

HERITAGE COMMERCE CORP  
Form 10-Q  
November 04, 2016

Use these links to rapidly review the document

[TABLE OF CONTENTS](#)

[Table of Contents](#)

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

---

**FORM 10-Q**

(MARK ONE)

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 000-23877

**Heritage Commerce Corp**

(Exact name of Registrant as Specified in its Charter)

**California**  
(State or Other Jurisdiction of  
Incorporation or Organization)

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

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

**95113**  
(Zip Code)

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

**N/A**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been

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

subject to such filing requirements for the past 90 days. YES  NO

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a  
smaller reporting company)

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

The Registrant had 37,926,537 shares of Common Stock outstanding on October 27, 2016.

---

Table of Contents

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

		<b>Page No.</b>
	<b><u>Cautionary Note on Forward-Looking Statements</u></b>	<u>3</u>
	<b><u>Part I. FINANCIAL INFORMATION</u></b>	
<u>Item 1.</u>	<u>Consolidated Financial Statements (unaudited)</u>	<u>5</u>
	<u>Consolidated Balance Sheets</u>	<u>5</u>
	<u>Consolidated Statements of Income</u>	<u>6</u>
	<u>Consolidated Statements of Comprehensive Income</u>	<u>7</u>
	<u>Consolidated Statements of Changes in Shareholders' Equity</u>	<u>8</u>
	<u>Consolidated Statements of Cash Flows</u>	<u>9</u>
	<u>Notes to Unaudited Consolidated Financial Statements</u>	<u>10</u>
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>54</u>
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>96</u>
<u>Item 4.</u>	<u>Controls and Procedures</u>	<u>96</u>
	<b><u>PART II. OTHER INFORMATION</u></b>	
<u>Item 1.</u>	<u>Legal Proceedings</u>	<u>98</u>
<u>Item 1A.</u>	<u>Risk Factors</u>	<u>98</u>
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>98</u>
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u>	<u>98</u>
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>	<u>98</u>
<u>Item 5.</u>	<u>Other Information</u>	<u>98</u>
<u>Item 6.</u>	<u>Exhibits</u>	<u>99</u>
	<b><u>SIGNATURES</u></b>	<u>100</u>
	<b><u>EXHIBIT INDEX</u></b>	<u>101</u>

Table of Contents

**Cautionary Note Regarding Forward-Looking Statements**

This Report on Form 10-Q contains various statements that may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, 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," "should," "could," "goal," "potential" and similar expressions. We base these forward-looking statements on our current expectations and projections about future events, our assumptions regarding these events and our knowledge of facts at the time the statements are made. These statements include statements relating to our projected growth, anticipated future financial performance, and management's long-term performance goals, as well as statements relating to the anticipated effects on results of operations and financial condition.

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

local, regional, and national economic conditions and events and their impact on us and our customers;

changes in the financial performance or condition of the Company's customers;

volatility in credit and equity markets and its effect on the global economy;

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

our ability to increase market share and control expenses;

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;

other than temporary impairment charges to our securities portfolio;

an oversupply of inventory and deterioration in values of California commercial real estate;

a prolonged slowdown in construction activity;

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

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

changes in inflation, interest rates, and market liquidity which may impact interest margins and impact funding sources;

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;

changes in our capital management policies, including those regarding business combinations, dividends, and share repurchases, among others;

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

### Table of Contents

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;

the ability to keep pace with, and implement on a timely basis, technological changes;

the impact of cyber security attacks or other disruptions to the Company's information systems and any resulting compromise of data or disruptions in service;

changes in the competitive environment among financial or bank holding companies and other financial service providers;

the 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;

significant changes in applicable laws and regulations, including those concerning taxes, banking and securities;

