

HERITAGE FINANCIAL CORP /WA/
Form 10-Q
May 01, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2007

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number 0-29480

HERITAGE FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of incorporation or organization)

91-1857900
(I.R.S. Employer Identification No.)

201 Fifth Avenue SW, Olympia, WA
(Address of principal executive office)

98501
(ZIP Code)

(360) 943-1500

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant 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.

Large accelerated filer Accelerated filer Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date:

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As of April 10, 2007 there were 6,585,669 common shares outstanding, with no par value, of the registrant.

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HERITAGE FINANCIAL CORPORATION

FORM 10-Q

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(Dollars in thousands, except for per share data)

(Unaudited)

	Three Months Ended	
	March 31, 2007	2006
INTEREST INCOME:		
Interest and fees on loans	\$ 14,419	\$ 11,909
Taxable interest on investment securities	414	409
Nontaxable interest on investment securities	44	39
Interest on federal funds sold and interest bearing deposits	44	13
Dividends on Federal Home Loan Bank stock	3	
Total interest income	14,924	12,370
INTEREST EXPENSE:		
Deposits	5,614	3,599
Other borrowings	413	286
Total interest expense	6,027	3,885
Net interest income	8,897	8,485
Provision for loan losses	180	140
Net interest income after provision for loan losses	8,717	8,345
NONINTEREST INCOME:		
Gains on sales of loans, net	2	60
Brokered mortgage income	181	101
Service charges on deposits	853	738
Rental income	80	77
Merchant visa income	655	572
Other income	262	223
Total noninterest income	2,033	1,771
NONINTEREST EXPENSE:		
Salaries and employee benefits	3,836	3,405
Occupancy and equipment	1,090	990
Data processing	380	317
Marketing	89	117
Office supplies and printing	99	104
Merchant visa	525	443
Professional services	171	140
State and local taxes	216	192
Other expense	779	577
Total noninterest expense	7,185	6,285

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Income before federal income taxes	3,565	3,831
Federal income taxes	1,192	1,267
Net income	\$ 2,373	\$ 2,564
Earnings per share:		
Basic	\$ 0.37	\$ 0.41
Diluted	\$ 0.36	\$ 0.40
Dividends declared per share:	\$ 0.210	\$ 0.195
See Notes to Condensed Consolidated Financial Statements.		

Table of Contents**HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION****March 31, 2007 and December 31, 2006**

(Dollars in thousands)

(Unaudited)

	March 31, 2007	December 31, 2006
Assets		
Cash on hand and in banks	\$ 19,062	\$ 23,713
Interest earning deposits	5,916	2,718
Investment securities available for sale	36,677	39,124
Investment securities held to maturity (market value of \$3,816 and \$3,861)	3,810	3,858
Loans held for sale	393	
Loans receivable	765,117	749,701
Less: Allowance for loan losses	(10,086)	(10,105)
Loans receivable, net	755,031	739,596
Other real estate owned	80	225
Premises and equipment, net	15,656	15,681
Federal Home Loan Bank and Federal Reserve stock, at cost	3,227	3,227
Accrued interest receivable	4,242	4,298
Prepaid expenses and other assets	5,002	4,550
Deferred federal income taxes, net	2,069	2,242
Intangible assets, net	561	580
Goodwill	13,086	13,081
Total assets	\$ 864,812	\$ 852,893
Liabilities and Stockholders Equity		
Deposits	\$ 742,832	\$ 725,921
Advances from Federal Home Loan Bank	29,572	37,167
Other borrowings	3,146	3,371
Accrued expenses and other liabilities	9,086	7,795
Total liabilities	784,636	774,254
Stockholders equity:		
Common stock, no par, 15,000,000 shares authorized; 6,583,931 and 6,558,206 shares outstanding at March 31, 2007 and December 31, 2006, respectively	24,494	24,053
Unearned compensation - ESOP	(513)	(535)
Retained earnings, substantially restricted	56,637	55,647
Accumulated other comprehensive loss, net	(442)	(526)
Total stockholders equity	80,176	78,639
Commitments and contingencies		
Total liabilities and stockholders equity	\$ 864,812	\$ 852,893

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND COMPREHENSIVE INCOME FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006**

(In Thousands)

(Unaudited)

