

HERITAGE COMMERCE CORP

Form 10-Q

November 03, 2017

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10 Q

(MARK
ONE)

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

For the quarterly period ended September 30, 2017

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)

150 Almaden Boulevard, San Jose, California

(Address of Principal Executive Offices)

77 0469558

(I.R.S. Employer Identification No.)

95113

(Zip Code)

(408) 947 6900

(Registrant's Telephone Number, Including Area Code)

N/A

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The Registrant had 38,200,006 shares of Common Stock outstanding on October 30, 2017.

Table of Contents

HERITAGE COMMERCE CORP

QUARTERLY REPORT ON FORM 10 Q

TABLE OF CONTENTS

	Page No.
<u>Cautionary Note on Forward Looking Statements</u>	3
 <u>Part I. FINANCIAL INFORMATION</u>	
<u>Item 1. Consolidated Financial Statements (unaudited)</u>	5
<u>Consolidated Balance Sheets</u>	5
<u>Consolidated Statements of Income</u>	6
<u>Consolidated Statements of Comprehensive Income</u>	7
<u>Consolidated Statements of Changes in Shareholders' Equity</u>	8
<u>Consolidated Statements of Cash Flows</u>	9
<u>Notes to Unaudited Consolidated Financial Statements</u>	10
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	40
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	75
<u>Item 4. Controls and Procedures</u>	75
 <u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	76
<u>Item 1A. Risk Factors</u>	76
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	76
<u>Item 3. Defaults Upon Senior Securities</u>	76
<u>Item 4. Mine Safety Disclosures</u>	76
<u>Item 5. Other Information</u>	76
<u>Item 6. Exhibits</u>	77

SIGNATURES

77

2

Table of Contents

Cautionary Note Regarding Forward Looking Statements

This Report on Form 10 Q contains various statements that may constitute forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended, Rule 3b 6 promulgated thereunder and are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Any statements about our expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and may be forward looking. These forward looking statements often can be, but are not always, identified by the use of words such as “assume,” “expect,” “intend,” “plan,” “project,” “believe,” “estimate,” “predict,” “anticipate,” “may,” “might,” “could,” “goal,” “potential” and similar expressions. We base these forward looking statements on our current expectations and projections about future events, our assumptions regarding these events and our knowledge of facts at the time the statements are made. These statements include statements relating to our projected growth, anticipated future financial performance, and management’s long term performance goals, as well as statements relating to the anticipated effects on results of operations and financial condition.

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

- current and future economic and market conditions in the United States generally or in the communities we serve, including the effects of declines in property values, high unemployment rates and overall slowdowns in economic growth should these events occur;
- effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Federal Open Market Committee of the Federal Reserve Board;
- changes in inflation, interest rates, and market liquidity which may impact interest margins and impact funding sources;
- volatility in credit and equity markets and its effect on the global economy;
- changes in the competitive environment among financial or bank holding companies and other financial service providers;
- changes in consumer and business spending and saving habits and the related effect on our ability to increase assets and to attract deposits;
- our ability to develop and promote customer acceptance of new products and services in a timely manner;
- risks associated with concentrations in real estate related loans;
- an imbalance of supply and demand or deterioration in values of California commercial real estate;
- a prolonged slowdown in construction activity;
- other than temporary impairment charges to our securities portfolio;
- changes in the level of nonperforming assets and charge offs and other credit quality measures, and their impact on the adequacy of the Company’s allowance for loan losses and the Company’s provision for loan losses;
- our ability to raise capital or incur debt on reasonable terms;
- regulatory limits on Heritage Bank of Commerce’s ability to pay dividends to the Company;

Table of Contents

- changes in our capital management policies, including those regarding business combinations, dividends, and share repurchases, among others;
- operational issues stemming from, and/or capital spending necessitated by, the potential need to adapt to industry changes in information technology systems, on which we are highly dependent;
- our ability to keep pace with technological changes, including our ability to identify and address cyber-security risks such as data security breaches, “denial of service” attacks, “hacking” and identity theft;
- inability of our framework to manage risks associated with our business, including operational risk and credit risk;
- risks of loss of funding of Small Business Administration or SBA loan programs, or changes in those programs;
- effect and uncertain impact on the Company of the enactment of the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 and the rules and regulations promulgated by supervisory and oversight agencies implementing the new legislation;
- effect of lower corporate tax rates if enacted on the Company’s deferred tax assets, equity, and income tax provision;
- significant changes in applicable laws and regulations, including those concerning taxes, banking and securities;
 - effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;
- costs and effects of legal and regulatory developments, including resolution of legal proceedings or regulatory or other governmental inquiries, and the results of regulatory examinations or reviews;
- availability of and competition for acquisition opportunities;
- risks associated with merger and acquisition integration;
- risks resulting from domestic terrorism;
- risks of natural disasters and other events beyond our control; and
- our success in managing the risks involved in the foregoing factors.

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

Table of Contents

Part I—FINANCIAL INFORMATION

ITEM 1—CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HERITAGE COMMERCE CORP

CONSOLIDATED BALANCE SHEETS (Unaudited)

	September 30, 2017	December 31, 2016
	(Dollars in thousands)	
Assets		
Cash and due from banks	\$ 37,133	\$ 27,993
Other investments and interest-bearing deposits in other financial institutions	308,987	238,110
Total cash and cash equivalents	346,120	266,103
Securities available-for-sale, at fair value	390,107	306,589
Securities held-to-maturity, at amortized cost (fair value of \$377,845 at September 30, 2017 and \$318,748 at December 31, 2016)	379,550	324,010
Loans held-for-sale - SBA, at lower of cost or fair value, including deferred costs	4,602	5,705
Loans, net of deferred fees	1,565,950	1,502,607
Allowance for loan losses	(19,748)	(19,089)
Loans, net	1,546,202	1,483,518
Federal Home Loan Bank and Federal Reserve Bank stock and other investments, at cost	17,905	15,196
Company-owned life insurance	60,407	59,148
Premises and equipment, net	7,539	7,490
Goodwill	45,664	45,664
Other intangible assets	5,867	6,950
Accrued interest receivable and other assets	39,985	50,507
Total assets	\$ 2,843,948	\$ 2,570,880
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 943,723	\$ 917,187
Demand, interest-bearing	605,301	541,282
Savings and money market	713,693	572,743
Time deposits - under \$250	53,479	57,857
Time deposits - \$250 and over	147,422	163,670
CDARS - interest-bearing demand, money market and time deposits	16,986	9,401

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total deposits	2,480,604	2,262,140
Subordinated debt, net of issuance costs	39,137	—
Accrued interest payable and other liabilities	48,762	48,890
Total liabilities	2,568,503	2,311,030
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized; none issued and outstanding	—	—
Common stock, no par value; 60,000,000 shares authorized; 39,199,006 shares issued and outstanding at September 30, 2017 and 37,941,007 shares issued and outstanding at December 31, 2016	217,906	215,237
Retained earnings	63,679	52,527
Accumulated other comprehensive loss	(6,140)	(7,914)
Total shareholders' equity	275,445	259,850
Total liabilities and shareholders' equity	\$ 2,843,948	\$ 2,570,880

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(Dollars in thousands, except per share amounts)			
Interest income:				
Loans, including fees	\$ 22,507	\$ 20,312	\$ 64,112	\$ 59,235
Securities, taxable	3,596	2,401	9,916	8,004
Securities, exempt from Federal tax	563	569	1,694	1,723
Other investments and interest- bearing deposits in other financial institutions	1,289	592	3,037	1,478
Total interest income	27,955	23,874	78,759	70,440
Interest expense:				
Deposits	1,051	826	2,867	2,332
Subordinated debt	583	—	811	—
Short-term borrowings	—	—	1	12
Total interest expense	1,634	826	3,679	2,344
Net interest income before provision for loan losses	26,321	23,048	75,080	68,096
Provision for loan losses	115	245	390	997
Net interest income after provision for loan losses	26,206	22,803	74,690	67,099
Noninterest income:				
Service charges and fees on deposit accounts	869	798	2,410	2,348
Increase in cash surrender value of life insurance	417	428	1,259	1,317
Servicing income	246	364	736	1,106
Gain on sales of SBA loans	147	69	635	653
Gain on proceeds from company-owned life insurance	—	—	—	1,019
Gain (loss) on sales of securities	—	—	(6)	527
Other	781	653	2,014	1,616
Total noninterest income	2,460	2,312	7,048	8,586
Noninterest expense:				
Salaries and employee benefits	9,071	8,363	27,766	26,052
Occupancy and equipment	1,142	1,120	3,426	3,277
Professional fees	695	1,086	2,439	2,619
Other	3,926	3,727	11,785	11,414
Total noninterest expense	14,834	14,296	45,416	43,362
Income before income taxes	13,832	10,819	36,322	32,323
Income tax expense	5,249	4,054	13,752	12,157

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Net income	8,583	6,765	22,570	20,166
Dividends on preferred stock	—	(504)	—	(1,512)
Net income available to common shareholders	8,583	6,261	22,570	18,654
Undistributed earnings allocated to Series C preferred stock	—	(300)	—	(1,278)
Distributed and undistributed earnings allocated to common shareholders	\$ 8,583	\$ 5,961	\$ 22,570	\$ 17,376
Earnings per common share:				
Basic	\$ 0.22	\$ 0.18	\$ 0.59	\$ 0.53
Diluted	\$ 0.22	\$ 0.18	\$ 0.59	\$ 0.53

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(Dollars in thousands)			
Net income	\$ 8,583	\$ 6,765	\$ 22,570	\$ 20,166
Other comprehensive income:				
Change in net unrealized holding gains on available-for-sale securities and I/O strips	539	208	2,975	7,770
Deferred income taxes	(227)	(87)	(1,250)	(3,263)
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(12)	(13)	(38)	(103)
Deferred income taxes	5	5	16	43
Reclassification adjustment for losses (gains) realized in income	—	—	6	(527)
Deferred income taxes	—	—	(2)	221
Change in unrealized gains on securities and I/O strips, net of deferred income taxes	305	113	1,707	4,141
Change in net pension and other benefit plan liability adjustment	39	37	116	123
Deferred income taxes	(17)	(16)	(49)	(52)
Change in pension and other benefit plan liability, net of deferred income taxes	22	21	67	71
Other comprehensive income	327	134	1,774	4,212
Total comprehensive income	\$ 8,910	\$ 6,899	\$ 24,344	\$ 24,378

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

Nine Months Ended September 30, 2017 and 2016

	Preferred Stock		Common Stock		Retained Earnings	Accumulated Other Comprehensive Income / (Loss)	Total Shareholders' Equity
	Shares	Amount (Dollars in thousands)	Shares	Amount			
Balance, January 1, 2016	21,004	\$ 19,519	32,113,479	\$ 193,364	\$ 38,773	\$ (6,220)	\$ 245,436
Net income	—	—	—	—	20,166	—	20,166
Other comprehensive income	—	—	—	—	—	4,212	4,212
Preferred stock exchanged for common stock	(21,004)	(19,519)	5,601,000	19,519	—	—	—
Issuance of restricted stock awards, net	—	—	82,372	—	—	—	—
Amortization of restricted stock awards, net of forfeitures and taxes	—	—	—	291	—	—	291
Cash dividend declared \$0.27 per share	—	—	—	—	(10,213)	—	(10,213)
Stock option expense, net of forfeitures and taxes	—	—	—	712	—	—	712
Stock options exercised	—	—	118,885	715	—	—	715
Balance, September 30, 2016	—	\$ —	37,915,736	\$ 214,601	\$ 48,726	\$ (2,008)	\$ 261,319
Balance, January 1, 2017	—	—	37,941,007	\$ 215,237	\$ 52,527	\$ (7,914)	\$ 259,850
Net income	—	—	—	—	22,570	—	22,570
Other comprehensive income	—	—	—	—	—	1,774	1,774
Issuance of restricted stock awards, net	—	—	64,136	—	—	—	—
Amortization of restricted stock awards, net of forfeitures and taxes	—	—	—	678	—	—	678
Cash dividend declared \$0.30 per share	—	—	—	—	(11,418)	—	(11,418)
Stock option expense, net of forfeitures and taxes	—	—	—	639	—	—	639
Stock options exercised	—	—	193,863	1,352	—	—	1,352

Balance, September 30, 2017	—	\$ —	38,199,006	\$ 217,906	\$ 63,679	\$ (6,140)	\$ 275,445
--------------------------------	---	------	------------	------------	-----------	------------	------------

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Nine Months Ended September 30,	
	2017	2016
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 22,570	\$ 20,166
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	3,218	3,013
(Gain) loss on sale of securities available-for-sale	6	(527)
(Gain) loss on sale of SBA loans	(635)	(653)
Proceeds from sale of SBA loans originated for sale	8,304	9,447
Net change in SBA loans originated for sale	(8,957)	(11,029)
Provision for loan losses	390	997
Increase in cash surrender value of life insurance	(1,259)	(1,317)
Depreciation and amortization	586	565
Amortization of other intangible assets	1,083	1,176
Stock option expense, net	639	712
Amortization of restricted stock awards, net	678	291
Amortization of subordinated debt issuance costs	64	—
Gain on proceeds from company owned life insurance	—	(1,019)
Effect of changes in:		
Accrued interest receivable and other assets	2,428	(1,340)
Accrued interest payable and other liabilities	(12)	(2,311)
Net cash provided by operating activities	29,103	18,171
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(123,561)	(75,803)
Purchase of securities held-to-maturity	(89,470)	(109,934)
Maturities/paydowns/calls of securities available-for-sale	41,463	47,635
Maturities/paydowns/calls of securities held-to-maturity	32,502	15,941
Proceeds from sales of securities available-for-sale	6,536	49,171
Net change in loans	(60,683)	(88,609)
Changes in Federal Home Loan Bank stock and other investments	(2,709)	(2,502)
Purchase of premises and equipment	(635)	(344)
Proceeds from sale of foreclosed assets	—	49
Proceeds from company owned life insurance	—	3,164
Net cash used in investing activities	(196,557)	(161,232)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	218,464	155,859

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Issuance of subordinated debt, net of issuance costs	39,073	—
Exercise of stock options	1,352	715
Repayment of short-term borrowings	—	(3,000)
Payment of cash dividends	(11,418)	(10,213)
Net cash provided by financing activities	247,471	143,361
Net decrease in cash and cash equivalents	80,017	300
Cash and cash equivalents, beginning of year	266,103	344,092
Cash and cash equivalents, end of year	\$ 346,120	\$ 344,392
Supplemental disclosures of cash flow information:		
Interest paid	\$ 2,912	\$ 2,327
Income taxes paid	11,731	12,135
Supplemental schedule of non-cash investing activity:		
Transfer of loans held-for-sale to loan portfolio	\$ 2,391	\$ 2,791
Loans transferred to foreclosed assets	—	49

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2017

(Unaudited)

1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the “Company” or “HCC”) and its wholly owned subsidiary, Heritage Bank of Commerce (“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, 2016.

The Company acquired Focus Business Bank (“Focus”) on August 20, 2015. Focus was merged with HBC, with HBC as the surviving bank.

HBC is a commercial bank serving customers primarily located in Santa Clara, Alameda, Contra Costa, and San Benito counties of California. BVF/CSNK Acquisition Corp., a Delaware corporation (“BVF/CSNK”), the parent company of CSNK Working Capital Finance Corp. dba Bay View Funding (“Bay View Funding”) is a wholly owned subsidiary of HBC, and provides business-essential working capital factoring financing to various industries throughout the United States. No customer accounts for more than 10% of revenue for HBC or the Company. The Company reports its results for two segments: banking and factoring. The Company’s management uses segment results in its operating and strategic planning.

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

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

The results for the three and nine months ended September 30, 2017 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2017.

Reclassifications

Certain reclassifications of prior year balances have been made to conform to the current year presentation. These reclassifications had no impact on the Company's consolidated financial position, results of operations or net change in cash and cash equivalents.

Adoption of New Accounting Standards

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-09, Compensation—Stock Compensation: Improvements to Employee Share Based Payment Accounting. The standard is intended to simplify several areas of accounting for share based compensation arrangements, including the income tax impact, classification on the statement of cash flows and forfeitures. All excess tax benefits and tax deficiencies (including tax benefits of dividends on share based payment awards) should be recognized as income tax expense or benefit in the income statement. The tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. An entity also should recognize excess tax benefits regardless of whether the benefit reduces taxes payable in the current period. Excess tax benefits should be classified along with other income tax cash flows as an operating activity. An entity can make an entity wide accounting

Table of Contents

policy election to either estimate the number of awards that are expected to vest (current GAAP) or account for forfeitures when they occur. The threshold to qualify for equity classification permits withholding up to the maximum statutory tax rates in the applicable jurisdictions. The Company adopted the new guidance on January 1, 2017. The amount of the impact on the effective tax rate will be determined by the number of stock options exercised and the stock price of the Company when the stock options are exercised, and the amount of restricted stock awards vesting. The adoption of this guidance resulted in a reduction to net income tax expense of (\$106,000) for the third quarter of 2017, and a reduction to income tax expense of (\$158,000) for the first nine months of 2017. In connection with the adoption, the Company has elected to estimate forfeitures each reporting period.

Newly Issued, but not yet Effective Accounting Standards

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which was an update to the guidance for accounting for revenue from contracts with customers. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2017. The Company's revenue is primarily comprised of net interest income on financial assets and liabilities, which is excluded from the scope of ASU No. 2014-09. The Company has determined the result of applying this ASU to the individual revenue streams affected, as well as on an aggregate basis, will not be material to the Company's consolidated financial statements. The Company continues to evaluate the impact of the disclosure requirements associated with ASU No. 2014-09.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Recognition and Measurement of Financial Assets and Liabilities. The new guidance is intended to improve the recognition and measurement of financial instruments by requiring: equity investments (other than equity method or consolidation) to be measured at fair value with changes in fair value recognized in net income; public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; separate presentation of financial assets and financial liabilities by measurement category and form of financial assets (i.e. securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement to disclose the fair value of financial instruments measured at amortized cost for organizations that are not public business entities; eliminating the requirement for non-public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is to be required to be disclosed for financial instruments measured at amortized cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from the change in the instrument-specific credit risk (also referred to as "own credit") when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. The new guidance is effective

for public business entities for fiscal years beginning after December 15, 2017. We are currently evaluating the impact of adopting the new guidance on the consolidated financial statements. Our preliminary finding is that the new pronouncement will not have a significant impact on our Statement of Operations as the majority of the Company's investment securities are classified as available-for-sale and held-to-maturity debt securities. The pronouncement will require some revision to our disclosures within the consolidated financial statements and we are currently evaluating the impact.

In February 2016, the FASB issued ASU No. 2016-02, Leases. The standard requires a lessee to recognize assets and liabilities on the balance sheet for leases with lease terms greater than 12 months. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right of use asset representing its right to use the underlying asset for the lease term. When measuring assets and liabilities arising from a lease, a lessee (and a lessor) should include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. Similarly, optional payments to purchase the underlying asset should be included in the measurement of lease assets and lease liabilities only if the lessee is reasonably certain to exercise that purchase option. Reasonably certain is a high threshold that is consistent with and intended to be applied in the same way as the reasonably assured threshold in the previous leases

Table of Contents

guidance. In addition, also consistent with the previous leases guidance, a lessee (and a lessor) should exclude most variable lease payments in measuring lease assets and lease liabilities, other than those that depend on an index or a rate or are in substance fixed payments. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight line basis over the lease term. The new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, and early adoption is permitted. We are currently evaluating the provisions of this ASU and have determined that the provisions of ASU No. 2016-02 will result in an increase in assets to recognize the present value of the lease obligations with a corresponding increase in liabilities; however, we do not expect this to have a material impact to the Company's results of operations or cash flows.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments—Credit Losses: Measurement of Credit Losses on Financial Instruments. The standard is the final guidance on the new current expected credit loss (“CECL”) model. The amendments in this update replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to estimate future credit loss estimates. As CECL encompasses all financial assets carried at amortized cost, the requirement that reserves be established based on an organization's reasonable and supportable estimate of expected credit losses extends to held-to-maturity debt securities. The update amends the accounting for credit losses on available for sale securities, whereby credit losses will be presented as an allowance as opposed to a write down. In addition, CECL will modify the accounting for purchased loans with credit deterioration since origination, so that reserves are established at the date of acquisition for purchased loans. Lastly, the amendment requires enhanced disclosures on the significant estimates and judgments used to estimate credit losses, as well as on the credit quality and underwriting standards of an organization's portfolio. These disclosures require organizations to present the currently required credit quality disclosures disaggregated by the year of origination or vintage. The guidance allows for a modified retrospective approach with a cumulative effect adjustment to the balance sheet upon adoption (charge to retained earnings instead of the income statement). The new guidance is effective for public business entities for fiscal years, and interim periods within those years, beginning after December 15, 2019, and early adoption is permitted. We have formed a committee that is assessing our data and system needs and are evaluating the impact of adopting the new guidance. We expect to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, but cannot yet determine the magnitude of any such one-time adjustment or the overall impact of the new guidance on the consolidated financial statements.