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

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

the successful integration of the business, employees and operations of Focus Business Bank with the Company and our ability to achieve the projected synergies of this acquisition within expected time frame; 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, 2016	December 31, 2015
	(Dollars in thousands)	
<b>Assets</b>		
Cash and due from banks	\$ 39,838	\$ 24,112
Interest-bearing deposits in other financial institutions	304,554	319,980
<b>Total cash and cash equivalents</b>	<b>344,392</b>	<b>344,092</b>
Securities available-for-sale, at fair value	369,999	385,079
Securities held-to-maturity, at amortized cost (fair value of \$205,810 at September 30, 2016 and \$109,821 at December 31, 2015)	202,404	109,311
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	6,741	7,297
Loans, net of deferred fees	1,450,176	1,358,716
Allowance for loan losses	(20,032)	(18,926)
<b>Loans, net</b>	<b>1,430,144</b>	<b>1,339,790</b>
Federal Home Loan Bank and Federal Reserve Bank stock and other investments, at cost	15,196	12,694
Company owned life insurance	59,193	60,021
Premises and equipment, net	7,552	7,773
Goodwill	45,664	45,664
Other intangible assets	7,342	8,518
Accrued interest receivable and other assets	39,335	41,340
<b>Total assets</b>	<b>\$ 2,527,962</b>	<b>\$ 2,361,579</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities:</b>		
<b>Deposits:</b>		
Demand, noninterest-bearing	\$ 889,075	\$ 821,405
Demand, interest-bearing	536,541	496,278
Savings and money market	555,156	496,843
Time deposits-under \$250	57,718	62,026
Time deposits-\$250 and over	169,485	160,815
Time deposits-brokered	3,000	17,825
CDARS money market and time deposits	7,659	7,583
<b>Total deposits</b>	<b>2,218,634</b>	<b>2,062,775</b>
Short-term borrowings		3,000
Accrued interest payable and other liabilities	48,009	50,368
<b>Total liabilities</b>	<b>2,266,643</b>	<b>2,116,143</b>
<b>Shareholders' equity:</b>		
Preferred stock, no par value; 10,000,000 shares authorized		

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

Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at December 31, 2015 (liquidation preference of \$21,004 at December 31, 2015)		19,519
Common stock, no par value; 60,000,000 shares authorized; 37,915,736 shares issued and outstanding at September 30, 2016 and 32,113,479 shares issued and outstanding at December 31, 2015	214,601	193,364
Retained earnings	48,726	38,773
Accumulated other comprehensive loss	(2,008)	(6,220)
Total shareholders' equity	261,319	245,436
Total liabilities and shareholders' equity	\$ 2,527,962	\$ 2,361,579

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,	
	2016	2015	2016	2015
(Dollars in thousands, except per share data)				
<b>Interest income:</b>				
Loans, including fees	\$ 20,312	\$ 17,713	\$ 59,235	\$ 48,360
Securities, taxable	2,401	1,670	8,004	4,828
Securities, exempt from Federal tax	569	568	1,723	1,589
Other investments and interest-bearing deposits in other financial institutions	592	355	1,478	1,070
<b>Total interest income</b>	<b>23,874</b>	<b>20,306</b>	<b>70,440</b>	<b>55,847</b>
<b>Interest expense:</b>				
Deposits	826	623	2,344	1,664
<b>Total interest expense</b>	<b>826</b>	<b>623</b>	<b>2,344</b>	<b>1,664</b>
Net interest income before provision for loan losses	23,048	19,683	68,096	54,183
Provision (credit) for loan losses	245	(301)	997	(339)
<b>Net interest income after provision for loan losses</b>	<b>22,803</b>	<b>19,984</b>	<b>67,099</b>	<b>54,522</b>
<b>Noninterest income:</b>				
Service charges and fees on deposit accounts	798	748	2,348	2,086
Increase in cash surrender value of life insurance	428	429	1,317	1,225
Servicing income	364	214	1,106	819
Gain on sales of SBA loans	69	267	653	660
Gain on proceeds from company owned life insurance			1,019	
Gain on sales of securities			527	
Other	653	408	1,616	1,366
<b>Total noninterest income</b>	<b>2,312</b>	<b>2,066</b>	<b>8,586</b>	<b>6,156</b>
<b>Noninterest expense:</b>				
Salaries and employee benefits	8,363	10,358	26,052	26,112
Occupancy and equipment	1,120	1,063	3,277	3,135
Professional fees	1,086	612	2,619	946
Other	3,727	4,386	11,414	11,119
<b>Total noninterest expense</b>	<b>14,296</b>	<b>16,419</b>	<b>43,362</b>	<b>41,312</b>
Income before income taxes	10,819	5,631	32,323	19,366
Income tax expense	4,054	2,172	12,157	7,292
<b>Net income</b>	<b>6,765</b>	<b>3,459</b>	<b>20,166</b>	<b>12,074</b>
Dividends on preferred stock	(504)	(448)	(1,512)	(1,344)
<b>Net income available to common shareholders</b>	<b>6,261</b>	<b>3,011</b>	<b>18,654</b>	<b>10,730</b>
Undistributed earnings allocated to Series C preferred stock	(300)	(111)	(1,278)	(706)
<b>Distributed and undistributed earnings allocated to common shareholders</b>	<b>\$ 5,961</b>	<b>\$ 2,900</b>	<b>\$ 17,376</b>	<b>\$ 10,024</b>