	Number of common shares	Common stock	Unearned Compensation- ESOP	Retained earnings	Accumulated other comprehensive loss, net	Total stockholders equity
Balance at December 31, 2006	6,558	\$ 24,053	\$ (535)	\$ 55,647	\$ (526)	\$ 78,639
Stock option compensation expense		87				87
Earned ESOP shares	2	35	22			57
Earned restricted stock shares		16				16
Tax benefit on vesting of restricted stock shares		100				100
Restricted stock awards cancelled	(2)					
Tax benefit on dividends paid on unallocated ESOP shares and restricted stock shares		10				10
Exercise of stock options (including tax benefits from nonqualified stock options)	41	568				568
Stock repurchase	(15)	(375)				(375)
Net income				2,373		2,373
Change in fair value of securities available for sale, net of tax					84	84
Cash dividends declared				(1,383)		(1,383)
Balance at March 31, 2007	6,584	\$ 24,494	\$ (513)	\$ 56,637	\$ (442)	\$ 80,176

	Three months ended March 31,	
	2007	2006
Comprehensive Income		
Net income	\$ 2,373	\$ 2,564
Change in fair value of securities available for sale, net of tax of \$45 and \$(23)	84	(44)
Comprehensive income	\$ 2,457	\$ 2,520

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****For the three months ended March 31, 2007 and 2006**

(Dollars in thousands)

(Unaudited)

	2007	2006
Cash flows from operating activities:		
Net income	\$ 2,373	\$ 2,564
Adjustments to reconcile net income to net cash provided by (used in) operating activities		
Depreciation and amortization	419	445
Deferred loan fees, net of amortization	59	(120)
Provision for loan losses	180	140
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities	1,048	(668)
Recognition of compensation related to ESOP shares and restricted stock awards	73	105
Stock option compensation expense	87	90
Tax benefit realized from stock options exercised, restricted stock awards vested, and dividends on unallocated ESOP shares and restricted stock awards	(145)	(12)
Gain on sale of premises and equipment	(1)	
Amortization of intangible assets	19	
Deferred federal income tax	128	
Origination of loans held for sale	(393)	(4,225)
Gain on sale of loans		(60)
Proceeds from sale of loans		4,252
Loss on sale of other real estate owned	20	
Net cash provided by operating activities	3,867	2,511
Cash flows from investing activities:		
Loans originated, net of principal payments	(15,759)	(8,248)
Maturities of investment securities available for sale	2,584	1,733
Maturities of investment securities held to maturity	47	32
Purchase of investment securities available for sale		(737)
Purchase of investment securities held to maturity		(205)
Purchase of premises and equipment	(406)	(151)
Proceeds from sale of other real estate owned	205	2
Proceeds from sale of premises and equipment	5	
Net cash used in investing activities	(13,324)	(7,574)
Cash flows from financing activities:		
Net increase in deposits	16,911	24,031
Net decrease in borrowed funds	(7,820)	(24,700)
Cash dividends paid	(1,390)	(1,202)
Proceeds from exercise of stock options	533	390
Tax benefit realized from stock options exercised, restricted stock awards vested, and dividends on unallocated ESOP shares and restricted stock awards	145	12
Repurchase of common stock	(375)	(2)
Net cash provided by (used in) financing activities	8,004	(1,471)

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Net decrease in cash and cash equivalents	(1,453)	(6,534)
Cash and cash equivalents at beginning of period	26,431	28,002
Cash and cash equivalents at end of period	\$ 24,978	\$ 21,468
Supplemental disclosures of cash flow information:		
Cash payments for:		
Interest expense	\$ 6,346	\$ 4,246
Federal income taxes		100
Supplemental disclosures of cash flow information:		
Loans transferred to/from other real estate owned	(80)	
Elimination of unearned compensation restricted stock awards		527
See Notes to Condensed Consolidated Financial Statements.		

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HERITAGE FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Three Months Ended March 31, 2007 and 2006

(Unaudited)

NOTE 1. Description of Business and Basis of Presentation

(a.) Description of Business

Heritage Financial Corporation (Company) is a bank holding company that was incorporated in the State of Washington in August 1997. We were organized for the purpose of acquiring all of the capital stock of Heritage Savings Bank upon our reorganization from a mutual holding company form of organization to a stock holding company form of organization. Effective September 1, 2004, Heritage Savings Bank switched its charter from a State Chartered Savings Bank to a State Chartered Commercial Bank and changed its legal name from Heritage Savings Bank to Heritage Bank. Effective September 1, 2005, Central Valley Bank changed its charter from a Nationally Chartered Commercial Bank to a State Chartered Commercial Bank.