In January 2017, the FASB issued accounting standards ASU No. 2017-04, Simplifying the Test for Goodwill Impairment. The provisions of the update eliminate the existing second step of the goodwill impairment test which provides for the allocation of reporting unit fair value among existing assets and liabilities, with the net remaining amount representing the implied fair value of goodwill. In replacement of the existing goodwill impairment rule, the update will provide that impairment should be recognized as the excess of any of the reporting unit's goodwill over the fair value of the reporting unit. Under the provisions of this update, the amount of the impairment is limited to the carrying value of the reporting unit's goodwill. For public business entities that are SEC filers, the amendments of the update will become effective in fiscal years beginning after December 15, 2019. Management does not expect the requirements of this update to have a material impact on the Company's financial position, results of operations or cash flows.

2) Shareholders' Equity and Earnings Per Share

On September 12, 2016, the Company, entered into Exchange Agreements with Castle Creek Capital Partners IV, LP, Patriot Financial Partners, L.P. and Patriot Financial Partners Parallel, L.P. (collectively "Preferred Stockholders") providing for the exchange of 21,004 shares of the Company's Series C convertible perpetual preferred stock, no par value ("Series C Preferred Stock"), for 5,601,000 shares of the Company's common stock, no par value. The exchange ratio was equal to the equivalent number of shares the Preferred Stockholders would have received upon conversion of the Series C Preferred Stock into the Company's common stock.

12

Table of Contents

Earnings Per Share -- Basic earnings per common share is computed by dividing net income, less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. The Series C Preferred Stock participated in the earnings of the Company prior to the exchange for common stock and, therefore, the shares issued on the conversion of the Series C Preferred Stock were considered outstanding under the two class method of computing basic earnings per common share during periods of earnings. Diluted earnings per share reflect potential dilution from outstanding stock options using the treasury stock method. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(Dollars in thousands, except per share amounts)			
Net income available to common shareholders	\$ 8,583	\$ 6,261	\$ 22,570	\$ 18,654
Less: undistributed earnings allocated to Series C Preferred Stock	—	(300)	—	(1,278)
Distributed and undistributed earnings allocated to common shareholders	\$ 8,583	\$ 5,961	\$ 22,570	\$ 17,376
Weighted average common shares outstanding for basic earnings per common share	38,152,633	33,397,704	38,060,224	32,591,784
Dilutive effect of stock options outstanding, using the treasury stock method	428,665	295,624	504,910	272,071
Shares used in computing diluted earnings per common share	38,581,298	33,693,328	38,565,134	32,863,855
Basic earnings per share	\$ 0.22	\$ 0.18	\$ 0.59	\$ 0.53
Diluted earnings per share	\$ 0.22	\$ 0.18	\$ 0.59	\$ 0.53

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

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

Three Months Ended September 30, 2017 and 2016
Unamortized
Unrealized

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	Unrealized Gains (Losses) Available-for-Sale Securities and I/O Strips(1) (Dollars in thousands)	Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity	Defined Benefit Pension Plan Items	Total
Beginning balance July 1, 2017, net of taxes	\$ 877	\$ 321	\$ (7,665)	\$ (6,467)
Other comprehensive income (loss) before reclassification, net of taxes	312	—	(7)	305
Amounts reclassified from other comprehensive income (loss), net of taxes	—	(7)	29	22
Net current period other comprehensive income (loss), net of taxes	312	(7)	22	327
Ending balance September 30, 2017, net of taxes	\$ 1,189	\$ 314	\$ (7,643)	\$ (6,140)
Beginning balance July 1, 2016, net of taxes	\$ 5,170	\$ 351	\$ (7,663)	\$ (2,142)
Other comprehensive income (loss) before reclassification, net of taxes	121	—	(6)	115
Amounts reclassified from other comprehensive income (loss), net of taxes	—	(8)	27	19
Net current period other comprehensive income (loss), net of taxes	121	(8)	21	134
Ending balance September 30, 2016, net of taxes	\$ 5,291	\$ 343	\$ (7,642)	\$ (2,008)

Table of Contents

	Nine Months Ended September 30, 2017 and 2016			
	Unrealized Gains (Losses) Available-for-Sale Securities and I/O Strips	Unamortized Unrealized Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity	Defined Benefit Pension Plan Items	Total
Beginning balance January 1, 2017, net of taxes	\$ (540)	\$ 336	\$ (7,710)	\$ (7,914)
Other comprehensive (loss) before reclassification, net of taxes	1,725	—	(22)	1,703
Amounts reclassified from other comprehensive income (loss), net of taxes	4	(22)	89	71
Net current period other comprehensive income (loss), net of taxes	1,729	(22)	67	1,774
Ending balance September 30, 2017, net of taxes	\$ 1,189	\$ 314	\$ (7,643)	\$ (6,140)
Beginning balance January 1, 2016, net of taxes	\$ 1,090	\$ 403	\$ (7,713)	\$ (6,220)
Other comprehensive (loss) before reclassification, net of taxes	4,507	—	(11)	4,496
Amounts reclassified from other comprehensive income (loss), net of taxes	(306)	(60)	82	(284)
Net current period other comprehensive income (loss), net of taxes	4,201	(60)	71	4,212
Ending balance September 30, 2016, net of taxes	\$ 5,291	\$ 343	\$ (7,642)	\$ (2,008)

Details About AOCI Components	Amounts Reclassified from AOCI(1)		Affected Line Item Where Net Income is Presented
	Three Months Ended September 30, 2017	2016	
Unrealized (loss) gains on available-for-sale securities and I/O strips	\$ —	\$ —	Gain on sales of securities
	—	—	Income tax expense
	—	—	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	12	13	Interest income on taxable securities

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	(5)	(5)	Income tax expense
	7	8	Net of tax
Amortization of defined benefit pension plan items			
(1)			
Prior transition obligation	18	13	
Actuarial losses	(69)	(60)	
	(51)	(47)	Income before income tax
	22	20	Income tax benefit
	(29)	(27)	Net of tax
Total reclassification for the year	\$ (22)	\$ (19)	

(1) This AOCI component is included in the computation of net periodic benefit cost (see Note 8—Benefit Plans) and includes split-dollar life insurance benefit plan.

Table of Contents

Details About AOCI Components	Amounts Reclassified from AOCI(1) Nine Months Ended September 30,		Net Income is Presented
	2017	2016	
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	\$ (6)	\$ 527	Gain (loss) on sales of securities
	2	(221)	Income tax expense
	(4)	306	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	38	103	Interest income on taxable securities
	(16)	(43)	Income tax expense
	22	60	Net of tax
Amortization of defined benefit pension plan items (1)			
Prior transition obligation	53	39	
Actuarial losses	(207)	(180)	
	(154)	(141)	Income before income tax
	65	59	Income tax benefit
	(89)	(82)	Net of tax
Total reclassification from AOCI for the year	\$ (71)	\$ 284	

(1) This AOCI component is included in the computation of net periodic benefit cost (see Note 8—Benefit Plans) and includes split-dollar life insurance benefit plan.

4) Securities

The amortized cost and estimated fair value of securities at September 30, 2017 and December 31, 2016 were as follows:

September 30, 2017	Amortized Cost (Dollars in thousands)	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 374,057	1,275	(2,165)	\$ 373,167
Trust preferred securities	15,000	1,940	—	16,940

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total	\$ 389,057	\$ 3,215	\$ (2,165)	\$ 390,107
Securities held-to-maturity:				
Agency mortgage-backed securities	\$ 290,418	\$ 259	\$ (2,341)	\$ 288,336
Municipals - exempt from Federal tax	89,132	1,054	(677)	89,509
Total	\$ 379,550	\$ 1,313	\$ (3,018)	\$ 377,845

Table of Contents

December 31, 2016	Amortized Cost (Dollars in thousands)	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 293,598	\$ 928	\$ (3,537)	\$ 290,989
Trust preferred securities	15,000	600	—	15,600
Total	\$ 308,598	\$ 1,528	\$ (3,537)	\$ 306,589
Securities held-to-maturity:				
Agency mortgage-backed securities	\$ 233,409	\$ 15	\$ (3,554)	\$ 229,870
Municipals - exempt from Federal tax	90,601	521	(2,244)	88,878
Total	\$ 324,010	\$ 536	\$ (5,798)	\$ 318,748

Securities with unrealized losses at September 30, 2017 and December 31, 2016, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

September 30, 2017	Less Than 12 Months		12 Months or More		Total	Unrealized (Losses)
	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	
(Dollars in thousands)						
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 237,933	\$ (2,049)	\$ 9,346	\$ (116)	\$ 247,279	\$ (2,165)
Total	\$ 237,933	\$ (2,049)	\$ 9,346	\$ (116)	\$ 247,279	\$ (2,165)
Securities held-to-maturity:						
Agency mortgage-backed securities	\$ 191,603	\$ (1,980)	\$ 26,547	\$ (361)	\$ 218,150	\$ (2,341)
Municipals - exempt from Federal tax	15,922	(116)	20,443	(561)	36,365	(677)
Total	\$ 207,525	\$ (2,096)	\$ 46,990	\$ (922)	\$ 254,515	\$ (3,018)
December 31, 2016						
(Dollars in thousands)						
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 245,045	\$ (3,537)	\$ —	\$ —	\$ 245,045	\$ (3,537)
Total	\$ 245,045	\$ (3,537)	\$ —	\$ —	\$ 245,045	\$ (3,537)

Securities held-to-maturity:

Agency mortgage-backed securities	\$ 222,132	\$ (3,528)	\$ 612	\$ (26)	\$ 222,744	\$ (3,554)
Municipals - exempt from Federal tax	57,304	(2,026)	2,046	(218)	59,350	(2,244)
Total	\$ 279,436	\$ (5,554)	\$ 2,658	\$ (244)	\$ 282,094	\$ (5,798)

There were no holdings of securities of any one issuer, other than the U.S. Government and its sponsored entities, in an amount greater than 10% of shareholders' equity. At September 30, 2017, the Company held 494 securities (174 available-for-sale and 320 held to maturity), of which 250 had fair values below amortized cost. At September 30, 2017, there were \$9,346,000 of agency mortgage-back securities available-for-sale, \$26,547,000 of agency mortgage-backed securities held-to-maturity and \$20,443,000 of municipal bonds held-to-maturity, carried with an unrealized loss for 12 months or more. The total unrealized loss for securities 12 months or more was \$1,038,000 at September 30, 2017. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company does not consider these securities to be other than temporarily impaired at September 30, 2017.

Table of Contents

The proceeds from sales of securities and the resulting gains and losses were as follows for the periods indicated:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
	(Dollars in thousands)		(Dollars in thousands)	
Proceeds	\$ —	\$ —	\$ 6,536	\$ 49,171
Gross gains	—	—	—	544
Gross losses	—	—	(6)	(17)

The amortized cost and estimated fair values of securities as of September 30, 2017 are shown by contractual maturity below. The expected maturities will differ from contractual maturities if borrowers have the right to call or pre pay obligations with or without call or pre payment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after ten years	\$ 15,000	\$ 16,940
Agency mortgage-backed securities	374,057	373,167
Total	\$ 389,057	\$ 390,107

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due 3 months or less	\$ 370	\$ 371
Due after 3 months through one year	505	506
Due after one through five years	3,680	3,756
Due after five through ten years	20,125	20,668
Due after ten years	64,452	64,208
Agency mortgage-backed securities	290,418	288,336
Total	\$ 379,550	\$ 377,845

5) Loans

Loans were as follows for the periods indicated:

	September 30, 2017	December 31, 2016
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	\$ 587,276	\$ 604,331
Real estate:		
CRE	754,856	662,228
Land and construction	92,310	81,002
Home equity	74,171	82,459
Residential mortgages	46,489	52,887
Consumer	11,749	20,460
Loans	1,566,851	1,503,367
Deferred loan fees, net	(901)	(760)
Loans, net of deferred fees	1,565,950	1,502,607
Allowance for loan losses	(19,748)	(19,089)
Loans, net	\$ 1,546,202	\$ 1,483,518

Table of Contents

At September 30, 2017 and December 31, 2016, total net loans included in the table above include \$64,765,000 and \$88,453,000, respectively, of the loans acquired in the Focus transaction that were not purchased credit impaired loans.

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

	Three Months Ended September 30, 2017			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 11,259	\$ 7,982	\$ 156	\$ 19,397
Charge-offs	(111)	—	—	(111)
Recoveries	281	66	—	347
Net recoveries	170	66	—	236
Provision (credit) for loan losses	(441)	592	(36)	115
End of period balance	\$ 10,988	\$ 8,640	\$ 120	\$ 19,748

	Three Months Ended September 30, 2016			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 11,528	\$ 8,277	\$ 116	\$ 19,921
Charge-offs	(160)	—	—	(160)
Recoveries	21	5	—	26
Net (charge-offs) recoveries	(139)	5	—	(134)
Provision (credit) for loan losses	792	(519)	(28)	245
End of period balance	\$ 12,181	\$ 7,763	\$ 88	\$ 20,032

	Nine Months Ended September 30, 2017			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 10,656	\$ 8,327	\$ 106	\$ 19,089

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Charge-offs	(2,179)	—	—	(2,179)
Recoveries	1,453	995	—	2,448
Net (charge-offs) recoveries	(726)	995	—	269
Provision (credit) for loan losses	1,058	(682)	14	390
End of period balance	\$ 10,988	\$ 8,640	\$ 120	\$ 19,748

	Nine Months Ended September 30, 2016			Total
	Commercial	Real Estate	Consumer	
	(Dollars in thousands)			
Beginning of period balance	\$ 10,748	\$ 8,076	\$ 102	\$ 18,926
Charge-offs	(300)	—	—	(300)
Recoveries	182	227	—	409
Net (charge-offs) recoveries	(118)	227	—	109
Provision (credit) for loan losses	1,551	(540)	(14)	997
End of period balance	\$ 12,181	\$ 7,763	\$ 88	\$ 20,032

Table of Contents

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

	September 30, 2017			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 217	\$ 25	\$ —	\$ 242
Collectively evaluated for impairment	10,771	8,615	120	19,506
Acquired with deteriorated credit quality	—	—	—	—
Total allowance balance	\$ 10,988	\$ 8,640	\$ 120	\$ 19,748
Loans:				
Individually evaluated for impairment	\$ 1,833	\$ 1,982	\$ 1	\$ 3,816
Collectively evaluated for impairment	585,443	965,844	11,748	1,563,035
Acquired with deteriorated credit quality	—	—	—	—
Total loan balance	\$ 587,276	\$ 967,826	\$ 11,749	\$ 1,566,851
	December 31, 2016			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 329	\$ —	\$ —	\$ 329
Collectively evaluated for impairment	10,327	8,327	106	18,760
Acquired with deteriorated credit quality	—	—	—	—
Total allowance balance	\$ 10,656	\$ 8,327	\$ 106	\$ 19,089
Loans:				
Individually evaluated for impairment	\$ 2,057	\$ 885	\$ 3	\$ 2,945
Collectively evaluated for impairment	602,029	877,691	20,457	1,500,177
Acquired with deteriorated credit quality	245	—	—	245
Total loan balance	\$ 604,331	\$ 878,576	\$ 20,460	\$ 1,503,367

Table of Contents

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of September 30, 2017 and December 31, 2016. The recorded investment included in the following table represents loan principal net of any partial charge-offs recognized on the loans. The unpaid principal balance represents the recorded balance prior to any partial charge-offs. The recorded investment in consumer loans collateralized by residential real estate property that are in process of foreclosure according to local requirements of the applicable jurisdiction are not material as of the periods indicated:

	September 30, 2017			December 31, 2016		
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
(Dollars in thousands)						
With no related allowance recorded:						
Commercial	\$ 1,370	\$ 1,370	\$ —	\$ 1,808	\$ 1,808	\$ —
Real estate:						
CRE	501	501	—	1,278	419	—
Land and construction	202	183	—	218	199	—
Home Equity	388	388	—	267	267	—
Consumer	1	1	—	3	3	—
Total with no related allowance recorded	2,462	2,443	—	3,574	2,696	—
With an allowance recorded:						
Commercial	463	463	217	494	494	329
Real estate:						
Land and construction	910	910	25	—	—	—
Total with an allowance recorded	1,373	1,373	242	494	494	329
Total	\$ 3,835	\$ 3,816	\$ 242	\$ 4,068	\$ 3,190	\$ 329

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

	Three Months Ended September 30, 2017					
	Real Estate		Land and Construction	Home Equity	Consumer	Total
Commercial	CRE	Commercial				
(Dollars in thousands)						
Average of impaired loans during the period	\$ 2,010	\$ 501	\$ 641	\$ 394	\$ 1	\$ 3,547
Interest income during impairment	\$ —	\$ —	\$ 3	\$ —	\$ —	\$ 3

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Cash-basis interest earned \$ — \$ — \$ — \$ — \$ — \$ —

Three Months Ended September 30, 2016

Real Estate

	Commercial CRE (Dollars in thousands)	Land and Construction	Home Equity	Consumer	Total
Average of impaired loans during the period	\$ 2,200	\$ 1,644	\$ 204	\$ 3	\$ 4,567
Interest income during impairment	\$ —	\$ —	\$ —	\$ —	\$ —
Cash-basis interest earned	\$ —	\$ —	\$ —	\$ —	\$ —

Table of Contents

Nine Months Ended September 30, 2017

Real Estate

	Commercial CRE (Dollars in thousands)		Land and Construction	Home Equity	Consumer	Total
Average of impaired loans during the period	\$ 2,625	\$ 583	\$ 419	\$ 326	\$ 2	\$ 3,955
Interest income during impairment	\$ —	\$ —	\$ 3	\$ —	\$ —	\$ 3
Cash-basis interest earned	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —

Nine Months Ended September 30, 2016

Real Estate

	Commercial CRE (Dollars in thousands)		Land and Construction	Home Equity	Consumer	Total
Average of impaired loans during the period	\$ 1,771	\$ 2,298	\$ 210	\$ 715	\$ 3	\$ 4,997
Interest income during impairment	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Cash-basis interest earned	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —

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

	September 30, 2017	September 30, 2016	December 31, 2016
	(Dollars in thousands)		
Nonaccrual loans - held-for-investment	\$ 2,560	\$ 4,496	\$ 3,059
Restructured and loans over 90 days past due and still accruing	931	—	—
Total nonperforming loans	3,491	4,496	3,059
Other restructured loans	325	137	131
Total impaired loans	\$ 3,816	\$ 4,633	\$ 3,190

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

September 30, 2017	December 31, 2016
Restructured and Loans	Restructured and Loans

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	over 90 Days Past Due and Still			over 90 Days Past Due and Still		
	Nonaccrual	Accruing	Total	Nonaccrual	Accruing	Total
	(Dollars in thousands)					
Commercial	\$ 1,487	\$ 21	\$ 1,508	\$ 2,171	\$ —	\$ 2,171
Real estate:						
CRE	501	—	501	419	—	419
Land and construction	183	910	1,093	199	—	199
Home equity	388	—	388	267	—	267
Consumer	1	—	1	3	—	3
Total	\$ 2,560	\$ 931	\$ 3,491	\$ 3,059	\$ —	\$ 3,059

21

Table of Contents

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

	September 30, 2017			Total Past Due	Loans Not Past Due	Total
	30 - 59 Days Past Due (Dollars in thousands)	60 - 89 Days Past Due	90 Days or Greater Past Due			
Commercial	\$ 3,798	\$ 601	\$ 575	\$ 4,974	\$ 582,302	\$ 587,276
Real estate:						
CRE	—	831	—	831	754,025	754,856
Land and construction	—	—	1,093	1,093	91,217	92,310
Home equity	—	—	—	—	74,171	74,171
Residential mortgages	—	—	—	—	46,489	46,489
Consumer	—	—	—	—	11,749	11,749
Total	\$ 3,798	\$ 1,432	\$ 1,668	\$ 6,898	\$ 1,559,953	\$ 1,566,851

	December 31, 2016			Total Past Due	Loans Not Past Due	Total
	30 - 59 Days Past Due (Dollars in thousands)	60 - 89 Days Past Due	90 Days or Greater Past Due			
Commercial	\$ 3,998	\$ 857	\$ 2,036	\$ 6,891	\$ 597,440	\$ 604,331
Real estate:						
CRE	632	—	—	632	661,596	662,228
Land and construction	—	—	199	199	80,803	81,002
Home equity	—	267	—	267	82,192	82,459
Residential mortgages	—	—	—	—	52,887	52,887
Consumer	—	—	—	—	20,460	20,460
Total	\$ 4,630	\$ 1,124	\$ 2,235	\$ 7,989	\$ 1,495,378	\$ 1,503,367

Past due loans 30 days or greater totaled \$6,898,000 and \$7,989,000 at September 30, 2017 and December 31, 2016, respectively, of which \$1,256,000 and \$2,057,000 were on nonaccrual, respectively. At September 30, 2017, there were also \$1,304,000 of loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2016, there were also \$1,002,000 of loans less than 30 days past due included in nonaccrual loans held-for-investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

Credit Quality Indicators

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

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis. Nonclassified loans generally include those loans that are expected to be repaid in accordance with contractual loans terms. Classified loans

Table of Contents

are those loans that are assigned a substandard, substandard-nonaccrual, or doubtful risk rating using the following definitions:

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

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

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

Loss. Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for loan losses. Therefore, there is no balance to report at September 30, 2017 and December 31, 2016.

