM 5 – OTHER INFORMATION

None

28

---

ITEM 6 - EXHIBITS

| Exhibit | Description   |
|---------|---|
| 3.1     | Heritage Commerce Corp Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 16, 2009)       |
| 3.2     | Heritage Commerce Corp Bylaws, as amended (incorporated by reference to Exhibit 3.2 to the Registrant's Annual Report on Form 10-K filed on March 16, 2009)                                   |
| 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 on 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)                                   |
| 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   |
| 31.1    | Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350  |
| 31.2    | Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350  |

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<br>(Registrant)                                      |
| May 11, 2009<br>Date | /s/ Walter T. Kaczmarek<br>Walter T. Kaczmarek<br>Chief Executive Officer   |
| May 11, 2009<br>Date | /s/ Lawrence D. McGovern<br>Lawrence D. McGovern<br>Chief Financial Officer |

EXHIBIT INDEX

| Exhibit | Description   |
|---------|---|
| 3.1     | Heritage Commerce Corp Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 16, 2009)       |
| 3.2     | Heritage Commerce Corp Bylaws, as amended (incorporated by reference to Exhibit 3.2 to the Registrant's Annual Report on Form 10-K filed on March 16, 2009)                                   |
| 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 on 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)                                   |
| 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   |
| 31.1    | Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350  |
| 31.2    | Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350  |