We are primarily engaged in the business of planning, directing, and coordinating the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. Heritage Bank is a Washington state-chartered commercial bank whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) under the Deposit Insurance Fund (DIF). Heritage Bank conducts business from its main office in Olympia, Washington and its thirteen branch offices located in Thurston, Pierce, Mason and south King Counties of Washington State. Central Valley Bank is also a Washington state-chartered commercial bank whose deposits are insured by the FDIC under the DIF. Central Valley Bank conducts business from its main office in Toppenish, Washington and its five branch offices located in Yakima and Kittitas Counties of Washington State.

Our business consists primarily of lending and deposit relationships with small businesses including agribusiness and their owners in our market area, attracting deposits from the general public and originating for sale or investment purposes first mortgage loans on residential properties located in western and central Washington. We also make residential construction loans, income property loans, and consumer loans.

(b.) Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. These condensed consolidated financial statements should be read with our December 31, 2006 audited consolidated financial statements and its accompanying notes included in our Annual Report on Form 10-K. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ended December 31, 2007. In preparing the consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates.

Certain amounts in the consolidated financial statements for the prior year have been reclassified to conform to the current consolidated financial statement presentation.

(c.) Recently Issued Accounting Pronouncements

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainties in Income Taxes, an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As of March 31, 2007 and January 1, 2007, we had an insignificant amount of unrecognized tax benefits. Our policy is to recognize interest and penalties on unrecognized tax benefits in Federal income taxes in the Consolidated Statements of Income. The amount of interest and penalties for the three months ended March 31, 2007 was immaterial. The tax years subject to examination by the taxing authorities are the years ending December 31, 2006, 2005, 2004 and 2003.

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In February 2007, FASB issued Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. This statement is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Early adoption of this statement is permitted provided the entity also elects to apply the provisions of SFAS No. 157, *Fair Value Measurements*. Management does not intend to early adopt SFAS No. 159. Management is assessing the impact of adopting SFAS No. 159, which will become effective on January 1, 2008, on the Company's consolidated financial statements.

Table of Contents**NOTE 2. Stockholders Equity***(a.) Earnings per Share*

The following table illustrates the reconciliation of weighted average shares used for earnings per share for the noted periods.

	Three months ended March 31,	
	2007	2006
Basic:		
Weighted average shares outstanding	6,567,677	6,267,471
Less: Weighted average unvested restricted stock awards	(63,128)	(64,486)
Basic weighted average shares outstanding	6,504,549	6,202,985
Diluted:		
Basic weighted average shares outstanding	6,504,549	6,202,985
Incremental shares from unexercised stock options and unvested restricted stock awards	174,011	227,213
Diluted weighted average shares outstanding	6,678,560	6,430,198

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three months ended March 31, 2007, anti-dilutive shares outstanding related to options to acquire common stock totaled 105,600 as the exercise price was in excess of the market value. For the three months ended March 31, 2006, there were no anti-dilutive shares outstanding related to options to acquire common stock.

(b.) Cash Dividend Declared

On March 20, 2007, we announced a quarterly cash dividend of 21.0 cents per share payable on April 30, 2007 to stockholders of record on April 16, 2007.

NOTE 3. Share Based Payment

The Company maintains a number of stock-based incentive programs, which are discussed in more detail in Note 4. Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R (SFAS No. 123R) Share-based Payment. SFAS No. 123R requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award on the grant date. This statement was adopted using the modified prospective method of application, which requires the Company to recognize compensation expense on a prospective basis. Therefore, prior period financial statements have not been restated. Under this method, in addition to reflecting compensation expense for new share-based awards, expense is also recognized to reflect the remaining service period of awards that had been included in pro forma disclosures in prior periods.

Total stock-based compensation expense (excluding ESOP expense) for the three months ended March 31, 2007 and 2006 were as follows:

	2007	2006
	(Dollars in thousands)	
Compensation expense recognized	\$ 103	\$ 135
Related tax benefit recognized	10	20

As of March 31, 2007, the total unrecognized compensation expense related to non-vested stock awards was \$546,000 and the related weighted average period over which it is expected to be recognized is approximately 2.7 years.