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

	September 30, 2017			December 31, 2016		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
Commercial	\$ 578,867	\$ 8,409	\$ 587,276	\$ 594,255	\$ 10,076	\$ 604,331
Real estate:						
CRE	754,152	704	754,856	659,777	2,451	662,228
Land and construction	91,217	1,093	92,310	80,803	199	81,002
Home equity	73,469	702	74,171	81,866	593	82,459

Residential mortgages	46,489	—	46,489	52,887	—	52,887
Consumer	11,748	1	11,749	20,455	5	20,460
Total	\$ 1,555,942	\$ 10,909	\$ 1,566,851	\$ 1,490,043	\$ 13,324	\$ 1,503,367

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

During the three months and nine months ended September 30, 2017, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included either one or both of the following: a reduction of the stated interest rate of the loan; or an extension of maturity date and/or at a stated rate of interest lower than the current market rate for new debt with similar risk.

The balance of troubled debt restructurings at September 30, 2017 was \$434,000, which included \$91,000 of nonaccrual loans and \$343,000 of accruing loans. The balance of troubled debt restructurings at December 31, 2016 was \$133,000, which included \$2,000 of nonaccrual loans and \$131,000 of accruing loans. Approximately \$36,000 and \$2,000 of specific reserves were established with respect to these loans as of September 30, 2017 and December 31, 2016, respectively.

Table of Contents

The following table presents loans by class modified as troubled debt restructurings:

Troubled Debt Restructurings:	During the Nine Months Ended September 30, 2017		
	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
	(Dollars in thousands)		
Commercial	3	\$ 318	\$ 318
Total	3	\$ 318	\$ 318

During the nine months ended September 30, 2017, there were no troubled debt restructurings in which the amount of principal or accrued interest owed from the borrower was forgiven or which resulted in a charge-off or change to the allowance for loan losses. The Company has committed to lend no additional amounts as of September 30, 2017 to customers with outstanding loans that are classified as troubled debt restructurings. There were no new loans modified as troubled debt restructurings during the nine months ended September 30, 2016.

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the three and nine month periods ended September 30, 2017 and 2016.

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

6) Goodwill and Other Intangible Assets

Goodwill

At September 30, 2017, the carrying value of goodwill was \$45,664,000, which included \$13,044,000 of goodwill related to its acquisition of Bay View Funding and \$32,620,000 from its acquisition of Focus.

Goodwill impairment exists when a reporting unit's carrying value exceeds its fair value, which is determined through a qualitative assessment whether it is more likely than not that the fair value of equity of the reporting unit exceeds the carrying value ("Step Zero"). If the qualitative assessment indicates it is more likely than not that the fair value of equity of a reporting unit is less than book value, then a quantitative two-step impairment test is required. Step 1 includes the determination of the carrying value of the Company's single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess.

The Company completed its annual impairment analysis on the goodwill from the Bay View Funding and Focus acquisitions as of November 30, 2016 with the assistance of an independent valuation firm. Based on the Step Zero qualitative analysis performed, the Company determined that it is more likely than not that the fair value of the reporting unit exceeded its reported book value of equity at November 30, 2016. As such, no impairment was indicated and no further testing was required.

Other Intangible Assets

The core deposit intangible asset originally acquired in the June 2007 acquisition of Diablo Valley Bank was \$5,049,000. The core deposit intangible asset was amortized over its estimated useful life of 10 years, and was fully amortized at September 30, 2017. Accumulated amortization of the core deposit intangible asset was \$4,854,000 at December 31, 2016.

Table of Contents

The core deposit intangible asset acquired in the acquisition of Focus in August 2015 was \$6,285,000. This asset is amortized over its estimated useful life of 10 years. Accumulated amortization of this intangible asset was \$1,776,000 and \$1,120,000 at September 30, 2017 and December 31, 2016, respectively.

Other intangible assets acquired in the acquisition of Bay View Funding in November 2014 included: a below market value lease intangible asset of \$109,000 (amortized over 3 years), customer relationship and brokered relationship intangible assets of \$1,900,000, (amortized over the 10 year estimated useful life), and a non-compete agreement intangible asset of \$250,000 (amortized over 3 years). Accumulated amortization of these intangible assets was \$901,000 and \$669,000 at September 30, 2017 and December 31, 2016, respectively.

Estimated amortization expense for 2017 and each of the next five years and thereafter as follows:

Year	Diablo Valley		Bay View Funding		Non-Compete Agreement Intangible	Total Amortization Expense
	Bank Core Deposit Intangible (Dollars in thousands)	Focus Core Deposit Intangible	Below Market Value Lease Intangible	Customer & Brokered Relationship Intangible		
2017	\$ 195	\$ 875	\$ 31	\$ 190	\$ 70	\$ 1,361
2018	—	775	—	190	—	965
2019	—	734	—	190	—	924
2020	—	716	—	190	—	906
2021	—	596	—	190	—	786
2022	—	502	—	190	—	692
Thereafter	—	967	—	349	—	1,316
	\$ 195	\$ 5,165	\$ 31	\$ 1,489	\$ 70	\$ 6,950

Impairment testing of the intangible assets is performed at the individual asset level. Impairment exists if the carrying amount of the asset is not recoverable and exceeds its fair value at the date of the impairment test. For intangible assets, estimates of expected future cash flows (cash inflows less cash outflows) that are directly associated with an intangible asset are used to determine the fair value of that asset. Management makes certain estimates and assumptions in determining the expected future cash flows from core deposit and customer relationship intangibles including account attrition, expected lives, discount rates, interest rates, servicing costs and other factors. Significant changes in these estimates and assumptions could adversely impact the valuation of these intangible assets. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset. Based on its assessment, management concluded that there was no impairment of intangible assets at September 30, 2017 and December 31, 2016.

7) Income Taxes

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

Under generally accepted accounting principles, a valuation allowance is required if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.

The Company had net deferred tax assets of \$22,400,000, and \$25,058,000, at September 30, 2017, and December 31, 2016, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at September 30, 2017 and December 31, 2016 will be fully realized in future years.

Table of Contents

The following table reflects the carry amounts of the low income housing investments included in accrued interest receivable and other assets, and the future commitments included in accrued interest payable and other liabilities for the periods indicated:

	September 30, 2017	December 31, 2016
	(Dollars in thousands)	
Low income housing investments	\$ 3,526	\$ 3,880
Future commitments	\$ 365	\$ 365

The Company expects future commitments of \$79,000 to be paid in 2017, \$14,000 in 2018, and \$272,000 in 2019 through 2023.

For tax purposes, the Company had low income housing tax credits of \$110,000 and \$111,000 for the three months ended September 30, 2017 and September 30, 2016, respectively, and low income housing investment losses of \$115,000 and \$118,000, respectively. For tax purposes, the Company had low income housing tax credits of \$329,000 and \$333,000 for the nine months ended September 30, 2017 and September 30, 2016, respectively, and low income housing investment losses of \$345,000 and \$353,000, respectively. The Company recognized low income housing investment expense as a component of income tax expense.

8) Benefit Plans

Supplemental Retirement Plan

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

	Three Months Ended September 30, 2017		Nine Months Ended September 30, 2016	
	2017	2016	2017	2016
	(Dollars in thousands)			
Components of net periodic benefit cost:				

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Service cost	\$ 81	\$ 134	\$ 243	\$ 400
Interest cost	259	259	777	777
Amortization of net actuarial loss	69	60	207	180
Net periodic benefit cost	\$ 409	\$ 453	\$ 1,227	\$ 1,357

Split Dollar Life Insurance Benefit Plan

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

	September 30, 2017	December 31, 2016
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$ 6,301	\$ 6,215
Interest cost	182	248
Actuarial gain	—	(162)
Projected benefit obligation at end of period	\$ 6,483	\$ 6,301

Table of Contents

	September 30, 2017	December 31, 2016
	(Dollars in thousands)	
Net actuarial loss	\$ 2,246	\$ 2,126
Prior transition obligation	1,261	1,328
Accumulated other comprehensive loss	\$ 3,507	\$ 3,454

	Three Months Ended September 30, 2017		Nine Months Ended September 30, 2016	
	2017		2016	
	(Dollars in thousands)			
Amortization of prior transition obligation	\$ (18)	\$ (13)	\$ (53)	\$ (39)
Interest cost	61	62	182	186
Net periodic benefit cost	\$ 43	\$ 49	\$ 129	\$ 147

9) Fair Value

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

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

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

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

Financial Assets and Liabilities Measured on a Recurring Basis

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

Table of Contents

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

	Balance	Fair Value Measurements Using		Significant Unobservable Inputs (Level 3)
		Quoted Prices for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	
(Dollars in thousands)				
Assets at September 30, 2017				
Available-for-sale securities:				
Agency mortgage-backed securities	\$ 373,167	—	\$ 373,167	—
Trust preferred securities	16,940	—	16,940	—
I/O strip receivables	989	—	989	—
Assets at December 31, 2016				
Available-for-sale securities:				
Agency mortgage-backed securities	\$ 290,989	—	\$ 290,989	—
Trust preferred securities	15,600	—	15,600	—
I/O strip receivables	1,067	—	1,067	—

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

Assets and Liabilities Measured on a Non Recurring Basis

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. The appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

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

Table of Contents

	Balance	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets at September 30, 2017				
Impaired loans - held-for-investment:				
Commercial	\$ 246	—	—	\$ 246
Real estate:				
Land and construction	1,068	—	—	1,068
	\$ 1,314	—	—	\$ 1,314
Assets at December 31, 2016				
Impaired loans - held-for-investment:				
Commercial	\$ 165	—	—	\$ 165
Real estate:				
CRE	419	—	—	419
Land and construction	199	—	—	199
	\$ 783	—	—	\$ 783
Foreclosed assets:				
Land and construction	\$ 229	—	—	\$ 229
	\$ 229			\$ 229

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

	September 30, 2017	December 31, 2016
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	\$ 1,556	\$ 1,112
Book value of impaired loans held-for-investment carried at cost	2,260	2,078
Total impaired loans held-for-investment	\$ 3,816	\$ 3,190
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	\$ 1,556	\$ 1,112
Specific valuation allowance	(242)	(329)
Impaired loans held-for-investment carried at fair value, net	\$ 1,314	\$ 783

Impaired loans held for investment which are measured primarily for impairment using the fair value of the collateral were \$3,816,000 at September 30, 2017. In addition, these loans had a specific valuation allowance of \$242,000 at September 30, 2017. Impaired loans held for investment totaling \$1,556,000 at September 30, 2017, were carried at fair

value as a result of the aforementioned partial charge offs and specific valuation allowances at period end. The remaining \$2,260,000 of impaired loans were carried at cost at September 30, 2017, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge offs and changes in specific valuation allowances during the first nine months of 2017 on impaired loans held for investment carried at fair value at September 30, 2017 resulted in an additional provision for loan losses of \$228,000.

At September 30, 2017, there were no foreclosed assets.

Impaired loans held-for-investment were \$3,190,000 at December 31, 2016. There were no partial charge-offs at December 31, 2016. In addition, these loans had a specific valuation allowance of \$329,000 at December 31, 2016. Impaired loans held-for-investment totaling \$1,112,000 at December 31, 2016 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining \$2,078,000 of impaired loans were carried at cost at December 31, 2016, as the fair value collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during 2016 on impaired loans held-for-investment carried at fair value at December 31, 2016 resulted in an additional provision for loan losses of \$320,000.

Table of Contents

At December 31, 2016, foreclosed assets had a carrying amount of \$229,000, with no valuation allowance.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at the periods indicated:

	September 30, 2017		Unobservable	Range
	Fair Value	Valuation Techniques	Inputs	(Weighted Average)
	(Dollars in thousands)			
Impaired loans - held-for-investment:				
Commercial	\$ 246	Market Approach	Discount adjustment for differences between comparable sales	Less than 1 %
Real estate:				
Land and construction	1,068	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%
	December 31, 2016		Unobservable	Range
	Fair Value	Valuation Techniques	Inputs	(Weighted Average)
	(Dollars in thousands)			
Impaired loans - held-for-investment:				
Commercial	\$ 165	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%
Real estate:				
CRE	419	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3)%
Land and construction	199	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%
Foreclosed assets:				
Land and construction	229	Market Approach	Discount adjustment for differences between comparable sales	0% to 2% (2)%

The Company obtains third party appraisals on its impaired loans held-for-investment and foreclosed assets to determine fair value. Generally, the third party appraisals apply the “market approach,” which is a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business. Adjustments are then made based on the type of property, age of appraisal, current status of property and other related factors to estimate the current value of collateral.

Table of Contents

The carrying amounts and estimated fair values of financial instruments at September 30, 2017 are as follows:

	Carrying Amounts (Dollars in thousands)	Estimated Fair Value			Total
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets:					
Cash and cash equivalents	\$ 346,120	\$ 346,120	\$ —	\$ —	\$ 346,120
Securities available-for-sale	390,107	—	390,107	—	390,107
Securities held-to-maturity	379,550	—	377,845	—	377,845
Loans (including loans held-for-sale), net	1,550,804	—	4,602	1,497,010	1,501,612
FHLB stock, FRB stock, and other investments	17,905	—	—	—	N/A
Accrued interest receivable	7,818	—	2,522	5,296	7,818
I/O strips receivables	989	—	989	—	989
Liabilities:					
Time deposits	\$ 204,291	\$ —	\$ 204,555	\$ —	\$ 204,555
Other deposits	2,276,313	—	2,276,313	—	2,276,313
Subordinated debt	39,137	—	39,937	—	39,937
Accrued interest payable	934	—	934	—	934

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2016:

	Carrying Amounts (Dollars in thousands)	Estimated Fair Value			Total
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets:					
Cash and cash equivalents	\$ 266,103	\$ 266,103	\$ —	\$ —	\$ 266,103
Securities available-for-sale	306,589	—	306,589	—	306,589
Securities held-to-maturity	324,010	—	318,748	—	318,748
Loans (including loans held-for-sale), net	1,489,223	—	5,705	1,444,076	1,449,781
FHLB stock, FRB stock, and other investments	15,196	—	—	—	N/A

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Accrued interest receivable	6,859	—	1,961	4,898	6,859
I/O strips receivables	1,067	—	1,067	—	1,067
Liabilities:					
Time deposits	\$ 224,717	\$ —	\$ 225,047	\$ —	\$ 225,047
Other deposits	2,037,423	—	2,037,423	—	2,037,423
Accrued interest payable	168	—	168	—	168

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

Cash and Cash Equivalents

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

Loans

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

Fair values of loans, excluding loans held-for-sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3

Table of Contents

classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

FHLB and FRB Stock

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

Accrued Interest Receivable/Payable

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

Deposits

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

Subordinated Debt

The fair values of the subordinated debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 3 classification.

Off balance Sheet Instruments

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

Limitations

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

10) Equity Plan

The Company maintained an Amended and Restated 2004 Equity Plan (the "2004 Plan") for directors, officers, and key employees. The 2004 Plan was terminated on May 23, 2013. On May 23, 2013, the Company's shareholders approved the 2013 Equity Incentive Plan (the "2013 Plan"). On May 25, 2017, the shareholders approved an amendment to the Heritage Commerce Corp 2013 Equity Incentive Plan to increase the number of shares available from 1,750,000 to 3,000,000 shares. The equity plans provide for the grant of incentive and nonqualified stock options and restricted stock. The equity plans provide that the option price for both incentive and nonqualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally options vest over four years. All options expire no later than ten years from the date of grant. Restricted stock is subject to time vesting. For the nine months ended September 30, 2017,

Table of Contents

the Company granted 270,000 shares of nonqualified stock options and 82,770 shares of restricted stock. There were 1,528,099 shares available for the issuance of equity awards under the 2013 Plan as of September 30, 2017.

Stock option activity under the equity plans is as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Total Stock Options				
Outstanding at January 1, 2017	1,719,091	\$ 9.79		
Granted	270,000	\$ 14.41		
Exercised	(193,863)	\$ 6.98		
Forfeited or expired	(151,119)	\$ 22.85		
Outstanding at September 30, 2017	1,644,109	\$ 9.69	6.41	\$ 6,972,963
Vested or expected to vest	1,545,462		6.41	\$ 6,554,585
Exercisable at September 30, 2017	1,085,246		5.21	\$ 5,799,239

Information related to the equity plans for the periods indicated:

	Nine Months Ended September 30,	
	2017	2016
Intrinsic value of options exercised	\$ 1,331,528	\$ 437,357
Cash received from option exercise	\$ 1,352,236	\$ 771,386
Tax benefit realized from option exercises	\$ 543,654	\$ 174,194
Weighted average fair value of options granted	\$ 2.66	\$ 2.12

As of September 30, 2017, there was \$1,446,000 of total unrecognized compensation cost related to nonvested stock options granted under the equity plans. That cost is expected to be recognized over a weighted average period of approximately 2.75 years.

The fair value of each option grant is estimated on the date of grant using the Black Scholes option pricing model that uses the assumptions noted in the following table, including the weighted average assumptions for the option grants for the periods indicated:

	Nine Months Ended			
	September 30,			
	2017		2016	
Expected life in months(1)	72		72	
Volatility(1)	24	%	31	%
Weighted average risk-free interest rate(2)	1.94	%	1.41	%
Expected dividends(3)	2.78	%	3.48	%

- (1) The expected life of employee stock options represents the weighted average period the stock options are expected to remain outstanding based on historical experience. Volatility is based on the historical volatility of the stock price over the same period of the expected life of the option.
- (2) Based on the U.S. Treasury constant maturity interest rate with a term consistent with the expected life of the option granted.
- (3) Each grant's dividend yield is calculated by annualizing the most recent quarterly cash dividend and dividing that amount by the market price of the Company's common stock as of the grant date
-

Table of Contents

Restricted stock activity under the equity plans is as follows:

	Number	Weighted Average Grant Date Fair Value
Total Restricted Stock Award		
Nonvested shares at January 1, 2017	199,503	\$ 9.74
Granted	82,770	\$ 14.36
Vested	(64,954)	\$ 10.02
Forfeited or expired	(18,634)	\$ 11.87
Nonvested shares at September 30, 2017	198,685	\$ 11.38

As of September 30, 2017, there was \$1,817,000 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the equity plans. The cost is expected to be recognized over a weighted average period of approximately 2.43 years.

11) Subordinated Debt

On May 26, 2017, the Company completed an underwritten public offering of \$40,000,000 aggregate principal amount of its fixed-to-floating rate subordinated notes (“Subordinated Debt”) due June 1, 2027. The Subordinated Debt initially bears a fixed interest rate of 5.25% per year, payable semi-annually. Commencing on June 1, 2022, the interest rate on the Subordinated Debt resets quarterly to the three-month LIBOR rate plus a spread of 336.5 basis points, payable quarterly in arrears. Interest on the Subordinated Debt is payable semi-annually on June 1 and December 1 of each year through June 1, 2022 and quarterly thereafter on March 1, June 1, September 1 and December 1 of each year through the maturity date or early redemption date. The first interest payment will be made on December 1, 2017. The Company at its option may redeem the Subordinated Debt, in whole or in part, on any interest payment date on or after June 1, 2022 without a premium. The issuance costs of the Subordinated Debt totaled \$927,000, which is being amortized through the Subordinated Debt maturity date. The Subordinated Debt, net of the unamortized issuance costs, totaled \$39,137,000 at September 30, 2017, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank.

12) Capital Requirements

The Company and its subsidiary bank are subject to various regulatory capital requirements administered by the banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Company’s financial statements and operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and HBC must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off balance sheet items as calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. There are no conditions or events since September 30, 2017, that management believes have changed the

categorization of the Company or HBC as “well-capitalized.”

As of January 1, 2015, HCC and HBC along with other community banking organizations became subject to new capital requirements and certain provisions of the new rules will be phased in from 2015 through 2019. The Federal Banking regulators approved the new rules to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of The Dodd Frank Wall Street Reform and Consumer Protection Act of 2010, as amended. The Company’s consolidated capital ratios and the Bank’s capital ratios exceeded the regulatory guidelines for a well-capitalized financial institution under the Basel III regulatory requirements at September 30, 2017.

Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios (set forth in the tables below) of total, Tier 1 capital, and common equity Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of September 30, 2017 and December 31, 2016, the Company and HBC met all capital adequacy guidelines to which they were subject.