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Earnings per common share:								
Basic	\$	0.18	\$	0.10	\$	0.53	\$	0.37
Diluted	\$	0.18	\$	0.10	\$	0.53	\$	0.36

See notes to unaudited consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
	<b>(Dollars in thousands)</b>			
Net income	\$ 6,765	\$ 3,459	\$ 20,166	\$ 12,074
Other comprehensive income (loss):				
Change in net unrealized holding gains (loss) on available-for-sale securities and I/O strips	208	2,185	7,770	(331)
Deferred income taxes	(87)	(912)	(3,263)	144
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(13)	(13)	(103)	(41)
Deferred income taxes	5	5	43	17
Reclassification adjustment for gains on sales of securities realized in income			(527)	
Deferred income taxes			221	
Change in unrealized gains on securities and I/O strips, net of deferred income taxes	113	1,265	4,141	(211)
Change in net pension and other benefit plan liabilities adjustment	37	47	123	143
Deferred income taxes	(16)	(20)	(52)	(60)
Change in pension and other benefit plan liabilities net of deferred income taxes	21	27	71	83
Other comprehensive income (loss)	134	1,292	4,212	(128)
Total comprehensive income	\$ 6,899	\$ 4,751	\$ 24,378	\$ 11,946

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, 2016 and 2015

	Preferred Stock		Common Stock		Retained	Accumulated	Total
	Shares	Amount	Shares	Amount	Earnings	Other Comprehensive Income / (Loss)	Shareholders' Equity
(Dollars in thousands, except share data)							
<b>Balance, January 1, 2015</b>	21,004	\$ 19,519	26,503,505	\$ 133,676	\$ 33,014	\$ (1,851)	\$ 184,358
Net income					12,074		12,074
Other comprehensive loss						(128)	(128)
Issuance of 5,456,713 shares to acquire Focus Business Bank			5,456,713	58,278			58,278
Issuance of restricted stock awards, net			68,855				
Amortization of restricted stock awards, net of forfeitures and taxes					126		126
Cash dividend declared \$0.24 per share					(7,722)		(7,722)
Stock option expense, net of forfeitures and taxes							721
Stock options exercised			47,432	269			269
<b>Balance, September 30, 2015</b>	21,004	\$ 19,519	32,076,505	\$ 193,070	\$ 37,366	\$ (1,979)	\$ 247,976
(Dollars in thousands, except share data)							
<b>Balance, January 1, 2016</b>	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
Stock options exercised			118,885	715			715
<b>Balance, September 30, 2016</b>		\$	37,915,736	\$ 214,601	\$ 48,726	\$ (2,008)	\$ 261,319

See notes to unaudited consolidated financial statements



Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**

	<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>
	<b>(Dollars in thousands)</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 20,166	\$ 12,074
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	3,013	1,027
Gain on sale of securities available-for-sale	(527)	
Gain on sale of SBA loans	(653)	(660)
Proceeds from SBA loans originated for sale	9,447	8,695
SBA loans originated for sale	(11,029)	(10,320)
Provision (credit) for loan losses	997	(339)
Increase in cash surrender value of life insurance	(1,317)	(1,225)
Depreciation and amortization	565	527
Amortization of intangible assets	1,176	655
Gain on sale of foreclosed assets, net		(106)
Stock option expense, net	712	721
Amortization of restricted stock awards, net	291	126
Gain on proceeds from company owned life insurance	(1,019)	
Effect of changes in:		
Accrued interest receivable and other assets	(1,340)	4,114
Accrued interest payable and other liabilities	(2,311)	687
Net cash provided by operating activities	18,171	15,976
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of securities available-for-sale	(75,803)	(19,953)
Purchase of securities held-to-maturity	(109,934)	(9,138)
Maturities/paydowns/calls of securities available-for-sale	47,635	21,705
Maturities/paydowns/calls of securities held-to-maturity	15,941	2,308
Proceeds from sale of securities available-for-sale	49,171	
Net change in loans	(88,609)	(69,160)
Change in Federal Home Loan Bank and Federal Reserve Bank stock and other investments	(2,502)	(32)
Purchase of premises and equipment	(344)	(589)
Proceeds from sale of foreclosed assets	49	1,571
Proceeds from company owned life insurance	3,164	
Cash received in bank acquisition, net of cash paid		165,786
Net cash provided by (used in) investing activities	(161,232)	92,498
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net change in deposits	155,859	168,514
Exercise of stock options	715	269
Other short-term borrowing	(3,000)	1,000
Payment of cash dividends	(10,213)	(7,722)
Net cash provided by financing activities	143,361	162,061
Net increase in cash and cash equivalents	300	270,535
Cash and cash equivalents, beginning of period	344,092	122,403
Cash and cash equivalents, end of period	\$ 344,392	\$ 392,938