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The fair value of options granted during the three months ended March 31, 2006 is estimated on the date of grant using the Black-Scholes option pricing model based on the assumptions noted in the following table (there were no options granted during the three months ended March 31, 2007). The expected term of share options is derived from historical data and represents the period of time that share options granted are expected to be outstanding. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on historical volatility of Company shares. Expected dividend yield is based on dividends expected to be paid during the expected term of the share options.

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Grant period ended	Weighted Average Risk Free Interest Rate	Expected Term in years	Expected Volatility	Expected Dividend Yield	Weighted Average Fair Value
March 31, 2006	4.80%	4.41	20%	3.60%	\$ 4.37

NOTE 4. Stock Option and Award Plans

On September 24, 1996, Heritage Bank's stockholders approved the adoption of the 1997 stock option plan. On October 15, 1998, the Company's stockholders approved the adoption of the 1998 stock option plan, which is similar to the 1997 plan. The 1998 plan does not affect any options granted under the 1997 plan. On April 25, 2002, the Company's stockholders approved the adoption of the 2002 Incentive Stock Option Plan, the 2002 Director Nonqualified Stock Option Plan and the 2002 Restricted Stock Plan, which are generally similar to the 1997 and 1998 stock plans. On April 27, 2006, the Company's stockholders approved the adoption of the 2006 Incentive Stock Option Plan, the 2006 Director Nonqualified Stock Option Plan and the 2006 Restricted Stock Plan, which are generally similar to the 1997, 1998 and 2002 stock plans.

Under these stock option plans, on the date of grant, the exercise price of the option must at least equal the market value per share of the Company's common stock. The 1997 plan provides for the granting of options and stock awards up to 270,333 common shares. The 1998 plan provides for the grant of stock options for up to 414,750 shares and stock awards for up to 69,431 shares. The 2002 and 2006 Incentive Stock Option plans provide for the grant of stock options for up to 451,500 and 400,000 shares, respectively. The 2002 and 2006 Director Nonqualified Stock Option Plans provide for the grant of stock options for up to 73,500 and 75,000 shares, respectively. The 2002 and 2006 Restricted Stock Plans provide for the grant of stock awards for up to 52,500 and 25,000 shares, respectively.

Stock options generally vest ratably over three years and expire five years after they become exercisable which amounts to an average term of seven years. Restricted Stock awards issued have a five-year cliff vesting. The Company issues new shares to satisfy share option exercises.

The following table summarizes stock option and award activity for the three months ended March 31, 2007.

	Outstanding Options		Outstanding Awards of Restricted Stock	
	Shares	Avg. Price	Shares	Avg. Price
Balance at December 31, 2006	638,461	\$ 18.79	79,475	\$ 17.99
Options and awards granted				
Less: Options exercised/Awards vested	(40,773)	13.08	(31,500)	11.67
Expired or canceled	(11,496)	20.90	(2,050)	23.55
Balance at March 31, 2007	586,192	\$ 19.14	45,925	\$ 22.09

Financial data pertaining to outstanding stock options and exercisable stock options at March 31, 2007 follows:

Exercise Price	Number of Outstanding Option Shares	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number of Exercisable Option Shares	Weighted Average Exercise Price
\$7.35 \$9.67	52,371	1.0	\$ 8.94	52,371	\$ 8.94
\$11.67	76,979	2.0	11.67	76,979	11.67
\$15.19 \$18.14	9,519	2.9	18.12	9,519	18.12
\$20.11	99,334	4.0	20.11	99,334	20.11
\$20.36	116,557	3.0	20.36	116,557	20.36
\$20.50	121,317	4.9	20.50	79,191	20.50
\$20.71 \$24.05	10,215	5.4	22.12	3,405	22.12

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\$25.94	\$27.32		99,900	6.0	26.00	700	27.22
			586,192	3.8	\$ 19.14	438,056	\$ 17.41

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At March 31, 2007, the aggregate intrinsic value of stock options outstanding and stock options exercisable was \$3.5 million and \$3.3 million, respectively. The total intrinsic value of options exercised during the three months ended March 31, 2007 and 2006, was \$478,000 and \$390,000, respectively. The weighted average remaining contractual life of exercisable option shares as of March 31, 2007 was 3.1 years. The total fair value of shares vested during the three months ended March 31, 2007 and 2006 was \$998,000 and \$388,000, respectively.

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

The following discussion is intended to assist in understanding the financial condition and results of the Company. The information contained in this section should be read with the unaudited condensed consolidated financial statements and its accompanying notes, and the December 31, 2006 audited consolidated financial statements and its accompanying notes included in our recent Annual Report on Form 10-K.