Table of Contents

The Company's consolidated capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of September 30, 2017, and December 31, 2016.

	Actual Amount (Dollars in thousands)	Ratio		Required For Capital Adequacy Purposes Under Basel III Amount	Ratio (1)	
As of September 30, 2017						
Total Capital (to risk-weighted assets)	\$ 289,231	14.6 %		\$ 183,750	9.25 %	
Tier 1 Capital (to risk-weighted assets)	\$ 229,656	11.6 %		\$ 144,020	7.25 %	
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 229,656	11.6 %		\$ 114,223	5.75 %	
Tier 1 Capital (to average assets)	\$ 229,656	8.3 %		\$ 111,329	4.00 %	

(1) Includes 1.25% capital conservation buffer, effective January 1, 2017, except the Tier 1 Capital to average assets ratio.

	Actual Amount (Dollars in thousands)	Ratio		Required For Capital Adequacy Purposes Under Basel III Amount	Ratio (1)	
As of December 31, 2016						
Total Capital (to risk-weighted assets)	\$ 234,629	12.5 %		\$ 161,868	8.625 %	
Tier 1 Capital (to risk-weighted assets)	\$ 214,924	11.5 %		\$ 124,333	6.625 %	
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 214,924	11.5 %		\$ 96,183	5.125 %	
Tier 1 Capital (to average assets)	\$ 214,924	8.5 %		\$ 100,625	4.000 %	

(1) Includes 0.625% capital conservation buffer, effective January 1, 2016, except the Tier 1 Capital to average assets ratio.

Table of Contents

HBC's actual capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of September 30, 2017, and December 31, 2016.

	Actual		To Be Well-Capitalized Under Basel III Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel III	
	Amount (Dollars in thousands)	Ratio	Amount	Ratio	Amount	Ratio (1)
As of September 30, 2017						
Total Capital (to risk-weighted assets)	\$ 265,269	13.4 %	\$ 198,513	10.0 %	\$ 183,625	9.25 %
Tier 1 Capital (to risk-weighted assets)	\$ 244,831	12.3 %	\$ 158,811	8.0 %	\$ 143,922	7.25 %
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 244,831	12.3 %	\$ 129,034	6.5 %	\$ 114,145	5.75 %
Tier 1 Capital (to average assets)	\$ 244,831	8.8 %	\$ 139,101	5.0 %	\$ 111,281	4.00 %

(1) Includes 1.25% capital conservation buffer, effective January 1, 2017, except the Tier 1 Capital to average assets ratio.

	Actual		To Be Well-Capitalized Under Basel III Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel III	
	Amount (Dollars in thousands)	Ratio	Amount	Ratio	Amount	Ratio (1)
As of December 31, 2016						
Total Capital (to risk-weighted assets)	\$ 231,069	12.3 %	\$ 187,602	10.0 %	\$ 161,807	8.625 %
Tier 1 Capital (to risk-weighted assets)	\$ 211,364	11.3 %	\$ 150,082	8.0 %	\$ 124,287	6.625 %
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 211,364	11.3 %	\$ 121,942	6.5 %	\$ 96,146	5.125 %
Tier 1 Capital (to average assets)	\$ 211,364	8.4 %	\$ 125,746	5.0 %	\$ 100,597	4.000 %

- (1) Includes 0.625% capital conservation buffer, effective January 1, 2016, except the Tier 1 Capital to average assets ratio.
-

The Subordinated Debt, net of unamortized issuance costs, totaled \$39,137,000 at September 30, 2017, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank. The issuance of Subordinated Debt resulted in an increase in the Company's total risk based capital ratio at September 30, 2017, compared to December 31, 2016, but had no effect on the other regulatory capital ratios of the Company. All of HBC's regulatory capital ratios increased at September 30, 2017, compared to December 31, 2016, primarily due to the downstream of \$20,000,000 of the proceeds of the Subordinated Debt from the Company to HBC, and from the retention of \$24,051,000 in earnings, net of distributed dividends totaling \$12,000,000 from HBC to the Company during the first nine months of 2017.

HCC is dependent upon dividends from HBC. Under California General Corporation Law, the holders of common stock are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available. The California Financial Code provides that a state licensed bank may not make a cash distribution to its shareholders in excess of the lesser of the following: (i) the bank's retained earnings; or (ii) the bank's net income for its last three fiscal years, less the amount of any distributions made by the bank to its shareholders during such period. However, a bank, with the prior approval of the Commissioner of the California Department of Business Oversight—Division of Financial Institutions ("DBO") may make a distribution to its shareholders of an amount not to exceed the

Table of Contents

greater of: (i) a bank's retained earnings; (ii) its net income for its last fiscal year; or (iii) its net income for the current fiscal year. Also with the prior approval of the Commissioner of the DBO and the shareholders of the bank, the bank may make a distribution to its shareholders, as a reduction in capital of the bank. In the event that the Commissioner determines that the shareholders' equity of a bank is inadequate or that the making of a distribution by a bank would be unsafe or unsound, the Commissioner may order a bank to refrain from making such a proposed distribution. As of September 30, 2017, HBC would not be required to obtain regulatory approval, and the amount available for cash dividends is \$21,260,000. Similar restrictions applied to the amount and sum of loan advances and other transfers of funds from HBC to the parent company. During each of the third, second, and first quarters of 2017, HBC distributed dividends of \$4,000,000, for a total of \$12,000,000 for the first nine months of 2017.

13) Loss Contingencies

The Company's policy is to accrue for legal costs associated with both asserted and unasserted claims when it is probable that such costs will be incurred and such costs can be reasonably estimated. A number of parties filed complaints in the Superior Court of California for the County of Santa Clara asserting certain claims against the Company arising from the transfer of funds. During the fourth quarter of 2016, the Company reached settlements with each of the parties in amounts not material to the Company.

14) Noninterest Expense

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(Dollars in thousands)			
Salaries and employee benefits	\$ 9,071	\$ 8,363	\$ 27,766	\$ 26,052
Occupancy and equipment	1,142	1,120	3,426	3,277
Professional fees	695	1,086	2,439	2,619
Software subscriptions	475	401	1,333	1,118
Data processing	411	372	1,080	1,143
Insurance expense	401	319	1,123	924
FDIC deposit insurance premiums	304	308	860	966
Amortization of intangible assets	296	392	1,083	1,176
Foreclosed assets	2	10	6	14
Other	2,037	1,925	6,300	6,073
Total	\$ 14,834	\$ 14,296	\$ 45,416	\$ 43,362

Table of Contents

15) Business Segment Information

The following presents the Company's operating segments. The Company operates through two business segments: Banking segment and Factoring segment. Transactions between segments consist primarily of borrowed funds. Intersegment interest expense is allocated to the Factoring segment based on the Company's prime rate and funding costs. The provision for loan loss is allocated based on the segment's allowance for loan loss determination which considers the effects of charge-offs. Noninterest income and expense directly attributable to a segment are assigned to it. Taxes are paid on a consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring originated by Bay View Funding.

	Three Months Ended September 30, 2017		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 24,805	\$ 3,150	\$ 27,955
Intersegment interest allocations	284	(284)	—
Total interest expense	1,634	—	1,634
Net interest income	23,455	2,866	26,321
Provision for loan losses	107	8	115
Net interest income after provision	23,348	2,858	26,206
Noninterest income	2,101	359	2,460
Noninterest expense	13,149	1,685	14,834
Intersegment expense allocations	130	(130)	—
Income before income taxes	12,430	1,402	13,832
Income tax expense	4,660	589	5,249
Net income	\$ 7,770	\$ 813	\$ 8,583
Total assets	\$ 2,776,262	\$ 67,686	\$ 2,843,948
Loans, net of deferred fees	\$ 1,517,186	\$ 48,764	\$ 1,565,950
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

	Three Months Ended September 30, 2016		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 20,743	\$ 3,131	\$ 23,874
Intersegment interest allocations	314	(314)	—
Total interest expense	826	—	826
Net interest income	20,231	2,817	23,048
Provision for loan losses	237	8	245
Net interest income after provision	19,994	2,809	22,803
Noninterest income	2,160	152	2,312

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Noninterest expense	12,382	1,914	14,296
Intersegment expense allocations	234	(234)	—
Income before income taxes	10,006	813	10,819
Income tax expense	3,712	342	4,054
Net income	\$ 6,294	\$ 471	\$ 6,765
Total assets	\$ 2,464,438	\$ 63,524	\$ 2,527,962
Loans, net of deferred fees	\$ 1,402,330	\$ 47,846	\$ 1,450,176
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

(1) Includes the holding company's results of operations

Table of Contents

	Nine Months Ended September 30, 2017		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 70,146	\$ 8,613	\$ 78,759
Intersegment interest allocations	786	(786)	—
Total interest expense	3,679	—	3,679
Net interest income	67,253	7,827	75,080
Provision for loan losses	372	18	390
Net interest income after provision	66,881	7,809	—74,690
Noninterest income	6,153	895	7,048
Noninterest expense	40,152	5,264	45,416
Intersegment expense allocations	392	(392)	—
Income before income taxes	33,274	3,048	36,322
Income tax expense	12,472	1,280	13,752
Net income	\$ 20,802	\$ 1,768	\$ 22,570
Total assets	\$ 2,776,262	\$ 67,686	\$ 2,843,948
Loans, net of deferred fees	\$ 1,517,186	\$ 48,764	\$ 1,565,950
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

	Nine Months Ended September 30, 2016		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 61,252	\$ 9,188	\$ 70,440
Intersegment interest allocations	863	(863)	—
Total interest expense	2,344	—	2,344
Net interest income	59,771	8,325	68,096
Provision for loan losses	949	48	997
Net interest income after provision	58,822	8,277	67,099
Noninterest income	8,069	517	8,586
Noninterest expense	38,036	5,326	43,362
Intersegment expense allocations	623	(623)	—
Income before income taxes	29,478	2,845	32,323
Income tax expense	10,962	1,195	12,157
Net income	\$ 18,516	\$ 1,650	\$ 20,166
Total assets	\$ 2,464,438	\$ 63,524	\$ 2,527,962
Loans, net of deferred fees	\$ 1,402,330	\$ 47,846	\$ 1,450,176
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

(1) Includes the holding company's results of operations

16) Subsequent Events

On October 26, 2017, the Company announced that its Board of Directors declared a \$0.10 per share quarterly cash dividend to holders of common stock. The dividend will be paid on November 21, 2017 to shareholders of record on November 7, 2017.

Table of Contents

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

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources of Heritage Commerce Corp (the “Company” or “HCC”), its wholly owned subsidiary, Heritage Bank of Commerce (“HBC”), and HBC’s wholly owned subsidiary, CSNK Working Capital Finance Corp., a California Corporation, dba Bay View Funding (“Bay View Funding”). This information is intended to facilitate the understanding and assessment of significant changes and trends related to our financial condition and the results of operations. This discussion and analysis should be read in conjunction with our consolidated financial statements and the accompanying notes presented elsewhere in this report. Unless we state otherwise or the context indicates otherwise, references to the “Company,” “Heritage,” “we,” “us,” and “our,” in this Report on Form 10 Q refer to Heritage Commerce Corp and its subsidiaries.

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are discussed in our Form 10 K for the year ended December 31, 2016. There are no changes to these policies as of September 30, 2017, except for accounting for share-based compensation arrangements.

In March 2016, the Financial Accounting Standards Board (“FASB”) issued new guidance intended to simplify several areas of accounting for share-based compensation programs, including the income tax impact, classification on the statement of cash flows, and forfeitures. The Company adopted the new guidance on share-based compensation during the first quarter of 2017. All excess tax benefits and tax deficiencies (including tax benefits of dividends on share based payment awards) are recognized as income tax expense or benefit in the income statement. The tax effects of exercised or vested awards are treated as discrete items in the reporting period in which they occur. The adoption of this guidance resulted in a reduction to tax expense of (\$106,000) for the third quarter of 2017, and a reduction to tax expense of (\$158,000) for the first nine months of 2017.

EXECUTIVE SUMMARY

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

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

Company's customers are primarily closely held businesses and professionals.

Performance Overview

For the three months ended September 30, 2017, net income was \$8.6 million, or \$0.22 per average diluted common share, compared to \$6.8 million, or \$0.18 per average diluted common share, for the three months ended September 30, 2016. The Company's annualized return on average tangible assets was 1.22% and annualized return on average tangible equity was 15.41% for the three months ended September 30, 2017, compared to 1.13% and 13.06%, respectively, for the three months ended September 30, 2016.

For the nine months ended September 30, 2017, net income was \$22.6 million, or \$0.59 per average diluted common share, compared to \$20.2 million, or \$0.53 per average diluted common share, for the nine months ended September 30, 2016. The Company's annualized return on average tangible assets was 1.14% and annualized return on average tangible equity was 14.11% for the nine months ended September 30, 2017 compared to 1.16% and 13.45%, respectively, for the nine months ended September 30, 2016.

Table of Contents

Factoring Activities - Bay View Funding

Based in Santa Clara, California, Bay View Funding provides business-essential working capital factoring financing to various industries throughout the United States. The following table reflects selected financial information for Bay View Funding for the periods indicated:

	September 30, 2017	September 30, 2016
	(Dollars in thousands)	
Total factored receivables	\$ 48,764	\$ 47,846
Average factored receivables		
For the three months ended	\$ 45,323	\$ 49,427
For the nine months ended	\$ 44,097	\$ 45,381
Total full time equivalent employees	40	35

Series C Preferred Stock

On September 12, 2016, the Company entered into Exchange Agreements with Castle Creek Capital Partners IV, LP, Patriot Financial Partners, L.P. and Patriot Financial Partners Parallel, L.P. (collectively “Preferred Stockholders”) providing for the exchange of 21,004 shares of the Company’s Series C Preferred Stock for 5,601,000 shares of the Company’s common stock. The exchange ratio was equal to the equivalent number of shares the Preferred Stockholders would have received upon conversion of the Series C Preferred Stock into the Company’s common stock. During the fourth quarter of 2016, the Preferred Stockholders sold all of their shares of common stock. The exchange of the Series C Preferred Stock for common stock resulted in an increase in the Company’s common equity Tier 1 risk-based capital ratio at September 30, 2017 and December 31, 2016, but had no effect on HBC’s common equity Tier 1 risk-based capital ratio or other regulatory capital ratios of the Company or HBC.

Subordinated Debt

On May 26, 2017, the Company completed an underwritten public offering of \$40.0 million aggregate principal amount of its fixed-to-floating rate subordinated notes (“Subordinated Debt”) due June 1, 2027. The Subordinated Debt initially bears a fixed interest rate of 5.25% per year, payable semi-annually. Commencing on June 1, 2022, the interest rate on the Subordinated Debt resets quarterly to the three-month LIBOR rate plus a spread of 336.5 basis points, payable quarterly in arrears. Interest on the Subordinated Debt is payable semi-annually on June 1 and December 1 of each year through June 1, 2022 and quarterly thereafter on March 1, June 1, September 1 and December 1 of each year through the maturity date or early redemption date. The first interest payment will be made on December 1, 2017. The Company at its option may redeem the Subordinated Debt, in whole or in part, on any interest payment date on or after June 1, 2022 without a premium.

The Subordinated Debt, net of unamortized issuance costs, totaled \$39.1 million at September 30, 2017, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank. The issuance of Subordinated Debt during the second quarter of 2017 resulted in an increase in the Company’s total risk based capital ratio at September 30, 2017, compared to December 31, 2016, but had no effect on the other regulatory capital ratios of the Company. All of HBC’s regulatory capital ratios increased at September 30, 2017, compared to December 31, 2016, primarily due to the downstream of \$20.0 million of the proceeds of the Subordinated Debt from the Company

to HBC, and from the retention of \$24.1 million in earnings, net of distributed dividends totaling \$12.0 million from HBC to the Company during the first nine months of 2017.

Third Quarter 2017 Highlights

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

- Net interest income before provision for loan losses increased 14% to \$26.3 million for the third quarter of 2017, compared to \$23.0 million for the third quarter of 2016. For the first nine months of 2017, net interest income increased 10% to \$75.1 million, compared to \$68.1 million for the first nine months of 2016. Net interest income increased for the third quarter and first nine months of 2017, compared to the respective periods in 2016, primarily due to an increase in the average balance of loans and investment securities.

Table of Contents

- For the third quarter of 2017, the fully tax equivalent (“FTE”) net interest margin contracted 12 basis points to 3.98% from 4.10% for the third quarter of 2016. The contraction was primarily due to the change in the mix of the balance sheet resulting in a higher average balance of lower yielding excess funds at the Federal Reserve Bank, and the full quarter impact from the issuance of subordinated debt during the second quarter of 2017. This was partially offset by an increase in the average balances of loans and securities, and the impact of increases in the prime rate on loan yields and overnight funds. The average balance of other investments and interest-bearing deposits in other financial institutions increased \$102.8 million to \$335.7 million for the third quarter of 2017, compared to \$232.9 million for the third quarter of 2016.
- For the first nine months of 2017, the net interest margin (FTE) contracted 16 basis points to 4.03%, compared to 4.19% for the first nine months of 2016. The contraction was primarily due to the change in the mix of the balance sheet resulting in a higher average balance of lower yielding excess funds at the Federal Reserve Bank, the issuance of subordinated debt, and a decrease in the accretion of the loan purchase discount into loan interest income from the Focus Business Bank (“Focus”) acquisition. This was partially offset by an increase in the average balances of loans and securities, and the impact of increases in the prime rate on loan yields and overnight funds. The average balance of other investments and interest-bearing deposits in other financial institutions increased \$95.3 million to \$291.2 million for the first nine months of 2017, compared to \$195.9 million for the first nine months of 2016.
- The average yield on the loan portfolio increased to 5.72% for the third quarter of 2017, compared to 5.60% for the third quarter of 2016, primarily due to increases in the prime rate, partially offset by the impact of lower yielding purchased residential mortgage loans and purchased commercial real estate loans (“CRE”). The average yield on the Company’s legacy loan portfolio (excluding the purchased residential loans, purchased CRE loans, factored receivables portfolio, and accretion of the loan purchase discount from the Focus transaction) increased 25 basis points for the third quarter of 2017, compared to the third quarter of 2016. The average yield on the purchased residential loans was 2.67% for the third quarter of 2017, compared to 2.93% for the third quarter of 2016. The average yield on the purchased CRE loans was 3.52% for the third quarter of 2017.
- The average yield on the loan portfolio increased to 5.63% for the first nine months of 2017, compared to 5.61% for the first nine months of 2016, primarily due to increases in the prime rate, partially offset by the impact of the lower yielding purchased residential mortgage loans and purchased CRE loans, a lower yield on the factored receivables portfolio, and a decrease in the accretion of the loan purchase discount into loan interest income from the Focus transaction. The average yield on the Company’s legacy loan portfolio (excluding the purchased residential loans, purchased CRE loans, factored receivables portfolio, and accretion of the loan purchase discount from the Focus transaction) increased 27 basis points for the first nine months of 2017, compared to the first nine months of 2016. The average yield on the purchased residential loans was 2.67% for the first nine months of 2017, compared to 3.07% for the first nine months of 2016. The yield on the purchased CRE loans was 3.51% for the first nine months of 2017.
- The accretion of the loan purchase discount into loan interest income from the Focus transaction was \$270,000 for the third quarter of 2017, compared to \$299,000 for the third quarter of 2016. The accretion of the loan purchase discount into loan interest income from the Focus transaction was \$741,000 for the first nine months of 2017, and \$1.1 million for the first nine months of 2016. The total purchase discount on non impaired loans from the Focus loan portfolio was \$4.6 million as of August 20, 2015 (the “acquisition date”), of which \$3.7 million has been accreted

into loan interest income from the acquisition date through September 30, 2017.

- There was a \$115,000 provision for loan losses for the third quarter of 2017, compared to a \$245,000 provision for loan losses for the third quarter of 2016. For the nine months ended September 30, 2017, there was a \$390,000 provision for loan losses, compared to a \$997,000 provision for loan losses for the first nine months of 2016.
- Total noninterest income was \$2.5 million for the third quarter of 2017, compared to \$2.3 million for the third quarter of 2016. For the nine months ended September 30, 2017, total noninterest income was \$7.0 million, compared to \$8.6 million for the nine months ended September 30, 2016. The decrease in total

Table of Contents

noninterest income for the first nine months of 2017, compared to the first nine months of 2016, was primarily due to a \$1.0 million gain on proceeds from company-owned life insurance in the second quarter of 2016, and lower servicing income and gain on sales of securities in the first nine months of 2017.