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

Supplemental disclosures of cash flow information:		
Interest paid	\$ 2,327	\$ 1,650
Income taxes paid	12,135	6,500
Due to broker for securities purchased, settling after quarter-end		344
Supplemental schedule of non-cash investing activity:		
Transfer of loans held for sale to loan portfolio	\$ 2,791	\$
Loans transferred to foreclosed assets	49	1,236
Summary of assets acquired and liabilities assumed through acquisition:		
Cash and cash equivalents, net of cash paid	\$	\$ 165,786
Securities available-for-sale		53,940
Securities held-to-maturity		8,665
Loans held-for-sale		4,416
Net loans		170,353
Goodwill and other intangible assets		38,905
Corporate owned life insurance		7,067
Other assets, net		20,250
Deposits		(405,123)
Other liabilities		(5,981)
Common stock issued to acquire Focus Business Bank		58,278

See notes to unaudited consolidated financial statements

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2016**

**(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, 2015.

The Company acquired BVF/CSNK Acquisition Corp., a Delaware corporation ("BVF/CSNK") on November 1, 2014, the parent company of CSNK Working Capital Finance Corp. dba Bay View Funding ("Bay View Funding"). BVF/CSNK was subsequently merged into Bay View Funding and Bay View Funding became a wholly owned subsidiary of HBC.

The Company acquired Focus Business Bank ("Focus") on August 20, 2015. Focus was merged with HBC, with HBC as the surviving bank. Focus's results of operations have been included in the Company's results of operations beginning August 21, 2015.

HBC is a commercial bank serving customers primarily located in Santa Clara, Alameda, Contra Costa, and San Benito counties of California. Bay View Funding provides business-essential working capital factoring financing to various industries throughout the United States. No customer accounts for more than 10 percent of revenue for HBC or the Company. With the acquisition of Bay View Funding, the Company now has two reportable segments consisting of 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, 2016 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2016.

***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.

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**September 30, 2016**

**(Unaudited)**

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

***Adoption of New Accounting Standards***

In September 2015, the FASB issued ASU No. 2015-16, *Simplifying the Accounting for Measurement Period Adjustment*. This update applies to all entities that have reported provisional amounts for items in a business combination for which the accounting is incomplete by the end of the reporting period in which the combination occurs and during the measurement period have an adjustment to provisional amounts recognized. The amendments in this update require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments in this update require that the acquirer's record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The amendments in this update require an entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The amendments in this update are effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. The Company has evaluated the adoption of the new guidance and has determined it did not have a material impact on the consolidated financial statements.

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

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, but it is not expected to have a material 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.

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**September 30, 2016**

**(Unaudited)**

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

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 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 impact of adopting the new guidance on our consolidated financial statements.

In March 2016, the FASB issued 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 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. Cash paid by an employer when directly withholding shares for tax withholding purposes should be classified as a financing activity. A nonpublic entity can make an accounting policy election to apply a practical expedient to estimate the expected term for all awards with performance or service conditions that meet certain conditions. A nonpublic entity can make a one-time accounting policy election to switch from measuring all liability-classified awards at fair value to intrinsic value. The new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, and early adoption is permitted. We are currently evaluating the impact of adopting the new guidance on our consolidated financial statements.

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

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**September 30, 2016**

**(Unaudited)**

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

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 ("HTM") debt securities. The update amends the accounting for credit losses on available-for-sale securities ("AFS"), 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 are currently evaluating the impact of adopting the new guidance on our consolidated financial statements.

**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 21,003.75 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.

**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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****2) Shareholders' Equity and Earnings Per Share (Continued)**

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,	
	2016	2015	2016	2015
	(Dollars in thousands, except per share amounts)			
Net income available to common shareholders	\$ 6,261	\$ 3,011	\$ 18,654	\$ 10,730
Less: undistributed earnings allocated to Series C Preferred Stock	(300)	(111)	(1,278)	(706)
Distributed and undistributed earnings allocated to common shareholders	\$ 5,961	\$ 2,900	\$ 17,376	\$ 10,024
Weighted average common shares outstanding for basic earnings per common share	33,397,704	29,075,782	32,591,784	27,386,471
Dilutive effect of stock options outstanding, using the treasury stock method	295,624	256,670	272,071	202,993
Shares used in computing diluted earnings per common share	33,693,328	29,332,452	32,863,855	27,589,464
Basic earnings per share	\$ 0.18	\$ 0.10	\$ 0.53	\$ 0.37
Diluted earnings per share	\$ 0.18	\$ 0.10	\$ 0.53	\$ 0.36