Statements concerning future performance, developments or events, expectations for growth and market forecasts, and any other guidance on future periods, constitute forward-looking statements and are subject to a number of risks and uncertainties, which might cause actual results to differ materially from stated expectations. Specific factors include, but are not limited to, the effect of interest rate changes, risks associated with acquisition of other banks and opening new branches, the ability to control costs and expenses, and general economic conditions. Additional information on these and other factors, which could affect our financial results, are included in our filings with the Securities and Exchange Commission.

Overview

Heritage Financial Corporation is a bank holding company, which primarily engages in the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. We provide financial services to our local communities with an ongoing strategic focus in expanding our commercial lending relationships, market expansion and a continual focus on asset quality. Effective January 8, 1998, our common stock began to trade on the NASDAQ National Market under the symbol HFWA .

Financial Condition Data

Total assets increased \$11.9 million (1.4%) to \$864.8 million as of March 31, 2007 from the December 31, 2006 balance of \$852.9 million. Deposits increased \$16.9 million (2.3%) to \$742.8 million as of March 31, 2007 from the December 31, 2006 balance of \$725.9 million. For the same period, net loans, which include loans held for sale but are net of the allowance for loan losses, increased \$15.8 million (2.1%) to \$755.4 million as of March 31, 2007 from the December 31, 2006 balance of \$739.6 million. Commercial loans increased by \$0.9 million to \$441.4 million as of March 31, 2007 from the December 31, 2006 balance of \$440.5 million. Commercial loans continue to be the largest segment of loans at 57.7% and 58.8% as a percentage of total loans as of March 31, 2007 and December 31, 2006, respectively.

As of March 31, 2007, we have repurchased a total of 5,974,416 of the Company's shares, or 52.4% of the total outstanding at March 31, 1999, which was the inception of our stock repurchase programs, at an average price of \$12.23 per share. We began our current 5% repurchase program on August 2, 2004 with the goal to repurchase approximately 309,750 shares. During the quarter ended March 31, 2007, we repurchased 15,311 shares at an average price of \$24.47. We have repurchased 126,450 shares under the current program at an average price of \$21.91.

Earnings Summary

Net income was \$0.36 per diluted share for the three months ended March 31, 2007 compared to \$0.40 per diluted share for the three months ended March 31, 2006. Actual earnings for the three months ended March 31, 2007 were \$2,373,000 compared to \$2,564,000 for the same period in 2006.

Return on average equity for the quarter ended March 31, 2007 was 11.92% compared to 15.20% for the same period last year. Average equity increased by \$12.3 million to \$80.7 million for the three months ended March 31, 2007 versus \$68.4 million for the same period last year while net income decreased by \$191,000.

Net Interest Income

Net interest income before provision for loan losses for the three months ended March 31, 2007 increased 4.9% to \$8,897,000 from \$8,485,000 for the same quarter in 2006. The net interest margin (net interest income divided by average interest earning assets) decreased to 4.59% for the current quarter from 4.96% for the same quarter last year. A continuation of a flat yield curve and a very competitive business environment has had the effect of reducing our net interest margin.

Interest income increased \$2.6 million, or 20.7%, for the three months ended March 31, 2007 as compared to the first quarter last year and interest expense increased \$2.1 million, or 55.1%, during this same period. Loans averaged \$737.6 million with an average yield of 7.93% for the three months ended March 31, 2007 compared to average loans of \$644.0 million with an average yield of 7.50% for the same period in 2006. Certificates of deposit averaged \$338.3 million with an average cost of 4.80% for the three months ended March 31, 2007 compared to \$285.4 million with an average cost of 3.66% for the same period in 2006.

Table of Contents**Provision for Loan Losses**

The provision for loan losses was \$180,000 for the three months ended March 31, 2007, which was \$40,000 more than the provision for loan losses during the first quarter of 2006.

Noninterest Income

Noninterest income increased 14.8% to \$2,033,000 for the three months ended March 31, 2007 compared with \$1,771,000 for the same quarter in 2006. The increase is due primarily to increases in service charges on deposits of \$115,000, merchant visa income of \$83,000 and brokered mortgage income of \$80,000.