- Total noninterest expense for the third quarter of 2017 was \$14.8 million, compared to \$14.3 million for the third quarter of 2016. Total noninterest expense for the nine months ended September 30, 2017 was \$45.4 million, compared to \$43.4 million for the nine months ended September 30, 2016. The increase in total noninterest expense in the third quarter of 2017 and the first nine months of 2017, compared to the respective periods in 2016, was primarily due to higher salaries and employee benefits as a result of annual salary increases and hiring additional employees.
- The efficiency ratio for the third quarter of 2017 was 51.54%, compared to 56.37% for the third quarter of 2016. The efficiency ratio for the nine months ended September 30, 2017 was 55.30%, compared to 56.55% for the nine months ended September 30, 2016.
- Income tax expense for the third quarter of 2017 was \$5.2 million, compared to \$4.1 million for the third quarter of 2016. The effective tax rate for the third quarter of 2017 was 37.9%, compared to 37.5% for the third quarter of 2016. Income tax expense for the nine months ended September 30, 2017 was \$13.8 million, compared to \$12.2 million for the nine months ended September 30, 2016. The effective tax rate for the nine months ended September 30, 2017 was 37.9%, compared to 37.6% for the nine months ended September 30, 2016.

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

- Cash, other investments and interest bearing deposits in other financial institutions and securities available for sale, at fair value, increased 3% to \$736.2 million at September 30, 2017, from \$714.4 million at September 30, 2016, and increased 29% from \$572.7 million at December 31, 2016.
- At September 30, 2017, securities held to maturity, at amortized cost, totaled \$379.5 million, compared to \$202.4 million at September 30, 2016, and \$324.0 million at December 31, 2016.
- Loans, excluding loans held for sale, increased \$115.8 million, or 8%, to \$1.57 billion at September 30, 2017, compared to \$1.45 billion at September 30, 2016, which included an increase of \$80.0 million, or 6% in the Company's legacy portfolio, \$37.6 million of purchased CRE loans, and an increase of \$918,000 in the factored receivables portfolio, partially offset by a decrease of \$2.8 million in purchased residential mortgage loans. Loans increased \$63.3 million, or 4%, to \$1.57 billion at September 30, 2017, compared to \$1.50 billion at December 31, 2016, primarily due to an increase in the Company's legacy portfolio.
- Total nonperforming assets ("NPAs") were \$3.5 million, or 0.12% of total assets, at September 30, 2017, compared to \$4.8 million, or 0.19% of total assets, at September 30, 2016, and \$3.3 million, or 0.13% of total assets, at December 31, 2016.
- Classified assets were \$10.9 million at September 30, 2017, compared to \$18.7 million at September 30, 2016, and \$13.6 million at December 31, 2016. There were no foreclosed assets at September 30, 2017, compared to

foreclosed assets of \$292,000 at September 30, 2016, and \$229,000 at December 31, 2016

- Net recoveries totaled \$236,000 for the third quarter of 2017, compared to net charge-offs of \$134,000 for the third quarter of 2016.
- The allowance for loan losses at September 30, 2017 was \$19.7 million, or 1.26% of total loans, representing 565.68% of nonperforming loans. The allowance for loan losses at September 30, 2016 was \$20.0 million, or 1.38% of total loans, representing 445.55% of nonperforming loans. The allowance for loan losses at December 31, 2016 was \$19.1 million, or 1.27% of total loans, representing 624.03% of nonperforming loans.

Table of Contents

- Total deposits increased \$262.0 million, or 12%, to \$2.48 billion at September 30, 2017, compared to \$2.22 billion at September 30, 2016, and increased \$218.5 million, or 10%, from \$2.26 billion at December 31, 2016.
- The ratio of noncore funding (which consists of time deposits of \$250,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase, subordinated debt, and short term borrowings) to total assets was 7.16% at September 30, 2017, compared to 7.13% at September 30, 2016, and 6.73% at December 31, 2016.
- The loan to deposit ratio was 63.13% at September 30, 2017, compared to 65.36% at September 30, 2016, and 66.42% at December 31, 2016.
- The Company's consolidated capital ratios exceeded regulatory guidelines and the Bank's capital ratios exceeded the regulatory guidelines for a well capitalized financial institution under the Basel III regulatory requirements at September 30, 2017.

	Heritage Commerce Corp	Heritage Bank of Commerce	Well-capitalized Financial Institution Basel III Regulatory Guidelines	Fully Phased-in Basel III Minimal Requirement(1) Effective January 1, 2019
Capital Ratios				
Total Risk-Based	14.6 %	13.4 %	10.0 %	10.5 %
Tier 1 Risk-Based	11.6 %	12.3 %	8.0 %	8.5 %
Common Equity Tier 1 Risk-based	11.6 %	12.3 %	6.5 %	7.0 %
Leverage	8.3 %	8.8 %	5.0 %	4.0 %

(1) Requirements for both HCC and HBC include a 2.5% capital conservation buffer, except the leverage ratio.

Deposits

The composition and cost of the Company's deposit base are important in analyzing the Company's net interest margin and balance sheet liquidity characteristics. Except for brokered time deposits, the Company's depositors are generally located in its primary market area. Depending on loan demand and other funding requirements, the Company also obtains deposits from wholesale sources including deposit brokers. HBC is a member of the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program allows customers with deposits in excess of FDIC insured limits to obtain coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through this program are considered brokered deposits under regulatory guidelines. The Company

has a policy to monitor all deposits that may be sensitive to interest rate changes to help assure that liquidity risk does not become excessive due to concentrations.

Total deposits increased \$262.0 million, or 12%, to \$2.48 billion at September 30, 2017, compared to \$2.22 billion at September 30, 2016, and increased \$218.5 million, or 10%, from \$2.26 billion at December 31, 2016. The Company had no brokered deposits at September 30, 2017 and December 31, 2016, compared to \$3.0 million at September 30, 2016. Certificates of deposit from the State of California totaled \$65.1 million at September 30, 2017, compared to \$85.1 million at September 30, 2016, and December 31, 2016.

Liquidity

Our liquidity position refers to our ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely fashion. At September 30, 2017, we had \$346.1 million in cash and cash equivalents and approximately \$606.0 million in available borrowing capacity from various sources including the Federal Home Loan Bank (“FHLB”), the Federal Reserve Bank of San Francisco (“FRB”), Federal funds facilities with several financial institutions, and line of credit with a correspondent bank. The Company also had \$655.6 million at fair value in unpledged securities available at September 30, 2017. Our loan to deposit ratio was 63.13% at September 30, 2017, compared to 65.36% at September 30, 2016, and 66.42% at December 31, 2016.

Table of Contents

Lending

Our lending business originates principally through our branch offices located in our primary markets. In addition, Bay View Funding provides factoring financing throughout the United States. Total loans, excluding loans held for sale, increased \$115.8 million, or 8%, to \$1.57 billion at September 30, 2017, compared to \$1.45 billion at September 30, 2016, which included an increase of \$80.0 million, or 6%, in the Company's legacy loan portfolio, \$37.6 million of purchased CRE loans, and an increase of \$918,000 in the factored receivables portfolio, partially offset by a decrease of \$2.8 million in purchased residential mortgage loans. Loans increased \$63.3 million, or 4%, to \$1.57 billion at September 30, 2017, compared to \$1.50 billion at December 31, 2016, primarily due to an increase in the Company's legacy portfolio. The loan portfolio remains well diversified with commercial and industrial ("C&I") loans accounting for 38% of the loan portfolio at September 30, 2017, which included \$48.8 million of factored receivables. CRE loans accounted for 48% of the total loan portfolio, of which 42% were occupied by businesses that own them. Land and construction loans accounted for 6% of total loans, consumer and home equity loans accounted for 5% of total loans, and residential mortgage loans accounted for the remaining 3% of total loans at September 30, 2017.

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). Net interest income increased 14% to \$26.3 million for the third quarter of 2017, compared to \$23.0 million for the third quarter of 2016. For the first nine months of 2017, net interest income increased 10% to \$75.1 million, compared to \$68.1 million for the first nine months of 2016. Net interest income increased for the third quarter and first nine months of 2017, compared to the respective periods in 2016, primarily due to an increase in the average balance of loans and investment securities.

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

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

Management of Credit Risk

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

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

Table of Contents

In June 2016, the FASB issued new guidance on measurement of credit losses on financial instruments, which is the final guidance on the new current expected credit loss (“CECL”) model. The new guidance will replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to estimate future credit loss estimates. Management is currently evaluating the impact of adopting CECL, which becomes effective for the Company on January 1, 2020. The effect of the adoption of CECL is currently unknown and could result in an increase to the allowance for loan losses and a charge to equity. Further discussion of the adoption of CECL appears in Note 1 – Basis of Presentation – Newly Issued, but not yet Effective Accounting Standards in the financial statements in this Form 10-Q.

Noninterest Income

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

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company’s performance. Total noninterest expense for the third quarter of 2017 was \$14.8 million, compared to \$14.3 million for the third quarter of 2016. Total noninterest expense for the nine months ended September 30, 2017 was \$45.4 million, compared to \$43.4 million for the nine months ended September 30, 2016. The increase in noninterest expense in the third quarter of 2017 and the first nine months of 2017, compared to the respective periods in 2016, was primarily due to higher salaries and employee benefits as a result of annual salary increases and hiring additional employees.

Capital Management

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

RESULTS OF OPERATIONS

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

Net Interest Income and Net Interest Margin

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

The following Distribution, Rate and Yield table presents the average amounts outstanding for the major categories of the Company's balance sheet, the average interest rates earned or paid thereon, and the resulting net interest margin on average interest earning assets for the periods indicated. Average balances are based on daily averages.

Table of Contents

Distribution, Rate and Yield

	Three Months Ended September 30, 2017				Three Months Ended September 30, 2016			
	Average Balance (Dollars in thousands)	Interest Income / Expense	Average Yield / Rate		Average Balance	Interest Income / Expense	Average Yield / Rate	
Assets:								
Loans, gross (1)(2)	\$ 1,560,421	22,507	5.72	%	\$ 1,442,006	\$ 20,312	5.60	%
Securities — taxable	671,528	3,596	2.12	%	497,821	2,401	1.92	%
Securities — exempt from Federal tax (3)	89,426	866	3.84	%	91,241	875	3.82	%
Other investments and interest- bearing deposits in other financial institutions	335,706	1,289	1.52	%	232,929	592	1.01	%
Total interest earning assets (3)	2,657,081	28,258	4.22	%	2,263,997	24,180	4.25	%
Cash and due from banks	35,173				32,628			
Premises and equipment, net	7,609				7,595			
Goodwill and other intangible assets	51,715				53,258			
Other assets	85,229				73,825			
Total assets	\$ 2,836,807				\$ 2,431,303			
Liabilities and shareholders' equity:								
Deposits:								
Demand, noninterest-bearing	\$ 980,554				\$ 842,565			
Demand, interest-bearing	583,363	290	0.20	%	515,296	259	0.20	%
Savings and money market	686,511	429	0.25	%	516,570	289	0.22	%
Time deposits — under \$100	19,770	14	0.28	%	21,707	16	0.29	%
Time deposits — \$100 and over	181,167	317	0.69	%	212,201	251	0.47	%
Time deposits — brokered CDARS — interest-bearing demand, money market and time deposits	—	—	N/A		4,874	10	0.82	%
Total interest-bearing deposits	1,489,461	1,051	0.28	%	1,278,904	826	0.26	%
Total deposits	2,470,015	1,051	0.17	%	2,121,469	826	0.15	%
	39,120	583	5.91	%	—	—	N/A	

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Subordinated debt, net of issuance costs								
Short-term borrowings	84	—	5.67	%	55	—	0.00	%
Total interest-bearing liabilities	1,528,665	1,634	0.42	%	1,278,959	826	0.26	%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	2,509,219	1,634	0.26	%	2,121,524	826	0.15	%
Other liabilities	54,922				50,384			
Total liabilities	2,564,141				2,171,908			
Shareholders' equity	272,666				259,395			
Total liabilities and shareholders' equity	\$ 2,836,807				\$ 2,431,303			
Net interest income (3) / margin		26,624	3.98	%		23,354	4.10	%
Less tax equivalent adjustment (3)		(303)				(306)		
Net interest income		\$ 26,321				\$ 23,048		

(1) Includes loans held for sale. Nonaccrual loans are included in average balance.

(2) Yield amounts earned on loans include fees and costs. The accretion (amortization) of deferred loan fees (costs) into loan interest income was \$200,000 for the third quarter of 2017, compared to \$62,000 for the third quarter of 2016.

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

Table of Contents

	Nine Months Ended September 30, 2017				Nine Months Ended September 30, 2016			
	Average Balance	Interest Income / Expense	Average Yield / Rate		Average Balance	Interest Income / Expense	Average Yield / Rate	
Assets:								
Loans, gross (1)(2)	\$ 1,521,447	64,112	5.63	%	\$ 1,409,637	\$ 59,235	5.61	%
Securities — taxable	616,648	9,916	2.15	%	500,497	8,004	2.14	%
Securities — exempt from Federal tax (3)	89,991	2,606	3.87	%	92,194	2,651	3.84	%
Other investments and interest- bearing deposits in other financial institutions	291,222	3,037	1.39	%	195,850	1,478	1.01	%
Total interest earning assets (3)	2,519,308	79,671	4.23	%	2,198,178	71,368	4.34	%
Cash and due from banks	33,656				32,927			
Premises and equipment, net	7,581				7,638			
Goodwill and other intangible assets	52,103				53,641			
Other assets	85,901				83,574			
Total assets	\$ 2,698,549				\$ 2,375,958			
Liabilities and shareholders' equity:								
Deposits:								
Demand, noninterest-bearing	\$ 924,841				\$ 800,049			
Demand, interest-bearing	574,966	880	0.20	%	505,442	731	0.19	%
Savings and money market	632,907	1,081	0.23	%	506,998	829	0.22	%
Time deposits — under \$100	20,141	44	0.29	%	22,534	48	0.28	%
Time deposits — \$100 and Over	191,301	859	0.60	%	212,300	660	0.42	%
Time deposits — brokered CDARS — interest-bearing demand, money market and time deposits	—	—	N/A		9,503	59	0.83	%
Total interest-bearing deposits	1,432,376	2,867	0.27	%	1,265,121	2,332	0.25	%
Total deposits	2,357,217	2,867	0.16	%	2,065,170	2,332	0.15	%
Subordinated debt, net of issuance costs								
Short-term borrowings	17,912	811	6.05	%	—	—	N/A	
	68	1	1.97	%	601	12	2.67	%
	1,450,356	3,679	0.34	%	1,265,722	2,344	0.25	%

Total interest-bearing liabilities								
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	2,375,197	3,679	0.21	%	2,065,771	2,344	0.15	%
Other liabilities	57,377				56,325			
Total liabilities	2,432,574				2,122,096			
Shareholders' equity	265,975				253,862			
Total liabilities and shareholders' equity	\$ 2,698,549				\$ 2,375,958			
Net interest income (3) / margin		75,992	4.03	%		69,024	4.19	%
Less tax equivalent adjustment (3)		(912)				(928)		
Net interest income		\$ 75,080				\$ 68,096		

(1) Includes loans held for sale. Nonaccrual loans are included in average balance.

(2) Yield amounts earned on loans include fees and costs. The accretion (amortization) of deferred loan fees (costs) into loan interest income was \$370,000 for the nine months ended September 30, 2017, compared to \$170,000 for the nine months ended September 30, 2016.

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

Table of Contents

Volume and Rate Variances

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

	Three Months Ended September 30, 2017 vs. 2016 Increase (Decrease) Due to Change in:		
	Average Volume	Average Rate	Net Change
	(Dollars in thousands)		
Income from the interest earning assets:			
Loans, gross	\$ 1,717	\$ 478	\$ 2,195
Securities — taxable	936	259	1,195
Securities — exempt from Federal tax (1)	(17)	8	(9)
Other investments, and interest- bearing deposits in other financial institutions	397	300	697
Total interest income on interest earning assets (1)	3,033	1,045	4,078
Expense from the interest-bearing liabilities:			
Demand, interest-bearing	30	1	31
Savings and money market	103	37	140
Time deposits — under \$100	(1)	(1)	(2)
Time deposits — \$100 and over	(52)	118	66
Time deposits — brokered	(10)	—	(10)
CDARS — interest-bearing demand, money market and time deposits	1	(1)	—
Subordinated debt, net of issuance costs	583	—	583
Short-term borrowings	—	—	—
Total interest expense on interest-bearing liabilities	654	154	808
Net interest income (1)	\$ 2,379	\$ 891	3,270
Less tax equivalent adjustment (1)			3
Net interest income			\$ 3,273

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

Table of Contents

	Nine Months Ended September 30, 2017 vs. 2016		
	Increase (Decrease)		
	Due to Change in:		
	Average	Average	Net
	Volume	Rate	Change
	(Dollars in thousands)		
Income from the interest earning assets:			
Loans, gross	\$ 4,753	\$ 124	\$ 4,877
Securities — taxable	1,868	44	1,912
Securities — exempt from Federal tax (1)	(63)	18	(45)
Other investments, and interest- bearing deposits in other financial institutions	1,001	558	1,559
Total interest expense on interest-earning assets (1)	7,559	744	8,303
Expense from the interest-bearing liabilities:			
Demand, interest-bearing	124	25	149
Savings and money market	209	43	252
Time deposits — under \$100	(5)	1	(4)
Time deposits — \$100 and over	(94)	293	199
Time deposits — brokered	(59)	—	(59)
CDARS — interest-bearing demand, money market and time deposits	1	(3)	(2)
Subordinated debt, net of issuance costs	811	—	811
Short-term borrowings	(8)	(3)	(11)
Total interest expense on interest-bearing liabilities	979	356	1,335
Net interest income (1)	\$ 6,580	\$ 388	6,968
Less tax equivalent adjustment (1)			16
Net interest income			\$ 6,984

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

The Company's net interest margin (FTE), expressed as a percentage of average earning assets, contracted 12 basis points to 3.98% for the third quarter of 2017, from 4.10% for the third quarter of 2016. The contraction was primarily due to the change in the mix of the balance sheet resulting in a higher average balance of lower yielding excess funds at the Federal Reserve Bank, and the full quarter impact from the issuance of subordinated debt during the second quarter of 2017. This was partially offset by an increase in the average balances of loans and securities, and the impact of increases in the prime rate on loan yields and overnight funds. The average balance of other investments and interest-bearing deposits in other financial institutions increased \$102.8 million to \$335.7 million for the third quarter of 2017, compared to \$232.9 million for the third quarter of 2016.

For the first nine months of 2017, the net interest margin contracted 16 basis points to 4.03%, compared to 4.19% for the first nine months of 2016. The contraction was primarily due to the change in the mix of the balance sheet

resulting in a higher average balance of lower yielding excess funds at the Federal Reserve Bank, the issuance of subordinated debt, and a decrease in the accretion of the loan purchase discount into loan interest income from the Focus acquisition. This was partially offset by an increase in the average balances of loans and securities, and the impact of increases in the prime rate on loan yields and overnight funds. The average balance of other investments and interest-bearing deposits in other financial institutions increased \$95.3 million to \$291.2 million for the first nine months of 2017, compared to \$195.9 million for the first nine months of 2016.

The average yield on the loan portfolio increased to 5.72% for the third quarter of 2017, compared to 5.60% for the third quarter of 2016, primarily due to increases in the prime rate, partially offset by the impact of lower yielding purchased residential mortgage loans and purchased CRE loans. The average yield on the Company's legacy loan portfolio (excluding the purchased residential loans, purchased CRE loans, factored receivables portfolio, and accretion of the loan purchase discount from the Focus transaction) increased 25 basis points for the third quarter of 2017, compared to the third quarter of 2016. The average yield on the purchased residential loans was 2.67% for the third quarter of 2017.

Table of Contents

The average yield on the loan portfolio increased to 5.63% for the first nine months of 2017, compared to 5.61% for the first nine months of 2016, primarily due to increases in the prime rate, partially offset by the impact of the lower yielding purchased residential mortgage loans and purchased CRE loans, a lower yield on the factored receivables portfolio, and a decrease in the accretion of the loan purchase discount into loan interest income from the Focus transaction. The average yield on the Company's legacy loan portfolio (excluding the purchased residential loans, purchased CRE loans, factored receivables portfolio, and accretion of the loan purchase discount from the Focus transaction) increased 27 basis points for the first nine months of 2017, compared to the first nine months of 2016. The average yield on the purchased residential loans was 2.67% for the first nine months of 2017, compared to 3.07% for the first nine months of 2016. The yield on the purchased CRE loans was 3.51% for the first nine months of 2017.

Net interest income increased 14% to \$26.3 million for the third quarter of 2017, compared to \$23.0 million for the third quarter of 2016. Net interest income increased 10% to \$75.1 million for the nine months ended September 30, 2017, compared to \$68.1 million for the nine months ended September 30, 2016. Net interest income increased for the third quarter of 2017 and the first nine months of 2017, compared to the respective periods in 2016, primarily due to an increase in the average balance of loans and investment securities.

Provision for Loan Losses

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

There was a \$115,000 provision for loan losses for the third quarter of 2017, compared to a provision for loan losses of \$245,000 for the third quarter of 2016. For the nine months ended September 30, 2017, there was a \$390,000 provision for loan losses, compared to a \$997,000 provision for loan losses for the nine months ended September 30, 2016. Provisions for loan losses are charged to operations to bring the allowance for loan losses to a level deemed appropriate by the Company based on the factors discussed under "Allowance for Loan Losses".

The allowance for loan losses totaled \$19.7 million, or 1.26% of total loans at September 30, 2017, compared to \$20.0 million, or 1.38% of total loans at September 30, 2016, and \$19.1 million, or 1.27% of total loans at December 31, 2016. Net recoveries totaled \$236,000 for the third quarter of 2017, compared to net charge-offs of \$134,000 for the third quarter of 2016, and net charge offs of \$1.2 million for the fourth quarter of 2016. The

allowance for loan losses to total nonperforming loans was 565.68% at September 30, 2017, compared to 445.55% at September 30, 2016, and 624.03% at December 31, 2016.

Noninterest Income

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

	Three Months Ended		Increase (decrease)		
	September 30, 2017	2016	2017 versus 2016 Amount	Percent	
	(Dollars in thousands)				
Service charges and fees on deposit accounts	\$ 869	\$ 798	\$ 71	9	%
Increase in cash surrender value of life insurance	417	428	(11)	(3)	%
Servicing income	246	364	(118)	(32)	%
Gain on sales of SBA loans	147	69	78	113	%
Other	781	653	128	20	%
Total	\$ 2,460	\$ 2,312	\$ 148	6	%

Table of Contents

	Nine Months Ended		Increase		
	September 30,		(decrease)		
	2017	2016	2017 versus 2016		
			Amount	Percent	
	(Dollars in thousands)				
Service charges and fees on deposit accounts	\$ 2,410	\$ 2,348	\$ 62	3	%
Increase in cash surrender value of life insurance	1,259	1,317	(58)	(4)	%
Servicing income	736	1,106	(370)	(33)	%
Gain on sales of SBA loans	635	653	(18)	(3)	%
Gain on proceeds from company-owned life insurance	—	1,019	(1,019)	(100)	%
Gain (loss) on sales of securities	(6)	527	(533)	(101)	%
Other	2,014	1,616	398	25	%
Total	\$ 7,048	\$ 8,586	\$ (1,538)	(18)	%

Total noninterest income was \$2.5 million for the third quarter of 2017, compared to \$2.3 million for the third quarter of 2016. For the nine months ended September 30, 2017, total noninterest income was \$7.0 million compared to \$8.6 million for the nine months ended September 30, 2016. The decrease in noninterest income for the first nine months of 2017, compared to the first nine months of 2016, was primarily due to a \$1.0 million gain on proceeds from company-owned life insurance in the second quarter of 2016, and lower servicing income and gain on sales of securities in the first nine months of 2017.

Historically, a portion of the Company's noninterest income has been associated with its SBA lending activity, as gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. For the three months ended September 30, 2017, SBA loan sales resulted in a \$147,000 gain, compared to a \$69,000 gain on sales of SBA loans for the three months ended September 30, 2016. For the nine months ended September 30, 2017, SBA loan sales resulted in a \$635,000 gain, compared to a \$653,000 gain on sale of SBA loans for the nine months ended September 30, 2016.

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

Noninterest Expense

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

	Three Months Ended		Increase (Decrease)		
	September 30, 2017	2016	2017 versus 2016 Amount	Percent	
	(Dollars in thousands)				
Salaries and employee benefits	\$ 9,071	\$ 8,363	\$ 708	8	%
Occupancy and equipment	1,142	1,120	22	2	%
Professional fees	695	1,086	(391)	(36)	%
Software subscriptions	475	401	74	18	%
Data processing	411	372	39	10	%
Insurance expense	401	319	82	26	%
FDIC deposit insurance premiums	304	308	(4)	(1)	%
Amortization of intangible assets	296	392	(96)	(24)	%
Foreclosed assets	2	10	(8)	(80)	%
Other	2,037	1,925	112	6	%
Total	\$ 14,834	\$ 14,296	\$ 538	4	%

Table of Contents

	Nine Months Ended		Increase (Decrease)		
	September 30, 2017	2016	2017 versus 2016 Amount	Percent	
	(Dollars in thousands)				
Salaries and employee benefits	\$ 27,766	\$ 26,052	\$ 1,714	7	%
Occupancy and equipment	3,426	3,277	149	5	%
Professional fees	2,439	2,619	(180)	(7)	%
Software subscriptions	1,333	1,118	215	19	%
Data processing	1,080	1,143	(63)	(6)	%
Insurance expense	1,123	924	199	22	%
FDIC deposit insurance premiums	860	966	(106)	(11)	%
Amortization of intangible assets	1,083	1,176	(93)	(8)	%
Foreclosed assets	6	14	(8)	(57)	%
Other	6,300	6,073	227	4	%
Total	\$ 45,416	\$ 43,362	\$ 2,054	5	%

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

Noninterest Expense by Category

	Three Months Ended September 30,			Percent of		
	2017	Percent of Total	2016	Percent of Total		
	(Dollars in thousands)					
Salaries and employee benefits	\$ 9,071	61	%	\$ 8,363	58	%
Occupancy and equipment	1,142	8	%	1,120	8	%
Professional fees	695	5	%	1,086	8	%
Software subscriptions	475	3	%	401	3	%
Data processing	411	3	%	372	3	%
Insurance expense	401	3	%	319	2	%
FDIC deposit insurance premiums	304	2	%	308	2	%
Amortization of intangible assets	296	2	%	392	3	%
Foreclosed assets	2	—	%	10	—	%
Other	2,037	13	%	1,925	13	%
Total	\$ 14,834	100	%	\$ 14,296	100	%

For the Nine Months Ended September 30,
2017 2016

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	Amount	Percent		Amount	Percent	
	(Dollars in thousands)	of Total			of Total	
Salaries and employee benefits	\$ 27,766	61	%	\$ 26,052	60	%
Occupancy and equipment	3,426	8	%	3,277	7	%
Professional fees	2,439	6	%	2,619	6	%
Software subscriptions	1,333	3	%	1,118	3	%
Data processing	1,080	2	%	1,143	3	%
Insurance expense	1,123	2	%	924	2	%
FDIC deposit insurance premiums	860	2	%	966	2	%
Amortization of intangible assets	1,083	2	%	1,176	3	%
Foreclosed assets	6	—		14	—	
Other	6,300	14	%	6,073	14	%
Total	\$ 45,416	100	%	\$ 43,362	100	%

Total noninterest expense for the third quarter of 2017 was \$14.8 million, compared to \$14.3 million for the third quarter of 2016. Noninterest expense for the nine months ended September 30, 2017 was \$45.4 million, compared to \$43.4 million for the nine months ended September 30, 2016. The increase in noninterest expense in the third quarter of 2017 and the first nine months of 2017, compared to the respective periods in 2016, was primarily due to higher

Table of Contents

salaries and employee benefits as a result of annual salary increases and the hiring of additional employees. Full time equivalent employees were 282 at September 30, 2017, 264 at September 30, 2016, and 263 at December 31, 2016.

Income Tax Expense

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

The Company's Federal and state income tax expense for the three and nine months ended September 30, 2017 was \$5.2 million and \$13.8 million, respectively. The income tax expense was \$4.1 million and \$12.2 million in the same periods in 2016. The following table shows the Company's effective income tax rates for the periods indicated:

	Three Months Ended September 30, 2017		Nine Months Ended September 30, 2016	
Effective income tax rate	37.9 %	37.5 %	37.9 %	37.6 %

The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of tax exempt securities, 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 Enterprise Zone hiring credits, and the tax benefit from the Company's stock-based compensation plans.

In March 2016, the FASB issued new guidance intended to simplify several areas of accounting for share-based compensation programs, including the income tax impact, classification on the statement of cash flows, and forfeitures. The Company adopted the new guidance on share-based compensation during the first quarter of 2017. All excess tax benefits and tax deficiencies (including tax benefits of dividends on share based payment awards) are recognized as income tax expense or benefit on the income statement. The tax effects of exercised or vested awards are treated as discrete items in the reporting period in which they occur. The adoption of this guidance resulted in a reduction to tax expense of (\$106,000) for the third quarter of 2017, and a reduction to tax expense of (\$158,000) for the first nine months of 2017.

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

tax liability until such time as they reverse.

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

The Company had net deferred tax assets of \$22.4 million at September 30, 2017 and \$25.1 million at December 31, 2016. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at September 30, 2017 and December 31, 2016 will be fully realized in future years.

Adoption of reduced corporate tax rates as being discussed in the United States Congress could have a material adverse effect on our deferred tax assets. The Company is monitoring the tax rates discussion and its potential impact to our deferred tax assets, equity, and income tax provision.

Table of Contents

Business Segment Information

The following presents the Company's operating segments. Transactions between segments consist primarily of borrowed funds. Intersegment interest expense is allocated to the Factoring segment based on the Company's prime rate and funding costs. The provision for loan loss is allocated based on the segment's allowance for loan loss determination which considers the effects of charge offs. Noninterest income and expense directly attributable to a segment are assigned to it. Taxes are paid on a consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring originated by Bay View Funding.

	Three Months Ended September 30, 2017		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 24,805	\$ 3,150	\$ 27,955
Intersegment interest allocations	284	(284)	—
Total interest expense	1,634	—	1,634
Net interest income	23,455	2,866	26,321
Provision for loan losses	107	8	115
Net interest income after provision	23,348	2,858	26,206
Noninterest income	2,101	359	2,460
Noninterest expense	13,149	1,685	14,834
Intersegment expense allocations	130	(130)	—
Income before income taxes	12,430	1,402	13,832
Income tax expense	4,660	589	5,249
Net income	\$ 7,770	\$ 813	\$ 8,583
Total assets	\$ 2,776,262	\$ 67,686	\$ 2,843,948
Loans, net of deferred fees	\$ 1,517,186	\$ 48,764	\$ 1,565,950
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

	Three Months Ended September 30, 2016		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 20,743	\$ 3,131	\$ 23,874
Intersegment interest allocations	314	(314)	—
Total interest expense	826	—	826
Net interest income	20,231	2,817	23,048
Provision for loan losses	237	8	245
Net interest income after provision	19,994	2,809	22,803
Noninterest income	2,160	152	2,312
Noninterest expense	12,382	1,914	14,296

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Intersegment expense allocations	234	(234)	—
Income before income taxes	10,006	813	10,819
Income tax expense	3,712	342	4,054
Net income	\$ 6,294	\$ 471	\$ 6,765
Total assets	\$ 2,464,438	\$ 63,524	\$ 2,527,962
Loans, net of deferred fees	\$ 1,402,330	\$ 47,846	\$ 1,450,176
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

(1) Includes the holding company's results of operations

55

Table of Contents

	Nine Months Ended September 30, 2017		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 70,146	\$ 8,613	\$ 78,759
Intersegment interest allocations	786	(786)	—
Total interest expense	3,679	—	3,679
Net interest income	67,253	7,827	75,080
Provision for loan losses	372	18	390
Net interest income after provision	66,881	7,809	74,690
Noninterest income	6,153	895	7,048
Noninterest expense	40,152	5,264	45,416
Intersegment expense allocations	392	(392)	—
Income before income taxes	33,274	3,048	36,322
Income tax expense	12,472	1,280	13,752
Net income	\$ 20,802	\$ 1,768	\$ 22,570
Total assets	\$ 2,776,262	\$ 67,686	\$ 2,843,948
Loans, net of deferred fees	\$ 1,517,186	\$ 48,764	\$ 1,565,950
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664
	Nine Months Ended September 30, 2016		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 61,252	\$ 9,188	\$ 70,440
Intersegment interest allocations	863	(863)	—
Total interest expense	2,344	—	2,344
Net interest income	59,771	8,325	68,096
Provision for loan losses	949	48	997
Net interest income after provision	58,822	8,277	67,099
Noninterest income	8,069	517	8,586
Noninterest expense	38,036	5,326	43,362
Intersegment expense allocations	623	(623)	—
Income before income taxes	29,478	2,845	32,323
Income tax expense	10,962	1,195	12,157
Net income	\$ 18,516	\$ 1,650	\$ 20,166
Total assets	\$ 2,464,438	\$ 63,524	\$ 2,527,962
Loans, net of deferred fees	\$ 1,402,330	\$ 47,846	\$ 1,450,176
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

(1) Includes the holding company's results of operations

Banking. Our banking segment's net income increased to \$7.8 million for the three months ended September 30, 2017, compared to net income of \$6.3 million for the three months ended September 30, 2016. For the nine months ended September 30, 2017, our banking segment's net income was \$20.8 million, compared to \$18.5 million for the nine months ended September 30, 2016. Net interest income increased to \$23.5 million for the three months ended September 30, 2017, compared to \$20.2 million for the three months ended September 30, 2016. For the nine months ended September 30, 2017, net interest income increased to \$67.3 million, compared to \$59.8 million for the nine months ended September 30, 2016. The increase in net interest income for the three and nine months ended September 30, 2017, compared to the comparable periods in 2016, was primarily as a result of an increase in the average balance of loans and investment securities. The provision for loan losses was \$107,000 for the three months ended September 30, 2017, compared to a provision for loan losses of \$237,000 for the three months ended September 30, 2016. For the nine months ended September 30, 2017, the provision for loan losses was \$372,000, compared with a provision for loan losses of \$949,000 for the nine months ended September 30, 2016. Noninterest income was \$2.1 million for the three months ended September 30, 2017, compared to \$2.2 million for the three months ended September 30, 2016. Noninterest income decreased to \$6.2 million for the nine months ended September 30, 2017, compared to \$8.1 million for the nine months ended September 30, 2016, primarily due to a \$1.0 million gain on proceeds from company-owned

Table of Contents

life insurance and gains on sales of investment securities in 2016. Noninterest expense increased to \$13.1 million for the three months ended September 30, 2017, compared to \$12.4 million for the three months ended September 30, 2016. For the nine months ended September 30, 2017, noninterest expense was \$40.2 million, compared to \$38.0 million for the nine months ended September 30, 2016. The increase in noninterest expense for the three months and nine months ended September 30, 2017, compared to the comparable periods in 2016, primarily due to higher salaries and employee benefits and hiring additional employees.

Factoring. Bay View Funding's primary business operation is purchasing and collecting factored receivables. Factored receivables are receivables that have been transferred by the originating organization and typically have not been subject to previous collection efforts. In a factoring transaction Bay View Funding directly purchases the receivables generated by its clients at a discount to their face value. The transactions are structured to provide the clients with immediate working capital when there is a mismatch between payments to the client for a good and service and the payment of operating costs incurred to provide such good or service. The average life of the factored receivables was 36 days for the nine months ended September 30, 2017, compared to 34 days for the nine months ended September 30, 2016. The balance of the purchased receivables as of September 30, 2017 and 2016 was \$48.8 million and \$47.8 million, respectively. Bay View Funding's net income was \$813,000 for the three months ended September 30, 2017, compared \$471,000 for the three months ended September 30, 2016. For the nine months ended September 30, 2017, Bay View Funding's net income was \$1.8 million, compared to \$1.7 million for the nine months ended September 30, 2016. Net interest income increased to \$2.9 million for the three months ended September 30, 2017, compared to \$2.8 million for the three months ended September 30, 2016. For the nine months ended September 30, 2017, net interest income decreased to \$7.8 million, compared to \$8.3 million for the nine months ended September 30, 2016, primarily due to a decrease in the average yield on the factored receivables portfolio, and a decrease in the average balance of factored receivables outstanding. The provision for loan losses was \$8,000 for the three months ended September 30, 2017, and the three months ended September 30, 2016. For the nine months ended September 30, 2017, the provision for loan losses was \$18,000, compared to a provision for loan losses of \$48,000 for the nine months ended September 30, 2016. Noninterest income was \$359,000 for the three months ended September 30, 2017, compared to \$152,000 for the three months ended September 30, 2016. For the nine months ended September 30, 2017, noninterest income was \$895,000, compared to \$517,000 for the nine months ended September 30, 2016. Noninterest income was higher in the third quarter of 2017 and the first nine months of 2017, compared to the respective periods in 2016, primarily due to an increase in fees. Noninterest expense was \$1.7 million for the three months ended September 30, 2017, compared to \$1.9 million for the three months ended September 30, 2016. For the nine months ended September 30, 2017 and the nine months ended September 30, 2016, noninterest expense was \$5.3 million.

FINANCIAL CONDITION

As of September 30, 2017, total assets increased to \$2.84 billion, compared to \$2.53 billion at September 30, 2016, and \$2.57 billion at December 31, 2016. Securities available for sale, at fair value, were \$390.1 million at September 30, 2017, an increase of 5% from \$370.0 million at September 30, 2016, and an increase of 27% from \$306.6 million at December 31, 2016. Securities held to maturity, at amortized cost, were \$379.5 million at September 30, 2017, an increase of 88% from \$202.4 million at September 30, 2016, and an increase of 17% from \$324.0 million at December 31, 2016. Total loans, excluding loans held for sale, increased \$115.8 million, or 8%, to \$1.57 billion at September 30, 2017, compared to \$1.45 billion at September 30, 2016, which included an increase of \$80.0 million, or

6%, in the Company's legacy loan portfolio, \$37.6 million of purchased CRE loans, and an increase of \$918,000 in the factored receivables portfolio, partially offset by a decrease of \$2.8 million in purchased residential mortgage loans. Loans increased \$63.3 million, or 4%, to \$1.57 billion at September 30, 2017, compared to \$1.50 billion at December 31, 2016, primarily due to an increase in the Company's legacy portfolio.

Total deposits increased \$262.0 million, or 12%, to \$2.48 billion at September 30, 2017, compared to \$2.22 billion at September 30, 2016, and increased \$218.5 million, or 10%, from \$2.26 billion at December 31, 2016. Deposits, excluding all time deposits and CDARS, deposits increased \$281.9 million, or 14%, to \$2.26 billion at September 30, 2017, from \$1.98 billion at September 30, 2016, and increased \$231.5 million, or 11%, from \$2.03 billion at December 31, 2016.

Table of Contents

Securities Portfolio

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

	September 30, 2017	2016	December 31, 2016
	(Dollars in thousands)		
Securities available-for-sale (at fair value):			
Agency mortgage-backed securities	\$ 373,167	\$ 352,552	\$ 290,989
Trust preferred securities	16,940	16,425	15,600
Corporate bonds	—	1,022	—
Total	\$ 390,107	\$ 369,999	\$ 306,589
Securities held-to-maturity (at amortized cost):			
Agency mortgage-backed securities	\$ 290,418	\$ 111,591	\$ 233,409
Municipals — exempt from Federal tax	89,132	90,813	90,601
	\$ 379,550	\$ 202,404	\$ 324,010

The following table summarizes the weighted average life and weighted average yields of securities at September 30, 2017:

	Weighted Average Life								Total Amount	
	Within One Year or Less		After One and Within Five Years		After Five and Within Ten Years		After Ten Years			
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield		
	(Dollars in thousands)									
Securities available-for-sale (at fair value):										
Agency mortgage-backed securities	\$ —	—	\$ 233,411	2.13 %	\$ 139,756	2.39 %	\$ —	—	\$ 373,167	—
Trust preferred securities	—	—	—	—	—	—	16,940	5.95 %	16,940	5.95 %
	\$ —	—	\$ 233,411	2.13 %	\$ 139,756	2.39 %	\$ 16,940	5.95 %	\$ 390,107	2.81 %
Securities held-to-maturity (at amortized cost):										
Agency mortgage-backed securities	\$ —	—	\$ 130,958	1.75 %	\$ 138,831	2.27 %	\$ 20,629	3.02 %	\$ 290,418	2.01 %
Municipals — exempt from Federal tax (1)	7,776	3.93 %	32,395	3.85 %	23,022	4.06 %	25,939	3.78 %	89,132	3.93 %
	\$ 7,776	3.93 %	\$ 163,353	2.16 %	\$ 161,853	2.52 %	\$ 46,568	3.44 %	\$ 379,550	2.52 %

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

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

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

The Company classifies its securities as either available for sale or held to maturity at the time of purchase. Accounting guidance requires available for sale securities to be marked to fair value with an offset to accumulated other comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available for sale securities.

Table of Contents

The investment securities available for sale portfolio totaled \$390.1 million at September 30, 2017, an increase of 5% from \$370.0 million at September 30, 2016, and an increase of 27% from \$306.6 million at December 31, 2016. At September 30, 2017, the Company's securities available for sale portfolio was comprised of \$373.2 million agency mortgage backed securities (all issued by U.S. Government sponsored entities), and \$16.9 million of single entity issue trust preferred securities. The pre tax unrealized gain on securities available for sale at September 30, 2017 was \$1.0 million compared to a pre tax unrealized gain on securities available for sale of \$8.0 million at September 30, 2016, and a pre tax unrealized loss on securities available for sale of (\$2.0) million at December 31, 2016. All other factors remaining the same, when market interest rates are rising, the Company will experience a higher unrealized loss (or lower unrealized gain) on the securities portfolio. During the third quarter of 2017, the Company purchased \$35.9 million of agency mortgage-backed investment securities available-for-sale, with a weighted average book yield of 2.30%, and a weighted average duration of 4.60 years.