Noninterest Expense

Noninterest expense increased 14.3% to \$7,185,000 during the three months ended March 31, 2007 compared to \$6,285,000 for the same period during 2006. Salaries and employee benefits increased by \$431,000 for the three months ended March 31, 2007 compared to the same period last year. This increase was primarily the result of the acquisition of Western Washington Bancorp, the opening of the Sumner branch and the hiring of additional loan officers. Occupancy and equipment expense and merchant visa expense increased \$100,000 and \$82,000, respectively, compared to the same period last year.

The efficiency ratio for the quarter ended March 31, 2007 was 65.7% compared to 61.3% for the comparable quarter in 2006. The efficiency ratio consists of noninterest expense divided by the sum of net interest income before provision for loan losses plus noninterest income.

Lending Activities

As indicated in the table below, total loans (including loans held for sale) increased to \$765.5 million at March 31, 2007 from \$749.7 million at December 31, 2006.

	At March 31, 2007	% of Total	At December 31, 2006	% of Total
(Dollars in thousands)				
Commercial	\$ 441,359	57.66%	\$ 440,450	58.75%
Real estate mortgages				
One-to-four family residential	59,000	7.71	58,911	7.86
Five or more family residential and commercial properties	185,297	24.21	172,937	23.07
Total real estate mortgages	244,297	31.91	231,848	30.93
Real estate construction				
One-to-four family residential	53,901	7.04	53,298	7.11
Five or more family residential and commercial properties	15,137	1.98	13,532	1.80
Total real estate construction	69,038	9.02	66,830	8.91
Consumer	13,278	1.73	12,976	1.73
Gross loans	767,972	100.32	752,104	100.32
Less: deferred loan fees	(2,462)	(0.32)	(2,403)	(0.32)
Total loans	\$ 765,510	100.00%	\$ 749,701	100.00%

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The following table describes our nonperforming assets for the dates indicated.

	At March 31, 2007	At December 31, 2006
	(Dollars in thousands)	
Nonaccrual loans	\$ 1,613	\$ 2,807
Other real estate owned	80	225
Total nonperforming assets	\$ 1,693	\$ 3,032
Accruing loans past due 90 days or more	\$	\$
Potential problem loans	7,330	7,792
Allowance for loan losses	10,086	10,105
Nonperforming loans to loans	0.21%	0.37%
Allowance for loan losses to loans	1.32%	1.35%
Allowance for loan losses to nonperforming loans	625.20%	360.05%
Nonperforming assets to total assets	0.20%	0.36%

Nonperforming assets decreased to \$1,693,000, or 0.20% of total assets at March 31, 2007 from \$3,032,000, or 0.36% of total assets at December 31, 2006. We believe that we are adequately reserved for losses in the portfolio as of March 31, 2007. Potential problem loans are those loans that are currently accruing interest, but which are considered possible credit problems because financial information of the borrowers causes us concerns as to their ability to comply with the present repayment program and could result in placing the loan on nonaccrual.

Analysis of Allowance for Loan Losses

Management maintains an allowance for loan losses to absorb estimated credit losses associated with the loan portfolio, including all binding commitments to lend. We determine an adequate allowance through our ongoing quarterly loan quality assessments.

We assess the estimated credit losses inherent in our non-classified loan portfolio by considering a number of elements including:

Risk rating of the credit portfolio;

Levels and trends in delinquencies and nonaccruals;

Trends in loan demand and structure including terms and interest rates;

National and local economic trends;

Specific industry conditions such as commercial and residential construction;

Concentrations of credits in specific industries;

Bank regulatory examination results and our own credit examinations; and

Recent loss experience in the portfolio.

We calculate an adequate allowance for the non-classified portion of our loan portfolio based on an appropriate percentage risk factor that is calculated based on the above-noted elements and trends. We may add specific provisions for each classified loan after a careful analysis of that loan's credit and collateral factors. Our analysis of an adequate allowance combines the provisions made for both our non-classified loans and the specific provisions made for each classified loan.

While we believe we use the best information available to determine the allowance for loan losses, net income could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance, unforeseen market conditions arise or if we are directed to make adjustments to the allowance for loan losses by our regulators.

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The following table summarizes the changes in our allowance for loan losses:

	Three Months Ended	
	March 31,	
	2007	2006
	(Dollars in thousands)	
Total loans outstanding at end of period (1)	\$ 765,510	\$ 660,817
Average loans outstanding during period	737,641	643,998
Allowance balance at beginning of period	10,105	8,496
Provision for loan losses	180	140
Charge offs:		
Real estate		(4)