At September 30, 2017, investment securities held to maturity totaled \$379.5 million, an increase of 88% from \$202.4 million at September 30, 2016, and an increase of 17% from \$324.0 million at December 31, 2016. At September 30, 2017, the Company's securities held-to-maturity portfolio, at amortized cost, was comprised of \$290.4 million agency mortgage-backed securities and \$89.1 million tax-exempt municipal bonds. During the third quarter of 2017, the Company purchased \$24.6 million of agency mortgage-backed investment securities held-to-maturity, with a weighted average book yield of 2.39%, and a weighted average duration of 4.79 years.

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

Loans

The Company's loans represent the largest portion of invested assets, substantially greater than the securities portfolio or any other asset category, and the quality and diversification of the loan portfolio is an important consideration when reviewing the Company's financial condition. Gross loans, excluding loans held for sale, represented 55% of total assets at September 30, 2017, represented 57% at September 30, 2016, and represented 58% at December 31, 2016. The ratio of loans to deposits was 63.13% at September 30, 2017, compared to 65.36% at September 30, 2016, and 66.42% at December 31, 2016.

Loan Distribution

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	September 30, 2017		September 30, 2016		December 31, 2016				
	Balance	% to Total	Balance	% to Total	Balance	% to Total			
(Dollars in thousands)									
Commercial	\$ 587,276	38	%	\$ 606,281	42	%	\$ 604,331	40	%
Real estate:									
CRE	754,856	48	%	612,030	42	%	662,228	44	%
Land and									
construction	92,310	6	%	88,371	6	%	81,002	5	%
Home equity	74,171	4	%	76,536	5	%	82,459	6	%
Residential									
mortgages	46,489	3	%	49,255	3	%	52,887	4	%
Consumer	11,749	1	%	18,328	2	%	20,460	1	%
Total Loans	1,566,851	100	%	1,450,801	100	%	1,503,367	100	%
Deferred loan									
fees, net	(901)	—		(625)	—		(760)	—	
Loans, net of									
deferred fees	1,565,950	100	%	1,450,176	100	%	1,502,607	100	%
Allowance for									
loan losses	(19,748)			(20,032)			(19,089)		
Loans, net	\$ 1,546,202			\$ 1,430,144			\$ 1,483,518		

The Company's loan portfolio is concentrated in commercial loans, (primarily manufacturing, wholesale, and services oriented entities), and commercial real estate, with the remaining balance in land development and construction, home equity, purchased residential mortgages, and consumer loans. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 61% of its gross loans were secured by real property at September 30, 2017, compared to 56% at September 30, 2016, and 59% at December 31, 2016. While no specific industry concentration is considered significant, the Company's bank lending operations are substantially located in areas that are dependent on the technology and real estate industries and their supporting companies.

Table of Contents

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

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

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such guaranteed loans (collectively referred to as "SBA loans"). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold the Company retains the servicing rights for the sold portion. During the third quarter and nine months ended September 30, 2017, loans were sold resulting in a gain on sales of SBA loans of \$147,000, and \$635,000, respectively.

The Company's factoring receivables are from the operations of Bay View Funding whose primary business is purchasing and collecting factored receivables. Factored receivables are receivables that have been transferred by the originating organization and typically have not been subject to previous collection efforts. These receivables are acquired from a variety of companies, including but not limited to service providers, transportation companies, manufacturers, distributors, wholesalers, apparel companies, advertisers, and temporary staffing companies. The portfolio of factored receivables is included in the Company's commercial loan portfolio. The average life of the factored receivables was 36 days for the first nine months of 2017, compared to 34 days for the first nine months of 2016. The balance of the purchased receivables was \$48.8 million at September 30, 2017, compared to \$47.8 million at September 30, 2016, and \$49.6 million at December 31, 2016.

The commercial loan portfolio of \$587.3 million at September 30, 2017 decreased \$19.0 million from \$606.3 million at September 30, 2016, and decreased \$17.0 million from \$604.3 million at December 31, 2016. C&I usage was 37% at September 30, 2017, compared to 41% at September 30, 2016, and 42% at December 31, 2016.

The Company's CRE loans consist primarily of loans based on the borrower's cash flow and are secured by deeds of trust on commercial property to provide a secondary source of repayment. The Company generally restricts real estate term loans to no more than 75% of the property's appraised value or the purchase price of the property depending on the type of property and its utilization. The Company offers both fixed and floating rate loans. Maturities on real estate mortgage loans are generally between five and ten years (with amortization ranging from fifteen to twenty five years

and a balloon payment due at maturity), however, SBA and certain other real estate loans that can be sold in the secondary market may be granted for longer maturities.

The CRE loan portfolio increased \$142.8 million, or 23%, to \$754.8 million at September 30, 2017, compared to \$612.0 million at September 30, 2016, which included an increase of \$105.2 million, or 17%, in the Company's legacy portfolio, and \$37.6 million of purchased CRE loans. There were no purchased CRE loans at September 30, 2016. The CRE loan portfolio increased \$92.6 million compared to \$662.2 million at December 31, 2016, which included an increase of \$86.0 million, or 14%, in the Company's legacy portfolio, and an increase of \$6.6 million of purchased CRE loans outstanding.

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Construction loans are provided only in our market area, and the Company has extensive controls for the disbursement process. Land and construction loans increased \$3.9 million to \$92.3 million at September 30, 2017, compared to \$88.4 million at September 30, 2016.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 75% loan to value ratio.

Table of Contents

During the year ended December 31, 2016, the Company purchased jumbo single family residential mortgage loans totaling \$57.5 million, all of which are domiciled in California, with an average loan principal amount of approximately \$834,000 per loan, and weighted average yield of 3.00%, net of servicing fees to the servicer. There were no purchases of residential mortgage during the first nine months of 2017. Residential mortgage loans outstanding at September 30, 2017 totaled \$46.5 million, compared to \$49.3 million at September 30, 2016, and \$52.9 million at December 31, 2016.

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

With certain exceptions, state chartered banks are permitted to make extensions of credit to any one borrowing entity up to 15% of the bank's capital and reserves for unsecured loans and up to 25% of the bank's capital and reserves for secured loans. For HBC, these lending limits were \$46.6 million and \$77.6 million at September 30, 2017, respectively.

Loan Maturities

The following table presents the maturity distribution of the Company's loans (excluding loans held for sale) as of September 30, 2017. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall Street Journal. As of September 30, 2017, approximately 49% of the Company's loan portfolio consisted of floating interest rate loans.

	Due in One Year or Less (Dollars in thousands)	Over One Year But Less than Five Years	Over Five Years	Total
Commercial	\$ 465,202	\$ 96,390	\$ 25,684	\$ 587,276
Real estate:				
CRE	85,542	250,724	418,590	754,856
Land and construction	92,310	—	—	92,310
Home equity	69,697	1,858	2,616	74,171
Residential mortgages	525	—	45,964	46,489
Consumer	11,194	553	2	11,749
Loans	\$ 724,470	\$ 349,525	\$ 492,856	\$ 1,566,851

Loans with variable interest rates	\$ 646,785	46,668	80,452	\$ 773,905
Loans with fixed interest rates	77,685	302,857	412,404	792,946
Loans	\$ 724,470	\$ 349,525	\$ 492,856	\$ 1,566,851

Loan Servicing

As of September 30, 2017 and 2016, \$141.9 million and \$169.6 million, respectively, in SBA loans were serviced by the Company for others. Activity for loan servicing rights was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(Dollars in thousands)			
Beginning of period balance	\$ 1,554	\$ 2,101	\$ 1,854	\$ 2,209
Additions	40	20	158	183
Amortization	(175)	(127)	(593)	(398)
End of period balance	\$ 1,419	\$ 1,994	\$ 1,419	\$ 1,994

Table of Contents

Loan servicing rights are included in accrued interest receivable and other assets on the unaudited consolidated balance sheets and reported net of amortization. There was no valuation allowance as of September 30, 2017 and 2016, as the fair value of the assets was greater than the carrying value.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
	(Dollars in thousands)			
Beginning of period balance	\$ 1,028	\$ 1,154	\$ 1,067	\$ 1,367
Unrealized holding loss	(39)	(53)	(78)	(266)
End of period balance	\$ 989	\$ 1,101	\$ 989	\$ 1,101

Credit Quality

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

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

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

Nonperforming assets are comprised of the following: loans for which the Company is no longer accruing interest; restructured loans which have been current under six months; loans 90 days or more past due and still accruing interest (although they are generally placed on nonaccrual when they become 90 days past due, unless they are both well secured and in the process of collection); and foreclosed assets. Past due loans 30 days or greater totaled \$6.9 million and \$8.0 million at September 30, 2017 and December 31, 2016, respectively, of which \$1.3 million and \$2.1 million were on nonaccrual. At September 30, 2017, there were also \$1.3 million loans less than 30 days past due included in nonaccrual loans held for investment. At December 31, 2016, there were also \$1.0 million loans less than 30 days past due included in nonaccrual loans held for investment.

Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued. Loans may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. Foreclosed assets consist of properties acquired by foreclosure or similar means that management is offering or will offer for sale.

Table of Contents

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

	September 30,		December 31,	
	2017	2016	2016	
	(Dollars in thousands)			
Nonaccrual loans — held-for-investment	\$ 2,560	\$ 4,496	\$ 3,059	
Restructured and loans 90 days past due and still accruing	931	—	—	
Total nonperforming loans	3,491	4,496	3,059	
Foreclosed assets	—	292	229	
Total nonperforming assets	\$ 3,491	\$ 4,788	\$ 3,288	
Nonperforming assets as a percentage of loans plus foreclosed assets	0.22 %	0.33 %	0.22 %	0.22 %
Nonperforming assets as a percentage of total assets	0.12 %	0.19 %	0.13 %	0.13 %

Nonperforming assets were \$3.5 million, or 0.12% of total assets, at September 30, 2017, compared to \$4.8 million, or 0.19% of total assets, at September 30, 2016, and \$3.3 million, or 0.13% of total assets, at December 31, 2016. There were no foreclosed assets at September 30, 2017, compared to \$292,000 at September 30, 2016, and \$229,000 at December 31, 2016.

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

	September 30, 2017			December 31, 2016		
	Restructured and Loans over 90 Days Past Due and Still		Total	Restructured and Loans over 90 Days Past Due and Still		Total
	Nonaccrual	Accruing		Nonaccrual	Accruing	
	(Dollars in thousands)					
Commercial Real estate:	\$ 1,487	\$ 21	\$ 1,508	\$ 2,171	\$ —	\$ 2,171
CRE	501	—	501	419	—	419
Land and construction	183	—	183	199	—	199
Home equity	388	910	1,298	267	—	267
Consumer	1	—	1	3	—	3
Total	\$ 2,560	\$ 931	\$ 3,491	\$ 3,059	\$ —	\$ 3,059

Loans with a well defined weakness, which are characterized by the distinct possibility that the Company will sustain a loss if the deficiencies are not corrected, are categorized as “classified.” Classified loans include all loans considered as substandard, substandard nonaccrual, and doubtful and may result from problems specific to a borrower’s business or from economic downturns that affect the borrower’s ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate). The principal balance of classified loans, was \$10.9 million at September 30, 2017, \$18.4 million at September 30, 2016, and \$13.3 million at December 31, 2016. Loans held for sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses.

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

	September 30, 2017			September 30, 2016			December 31, 2016		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)								
	\$ 578,867	\$ 8,409	\$ 587,276	\$ 591,554	\$ 14,727	\$ 606,281	\$ 594,255	\$ 10,076	\$ 604,331
	754,152	704	754,856	609,179	2,851	612,030	659,777	2,451	662,228
	91,217	1,093	92,310	88,170	201	88,371	80,803	199	81,002
	73,469	702	74,171	75,931	605	76,536	81,866	593	82,459
	46,489	—	46,489	49,255	—	49,255	52,887	—	52,887
	11,748	1	11,749	18,311	17	18,328	20,455	5	20,460
	\$ 1,555,942	\$ 10,909	\$ 1,566,851	\$ 1,432,400	\$ 18,401	\$ 1,450,801	\$ 1,490,043	\$ 13,324	\$ 1,503,367

Table of Contents

Classified commercial loans decreased to \$8.4 million at September 30, 2017, from \$14.7 million at September 30, 2016, and from \$10.1 million at December 31, 2016, primarily due to commercial loan upgrades in excess of downgrades during the nine months ended September 30, 2017. Classified CRE loans decreased to \$704,000 at September 30, 2017, from \$2.9 million at September 30, 2016, and from \$2.5 million at December 31, 2016, mainly as a result of upgrades and payoffs in the CRE loan portfolio.

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

	Nine Months Ended September 30, 2017		Total
	Performing TDRs	Nonperforming TDRs	
	(Dollars in thousands)		
Balance at January 1, 2017	\$ 131	\$ 2	\$ 133
Additions	228	90	318
Principal repayments	(16)	(1)	(17)
Balance at September 30, 2017	\$ 343	\$ 91	\$ 434

	Nine Months Ended September 30, 2016		Total
	Performing TDRs	Nonperforming TDRs	
	(Dollars in thousands)		
Balance at January 1, 2016	\$ 149	\$ 4	\$ 153
Principal repayments	(12)	(1)	(13)
Balance at September 30, 2016	\$ 137	\$ 3	\$ 140

Allowance for Loan Losses

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

Specific allowances are established for impaired loans. Management considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the loan agreement, including scheduled interest payments. Loans for which the terms have been modified with a concession granted, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. When a loan is considered to be impaired, the amount of impairment is measured based on the fair value of the collateral less costs to sell if the loan is collateral dependent, or on the present value of expected future cash flows or values that are observable in the secondary market. If the measure of the impaired loans is less than the investment in the loan, the deficiency will be charged off against the allowance for loan losses if the amount is a confirmed loss, or, alternatively, a specific allocation within the allowance will be established. Loans that are considered impaired are specifically excluded from the formula portion of the allowance for loan losses analysis.

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

The following provides a summary of the risks associated with various segments of the Company's loan portfolio, which are factors management regularly considers when evaluating the adequacy of the allowance:

- Commercial loans consist primarily of commercial and industrial loans (business lines of credit), and other commercial purpose loans. Repayment of commercial and industrial loans is generally provided from the

Table of Contents

cash flows of the related business to which the loan was made. Adverse changes in economic conditions may result in a decline in business activity, which may impact a borrower's ability to continue to make scheduled payments. The factored receivables at Bay View Funding are included in the Company's commercial loan portfolio; however, they are evaluated for risk primarily based on the agings of the receivables. Faster turning receivables imply less risk and therefore warrant a lower associated allowance. Should the overall aging for the portfolio increase, this structure will by formula increase the allowance to reflect the increasing risk. Should the portfolio turn more quickly, it would reduce the associated allowance to reflect the reducing risk.

- Real estate loans consist primarily of loans secured by commercial and residential real estate. Also included in this segment are land and construction loans and home equity lines of credit secured by real estate. As the majority of this segment is comprised of commercial real estate loans, risks associated with this segment lay primarily within these loan types. Adverse economic conditions may result in a decline in business activity and increased vacancy rates for commercial properties. These factors, in conjunction with a decline in real estate prices, may expose the Company to the potential for losses if a borrower cannot continue to service the loan with operating revenues, and the value of the property has declined to a level such that it no longer fully covers the Company's recorded investment in the loan.
- Consumer loans consist primarily of a large number of small loans and lines of credit. The majority of installment loans are made for consumer and business purchases. Weakened economic conditions may result in an increased level of delinquencies within this segment, as economic pressures may impact the capacity of such borrowers to repay their obligations.

As a result of the matters mentioned above, changes in the financial condition of individual borrowers, economic conditions, historical loss experience and the condition of the various markets in which collateral may be sold may all affect the required level of the allowance for loan losses and the associated provision for loan 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 perform independent credit reviews of our loan portfolio. The Federal Reserve Board and the California Department of Business Oversight—Division of Financial Institutions also review the allowance for loan losses as an integral part of the examination process. Based on information currently available, management believes that the allowance for loan losses is adequate. However, the loan portfolio can be adversely affected if California economic conditions and the real estate market in the Company's market area were to weaken. Also, any weakness of a prolonged nature in the technology industry would have a negative impact on the local market. The effect of such events, although uncertain at this time, could result in an increase in the level of nonperforming loans and increased loan losses, which could adversely affect the Company's future growth and profitability. No assurance of the ultimate level of credit losses can be given with any certainty.

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

Three Months Ended September 30, 2017

Real
Commercial Estate Consumer Total
(Dollars in thousands)

Beginning of period balance	\$ 11,259	\$ 7,982	\$ 156	\$ 19,397
Charge-offs	(111)	—	—	(111)
Recoveries	281	66	—	347
Net recoveries	170	66	—	236
Provision (credit) for loan losses	(441)	592	(36)	115
End of period balance	\$ 10,988	\$ 8,640	\$ 120	\$ 19,748

RATIOS:

Annualized net charge-offs (recoveries) to average loans (1)	(0.04) %	(0.02) %	0.00 %	(0.06) %
Allowance for loan losses to total loans (1)	0.70 %	0.55 %	0.01 %	1.26 %
Allowance for loan losses to nonperforming loans	314.75 %	247.49 %	3.44 %	565.68 %

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

Table of Contents

Three Months Ended September 30, 2016

	Real			
	Commercial	Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 11,528	\$ 8,277	\$ 116	\$ 19,921
Charge-offs	(160)	—	—	(160)
Recoveries	21	5	—	26
Net (charge-offs) recoveries	(139)	5	—	(134)
Provision (credit) for loan losses	792	(519)	(28)	245
End of period balance	\$ 12,181	\$ 7,763	\$ 88	\$ 20,032

RATIOS:

Annualized net charge-offs (recoveries) to average loans (1)	0.04	%	0.00	%	0.00	%	0.04	%
Allowance for loan losses to total loans (1)	0.84	%	0.53	%	0.01	%	1.38	%
Allowance for loan losses to nonperforming loans	270.93	%	172.66	%	1.96	%	445.55	%

Nine Months Ended September 30, 2017

	Real			
	Commercial	Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 10,656	\$ 8,327	\$ 106	\$ 19,089
Charge-offs	(2,179)	—	—	(2,179)
Recoveries	1,453	995	—	2,448
Net (charge-offs) recoveries	(726)	995	—	269
Provision (credit) for loan losses	1,058	(682)	14	390
End of period balance	\$ 10,988	\$ 8,640	\$ 120	\$ 19,748

RATIOS:

Annualized net charge-offs (recoveries) to average loans (1)	0.07	%	(0.09)	%	0.00	%	(0.02)	%
Allowance for loan losses to total loans (1)	0.70	%	0.55	%	0.01	%	1.26	%
Allowance for loan losses to nonperforming loans	314.75	%	247.49	%	3.44	%	565.68	%

Nine Months Ended September 30, 2016

	Real			
	Commercial	Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 10,748	\$ 8,076	\$ 102	\$ 18,926
Charge-offs	(300)	—	—	(300)
Recoveries	182	227	—	409
Net (charge-offs) recoveries	(118)	227	—	109
Provision (credit) for loan losses	1,551	(540)	(14)	997
End of period balance	\$ 12,181	\$ 7,763	\$ 88	\$ 20,032

RATIOS:

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Annualized net charge-offs (recoveries) to average loans								
(1)	0.01	%	(0.02)	%	0.00	%	(0.01)	%
Allowance for loan losses to total loans (1)	0.84	%	0.53	%	0.01	%	1.38	%
Allowance for loan losses to nonperforming loans	270.93	%	172.66	%	1.96	%	445.55	%

(2) Average loans and total loans exclude loans held for sale.

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

Table of Contents

Allocation of Allowance for Loan Losses

	September 30, 2017			2016			December 31, 2016		
	Allowance (Dollars in thousands)	Percent of Loans in each category to total loans	%	Allowance	Percent of Loans in each category to total loans	%	Allowance	Percent of Loans in each category to total loans	%
Commercial Real estate:	\$ 10,988	38	%	\$ 12,181	42	%	\$ 10,656	40	%
CRE	5,598	48	%	4,704	42	%	5,181	44	%
Land and construction	1,381	6	%	1,367	6	%	1,221	5	%
Home equity	1,435	4	%	1,496	5	%	1,639	6	%
Residential mortgages	226	3	%	196	3	%	286	4	%
Consumer	120	1	%	88	2	%	106	1	%
Total	\$ 19,748	100	%	\$ 20,032	100	%	\$ 19,089	100	%

The allowance for loan losses totaled \$19.7 million, or 1.26% of total loans at September 30, 2017, compared to \$20.0 million, or 1.38% of total loans at September 30, 2016, and \$19.1 million, or 1.27% of total loans at December 31, 2016. The Company had net recoveries of (\$236,000), or (0.06)% of average loans, for the third quarter of 2017, compared to net charge-offs of \$134,000, or 0.04% of average loans, for the third quarter of 2016, and net charge-offs of \$1.2 million, or 0.32% of average loans, for the fourth quarter of 2016.

The allowance for loan losses related to the commercial portfolio increased \$332,000, at September 30, 2017 from December 31, 2016, primarily due to net charge offs of \$726,000, resulting in a provision to the allowance for loan losses of \$1.1 million. The allowance for loan losses related to the real estate portfolio increased \$313,000 at September 30, 2017 from December 31, 2016, due to net recoveries of \$995,000, resulting in a credit provision for loan losses of \$682,000.

Goodwill and Other Intangible Assets

On November 1, 2014, estimated goodwill of \$13.0 million resulted from the acquisition of Bay View Funding. On August 20, 2015, estimated goodwill of \$32.6 million resulted from the merger of Focus. Goodwill represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate a more accurate or

appropriate value for an asset or liability. Total goodwill at September 30, 2017 and December 31, 2016 was \$45.6 million, which consisted of \$13.0 million related to the Bay View Funding acquisition, and \$32.6 million related to the Focus acquisition.

Goodwill impairment exists when a reporting unit's carrying value exceeds its fair value, which is determined through a qualitative assessment whether it is more likely than not that the fair value of equity of the reporting unit exceeds the carrying value ("Step Zero"). If the qualitative assessment indicates it is more likely than not that the fair value of equity of a reporting unit is less than book value, then a quantitative two step impairment test is required. Step 1 includes the determination of the carrying value of the Company's single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess.

The Company completed its annual impairment analysis on the goodwill from the Bay View Funding and Focus acquisitions as of November 30, 2016, with the assistance of an independent valuation firm. Based on the Step Zero qualitative analysis performed, the Company determined that it is more likely than not that the fair value of the Company's equity exceeded its reported book value of equity at November 30, 2016. As such, no impairment was indicated and no further testing was required.

Table of Contents

Other intangible assets were \$5.9 million at September 30, 2017, compared to \$7.0 million at December 31, 2016. The core deposit and customer relationship intangible assets arising from the acquisition of Diablo Valley Bank in June 2007 was fully amortized at September 30, 2017 and totaled \$195,000 at December 31, 2016, net of accumulated amortization. The core deposit intangible asset arising from the acquisition of Focus was \$4.5 million at September 30, 2017 and \$5.2 million at December 31, 2016, net of accumulated amortization. A below market lease, customer relationship and brokered relationship, and a non compete agreement intangible assets arising from the acquisition of Bay View Funding were \$1.4 million at September 30, 2017 and \$1.6 million at December 31, 2016, net of accumulated amortization.

Deposits

The composition and cost of the Company's deposit base are important components in analyzing the Company's net interest margin and balance sheet liquidity characteristics, both of which are discussed in greater detail in other sections herein. The Company's liquidity is impacted by the volatility of deposits from the propensity of that money to leave the institution for rate related or other reasons. Deposits can be adversely affected if economic conditions weaken in California, and the Company's market area in particular. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed \$250,000, as customers with balances of that magnitude are typically more rate sensitive than customers with smaller balances.

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

	September 30, 2017			September 30, 2016			December 31, 2016		
	Balance	% to Total		Balance	% to Total		Balance	% to Total	
	(Dollars in thousands)								
Demand, noninterest-bearing	\$ 943,723	38	%	\$ 889,075	40	%	\$ 917,187	41	%
Demand, interest-bearing	605,301	24	%	536,541	24	%	541,282	24	%
Savings and money market	713,693	29	%	555,156	24	%	572,743	25	%
Time deposits — under \$250	53,479	2	%	57,718	2	%	57,857	3	%
Time deposits — \$250 and over	147,422	6	%	169,485	8	%	163,670	7	%
Time deposits — brokered	—	0	%	3,000	1	%	—	0	%
CDARS — interest-bearing demand, money	16,986	1	%	7,659	1	%	9,401	0	%

market and time
deposits

Total deposits	\$ 2,480,604	100	%	\$ 2,218,634	100	%	\$ 2,262,140	100	%
----------------	--------------	-----	---	--------------	-----	---	--------------	-----	---

The Company obtains deposits from a cross section of the communities it serves. The Company's business is not generally seasonal in nature. Public funds were 3% of deposits at September 30, 2017, and 4% at September 30, 2016, and December 31, 2016.

Total deposits increased \$262.0 million, or 12%, to \$2.48 billion at September 30, 2017, compared to \$2.22 billion at September 30, 2016, and increased \$218.5 million, or 10%, from \$2.26 billion at December 31, 2016.

Noninterest bearing demand deposits increased \$54.6 million at September 30, 2017 from September 30, 2016, and increased \$26.5 million from December 31, 2016. Interest bearing demand deposits increased \$68.8 million at September 30, 2017 from September 30, 2016, and increased \$64.0 million from December 31, 2016. Savings and money market deposits increased \$158.5 million at September 30, 2017 from September 30, 2016, and increased \$141.0 million from December 31, 2016. Time deposits, \$250,000 and over, decreased \$22.1 million at September 30, 2017 from September 30, 2016, and decreased \$16.2 million from December 31, 2016, primarily due to certificates of deposits from the State of California that matured totaling \$20 million during the second quarter of 2017. Brokered deposits decreased \$3.0 million at September 30, 2017 from September 30, 2016. There were no brokered deposits at September 30, 2017 and December 31, 2016. Deposits, excluding all time deposits and CDARS deposits, increased \$281.9 million, or 14%, to \$2.26 billion at September 30, 2017, from \$1.98 billion at September 30, 2016, and increased \$231.5 million, or 11%, from \$2.03 billion at December 31, 2016.

At September 30, 2017, the Company had \$71.5 million (at fair value) of securities pledged for \$65.1 million in certificates of deposits from the State of California. At September 30, 2016, the Company had \$96.7 million (at fair value) of securities pledged for \$85.1 million in certificates of deposits from the State of California. At December 31,

Table of Contents

2016, the Company had \$94.1 million (at fair value) of securities pledged for \$85.1 million in certificates of deposits from the State of California.

At September 30, 2017, the \$17.0 million CDARS deposits were comprised of \$11.8 million of interest-bearing demand deposits, \$1.8 million of money market accounts and \$3.4 million of time deposits. At September 30, 2016, the \$7.7 million CDARS deposits were comprised of \$4.1 million of money market accounts and \$3.6 million of time deposits. At December 31, 2016, the \$9.4 million CDARS deposits were comprised of \$2.5 million of interest-bearing demand deposits, \$3.7 million of money market accounts and \$3.2 million of time deposits.

The following table indicates the contractual maturity schedule of the Company's time deposits of \$250,000 and over, and all CDARS time deposits as of September 30, 2017:

	Balance	% of Total	
	(Dollars in thousands)		
Three months or less	\$ 99,475	66	%
Over three months through six months	18,431	12	%
Over six months through twelve months	29,501	20	%
Over twelve months	3,405	2	%
Total	\$ 150,812	100	%

The Company focuses primarily on providing and servicing business deposit accounts that are frequently over \$250,000 in average balance per account. As a result, certain types of business clients that the Company serves typically carry average deposits in excess of \$250,000. The account activity for some account types and client types necessitates appropriate liquidity management practices by the Company to help ensure its ability to fund deposit withdrawals.

Return on Equity and Assets

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

Three Months	Nine Months
Ended	Ended
September 30,	September 30,

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	2017		2016		2017		2016
Return on average assets	1.20	%	1.11	%	1.12	%	1.13
Return on average tangible assets	1.22	%	1.13	%	1.14	%	1.16
Return on average equity	12.49	%	10.38	%	11.35	%	10.61
Return on average tangible equity	15.41	%	13.06	%	14.11	%	13.45
Average equity to average assets ratio	9.61	%	10.67	%	9.86	%	10.68

Off Balance Sheet Arrangements

In the normal course of business the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in the contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, but are not reflected on the Company's consolidated balance sheets. Total unused commitments to extend credit were \$684.0 million at September 30, 2017, compared to \$601.1 million at September 30, 2016, and \$596.5 million at December 31, 2016. Unused commitments represented 44% outstanding gross loans at September 30, 2017, 41% at September 30, 2016, and 40% at December 31, 2016.

Table of Contents

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

	September 30, 2017		2016		December 31, 2016	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)					
Unused lines of credit and commitments to make loans	\$ 17,024	\$ 652,105	\$ 18,748	\$ 566,902	\$ 15,556	\$ 565,166
Standby letters of credit	4,400	10,492	3,479	12,019	3,921	11,837
	\$ 21,424	\$ 662,597	\$ 22,227	\$ 578,921	\$ 19,477	\$ 577,003

Liquidity and Asset/Liability Management

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

One of the measures of liquidity is our loan to deposit ratio. Our loan to deposit ratio was 63.13% at September 30, 2017, compared to 65.36% at September 30, 2016, and 66.42% at December 31, 2016.

FHLB and FRB Borrowings and Available Lines of Credit

The Bank has off balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. The Bank can borrow from the FHLB on a short term (typically overnight) or long term (over one year) basis. The Bank had no overnight borrowings from the FHLB at September 30, 2017, September 30, 2016, and December 31, 2016. The Bank had \$222.8 million of loans pledged to the FHLB as collateral on an available line of credit of \$179.2 million at September 30, 2017, none of which was outstanding.

The Bank can also borrow from the FRB's discount window. The Bank had \$577.6 million of loans pledged to the FRB as collateral on an available line of credit of \$366.8 million at September 30, 2017, none of which was outstanding.

At September 30, 2017, the Bank had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at September 30, 2017, September 30, 2016, and December 31, 2016.

The Company has a \$5.0 million line of credit with a correspondent bank, of which none was outstanding at September 30, 2017.

The Bank may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase at September 30, 2017, September 30, 2016, and December 31, 2016.

Table of Contents

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

	September 30, 2017	September 30, 2016	December 31, 2016	
	(Dollars in thousands)			
Average balance during the year	\$ —	\$ 558	\$ 418	
Average interest rate during the year	—	2.57 %	2.57	%
Maximum month-end balance during the year	\$ —	\$ —	\$ 3,000	
Average rate at period-end	N/A	N/A	N/A	

Subordinated Debt

On May 26, 2017, the Company completed an underwritten public offering of \$40.0 million aggregate principal amount of Subordinated Debt due June 1, 2027. The Subordinated Debt initially bears a fixed interest rate of 5.25% per year, payable semi-annually. Commencing on June 1, 2022, the interest rate on the Subordinated Debt resets quarterly to the three-month LIBOR rate plus a spread of 336.5 basis points, payable quarterly in arrears. Interest on the Subordinated Debt is payable semi-annually on June 1 and December 1 of each year through June 1, 2022 and quarterly thereafter on March 1, June 1, September 1 and December 1 of each year through the maturity date or early redemption date. The first interest payment will be made on December 1, 2017. The Company at its option may redeem the Subordinated Debt, in whole or in part, on any interest payment date on or after June 1, 2022 without a premium. The Subordinated Debt, net of unamortized issuance costs, totaled \$39.1 million at September 30, 2017, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank. The Company down streamed \$20.0 million of the proceeds to HBC during the second quarter of 2017.

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 and the FDIC, establish a risk adjusted ratio relating capital to different categories of assets and off balance sheet exposures.

The following table summarizes risk based capital, risk weighted assets, and risk based capital ratios of the consolidated Company under the Basel III requirements for the periods indicated:

September 30, 2017	September 30, 2016	December 31, 2016
(Dollars in thousands)		

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Capital components:

Common equity Tier 1 capital	\$ 229,656	\$ 210,021	\$ 214,924
Additional Tier 1 capital	—	—	—
Tier 1 Capital	229,656	210,021	214,924
Tier 2 Capital	59,575	20,676	19,705
Total risk-based capital	\$ 289,231	\$ 230,697	\$ 234,629
Risk-weighted assets	\$ 1,986,488	\$ 1,812,623	\$ 1,876,732
Average assets for capital purposes	\$ 2,783,219	\$ 2,370,179	\$ 2,515,623

Capital ratios:

Total risk-based capital	14.6	%	12.7	%	12.5	%
Tier 1 risk-based capital	11.6	%	11.6	%	11.5	%
Common equity Tier 1 risk-based capital	11.6	%	11.6	%	11.5	%
Leverage(1)	8.3	%	8.9	%	8.5	%

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

Table of Contents

The following table summarizes risk based capital, risk-weighted assets, and risk-based capital ratios of HBC under the Basel III requirements for the periods indicated:

	September 30, 2017	September 30, 2016	December 31, 2016		
	(Dollars in thousands)				
Capital components:					
Common equity Tier 1 capital	\$ 244,831	\$ 207,070	\$ 211,364		
Additional Tier 1 capital	—	—	—		
Tier 1 Capital	244,831	207,070	211,364		
Tier 2 Capital	20,438	20,676	19,705		
Total risk-based capital	\$ 265,269	\$ 227,746	\$ 231,069		
Risk-weighted assets	\$ 1,985,132	\$ 1,812,204	\$ 1,876,024		
Average assets for capital purposes	\$ 2,782,021	\$ 2,369,430	\$ 2,514,922		
Capital ratios:					
Total risk-based capital	13.4	% 12.6	% 12.3	%	%
Tier 1 risk-based capital	12.3	% 11.4	% 11.3	%	%
Common equity Tier 1 risk-based capital	12.3	% 11.4	% 11.3	%	%
Leverage(1)	8.8	% 8.7	% 8.4	%	%

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

The following table presents the applicable well capitalized regulatory guidelines and the standards for minimum capital adequacy requirements under Basel III:

	Transitional Minimum Regulatory Requirement(1) Effective January 1, 2017	Fully Phased-in Minimum Regulatory Requirement(2) Effective January 1, 2019	Well-capitalized Financial Institution Regulatory Guidelines		
Capital ratios:					
Total risk-based capital	9.25	% 10.5	% 10.0	%	%
Tier 1 risk-based capital	7.25	% 8.5	% 8.0	%	%
Common equity Tier 1 risk-based capital	5.75	% 7.0	% 6.5	%	%
Leverage	4.00	% 4.0	% 5.0	%	%

- (1) Includes 1.25% capital conservation buffer, except the leverage capital ratio.
 - (2) Includes 2.5% capital conservation buffer, except the leverage capital ratio.
-

The Basel III capital rules introduce a new “capital conservation buffer,” for banking organizations to maintain a common equity Tier 1 ratio more than 2.5% above these minimum risk weighted asset ratios. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk weighted assets above the minimum but below the capital conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The implementation of the capital conservation buffer was phased in beginning on January 1, 2016 at 0.625% and will be phased in over a four year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The capital conservation buffer increased to 1.25% beginning on January 1, 2017.

The Subordinated Debt, net of unamortized issuance costs, totaled \$39.1 million at September 30, 2017, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve. The issuance of Subordinated Debt resulted in an increase in the Company’s total risk based capital ratio at September 30, 2017, compared to September 30, 2016 and December 31, 2016, but had no effect on the other regulatory capital ratios of the

Table of Contents

Company. All of HBC's regulatory capital ratios increased at September 30, 2017, compared to September 30, 2016 and December 31, 2016, primarily due to the downstream of \$20.0 million of the proceeds of the Subordinated Debt from the Company to HBC, partially offset by distributed dividends totaling \$12.0 million from HBC to the Company during the first nine months of 2017.

At September 30, 2017, the Company's consolidated capital ratio exceeded regulatory guidelines and HBC's capital ratios exceed the highest regulatory capital requirement of "well capitalized" under Basel III prompt corrective action provisions. Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios of total risk based capital, Tier 1 capital, and common equity Tier 1 (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of September 30, 2017, September 30, 2016, and December 31, 2016, the Company and HBC met all capital adequacy guidelines to which they were subject. There are no conditions or events since September 30, 2017, that management believes have changed the categorization of the Company or HBC as well capitalized.

At September 30, 2017, the Company had total shareholders' equity of \$275.4 million, compared to \$261.3 million at September 30, 2016, and \$259.9 million at December 31, 2016. At September 30, 2017, total shareholders' equity included \$217.9 million in common stock, \$63.6 million in retained earnings, and (\$6.1) million of accumulated other comprehensive loss.

The accumulated other comprehensive loss was (\$6.1) million at September 30, 2017, compared to accumulated other comprehensive loss of (\$2.0) million at September 30, 2016, and an accumulated other comprehensive loss of (\$7.9) million at December 31, 2016. The unrealized gain (loss) on securities available for sale, net of taxes, included in accumulated other comprehensive loss was an unrealized gain of \$614,000, at September 30, 2017, compared to an unrealized gain of \$4.7 million, at September 30, 2016, and an unrealized loss of (\$1.2) million, at December 31, 2016. The components of accumulated other comprehensive loss, net of taxes, at September 30, 2017 include the following: an unrealized gain on available for sale securities of \$614,000; the remaining unamortized unrealized gain on securities available for sale transferred to held to maturity of \$312,000; a split dollar insurance contracts liability of (\$3.5) million; a supplemental executive retirement plan liability of (\$4.1) million; and an unrealized gain on interest only strip from SBA loans of \$574,000.

Series C Preferred Stock

On September 12, 2016, the Company entered into Exchange Agreements with Castle Creek Capital Partners IV, LP, Patriot Financial Partners, L.P. and Patriot Financial Partners Parallel, L.P. (collectively "Preferred Stockholders") providing for the exchange of 21,004 shares of the Company's Series C convertible perpetual preferred stock, no par value ("Series C Preferred Stock"), for 5,601,000 shares of the Company's common stock no par value. The exchange ratio was equal to the equivalent number of shares the Preferred Stockholders would have received upon conversion of the Series C Preferred Stock into the Company's common stock. During the fourth quarter of 2016, the Preferred Stockholders sold all of their shares of common stock.

The book value per share was \$7.21 at September 30, 2017, compared to \$6.89 at September 30, 2016, and \$6.85 at December 31, 2016. The tangible book value per share was \$5.86 at September 30, 2017, compared to \$5.49 at September 30, 2016, and \$5.46 at December 31, 2016.

Market Risk

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

Interest Rate Management

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company's market risk exposure is primarily that of interest rate risk, and it has established policies and procedures to

Table of Contents

monitor and limit earnings and balance sheet exposure to changes in interest rates. The Company does not engage in the trading of financial instruments, nor does the Company have exposure to currency exchange rates.

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

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

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

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

The following table sets forth the estimated changes in the Company's annual net interest income that would result from the designated instantaneous parallel shift in interest rates noted, as of September 30, 2017. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

Change in Interest Rates (basis points)	Increase/(Decrease) in Estimated Net Interest Income		
	Amount	Percent	
	(Dollars in thousands)		
+400	\$ 21,392	20.4	%
+300	\$ 16,176	15.5	%
+200	\$ 10,829	10.3	%
+100	\$ 5,412	5.2	%
0	\$ —	—	%
-100	\$ (10,162)	(9.7)	%
-200	\$ (18,846)	(18.0)	%

Table of Contents

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

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

ITEM 3—QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4—CONTROLS AND PROCEDURES

Disclosure Control and Procedures

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of September 30, 2017. 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 September 30, 2017, the period covered by this

report on Form 10 Q.

During the three and nine months ended September 30, 2017, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

Table of Contents

Part II—OTHER INFORMATION

ITEM 1—LEGAL PROCEEDINGS

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

ITEM 1A—RISK FACTORS

In addition to the other information set forth in this Report, you should carefully consider the other factors discussed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10 K for the year ended December 31, 2016, which could materially affect our business, financial condition and/or operating results. There were no material changes from risk factors previously disclosed in our 2016 Annual Report on Form 10 K. The risk factors identified are in addition to those contained in any other cautionary statements, written or oral, which may be or otherwise addressed in connection with a forward looking statement or contained in any of our subsequent filings with the Securities and Exchange Commission.

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

None

ITEM 3—DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4—MINE SAFETY DISCLOSURES

None

ITEM 5—OTHER INFORMATION

None

ITEM 6—EXHIBITS

Exhibit	Description
3.1	<u>Heritage Commerce Corp Restated Articles of Incorporation, (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 16, 2009)</u>
3.2	<u>Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp as filed with the California Secretary of State on June 1, 2010 (incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-1 filed July 23, 2010).</u>
3.3	<u>Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 28, 2013)</u>
31.1	<u>Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002</u>
31.2	<u>Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002</u>
32.1	<u>Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350</u>
32.2	<u>Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350</u>
101.INS	XBRL Instance Document, filed herewith
101.SCH	XBRL Taxonomy Extension Schema Document, filed herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, filed herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, filed herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, filed herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, filed herewith

Table of Contents

SIGNATURES

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

Heritage Commerce Corp (Registrant)

Date: November 3, 2017 /s/ Walter T. Kaczmarek
Walter T. Kaczmarek
Chief Executive Officer

Date: November 3, 2017 /s/ Lawrence D. McGovern
Lawrence D. McGovern
Chief Financial Officer