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****3) Accumulated Other Comprehensive Income (Loss) ("AOCI")**

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

	<b>Three Months Ended September 30, 2016 and 2015</b>			
	<b>Unrealized Gains on Available- for-Sale Securities and I/O Strips</b>	<b>Unamortized Unrealized Gain on Available- for-Sale Securities Reclassified to Held-to- Maturity</b>	<b>Defined Benefit Pension Plan Items</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
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)
Beginning balance July 1, 2015, net of taxes	\$ 2,206	\$ 419	\$ (5,896)	\$ (3,271)
Other comprehensive income (loss) before reclassification, net of taxes	1,273		(12)	1,261
Amounts reclassified from other comprehensive income (loss), net of taxes		(8)	39	31
Net current period other comprehensive income (loss), net of taxes	1,273	(8)	27	1,292
Ending balance September 30, 2015, net of taxes	\$ 3,479	\$ 411	\$ (5,869)	\$ (1,979)

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2016

(Unaudited)

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

	Nine Months Ended September 30, 2016 and 2015			
	Unrealized Gains on 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
	(Dollars in thousands)			
Beginning balance January 1, 2016, net of taxes	\$ 1,090	\$ 403	\$ (7,713)	\$ (6,220)
Other comprehensive income (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)
Beginning balance January 1, 2015, net of taxes	\$ 3,666	\$ 435	\$ (5,952)	\$ (1,851)
Other comprehensive income (loss) before reclassification, net of taxes	(187)		(36)	(223)
Amounts reclassified from other comprehensive income (loss), net of taxes		(24)	119	95
Net current period other comprehensive income (loss), net of taxes	(187)	(24)	83	(128)
Ending balance September 30, 2015, net of taxes	\$ 3,479	\$ 411	\$ (5,869)	\$ (1,979)

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2016

(Unaudited)

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

Details About AOCI Components	Amounts Reclassified from AOCI Three Months Ended September 30,		Affected Line Item Where Net Income is Presented
	2016	2015	
	(Dollars in thousands)		
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	\$ 13	\$ 13	Interest income on taxable securities
	(5)	(5)	Income tax expense
	8	8	Net of tax
Amortization of defined benefit pension plan items(1)			
Prior transition obligation	13	28	
Actuarial losses	(60)	(96)	
	(47)	(68)	Salaries and employee benefits
	20	29	Income tax expense
	(27)	(39)	Net of tax
Total reclassification for the period	\$ (19)	\$ (31)	

(1) This AOCI component is included in the computation of net periodic benefit cost (see Note 9 Benefit Plans) and includes split-dollar life insurance benefit plan.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****3) Accumulated Other Comprehensive Income (Loss) ("AOCI") (Continued)**

Details About AOCI Components	Amounts Reclassified from AOCI Nine Months Ended September 30,		Affected Line Item Where Net Income is Presented
	2016	2015	
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	\$ 527	\$	Gains on sale of securities
	(221)		Income tax expense
	306		Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	103	41	Interest income on taxable securities
	(43)	(17)	Income tax expense
	60	24	Net of tax
Amortization of defined benefit pension plan items(1)	39	84	
Prior transition obligation	(180)	(288)	
Actuarial losses	(141)	(204)	Salaries and employee benefits
	59	85	Income tax expense
	(82)	(119)	Net of tax
Total reclassification for the period	\$ 284	\$ (95)	

(1) This AOCI component is included in the computation of net periodic benefit cost (see Note 9 Benefit Plans) and includes split-dollar life insurance benefit plan.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****4) Securities**

The amortized cost and estimated fair value of securities at September 30, 2016 and December 31, 2015 were as follows:

<b>September 30, 2016</b>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
<b>(Dollars in thousands)</b>				
<b>Securities available-for-sale:</b>				
Agency mortgage-backed securities	\$ 346,001	\$ 6,551	\$	\$ 352,552
Trust preferred securities	15,000	1,425		16,425
Corporate bonds	988	34		1,022
<b>Total</b>	<b>\$ 361,989</b>	<b>\$ 8,010</b>	<b>\$</b>	<b>\$ 369,999</b>

**Securities held-to-maturity:**

Agency mortgage-backed securities	\$ 111,591	\$ 1,038	\$ (7)	\$ 112,622
Municipals exempt from Federal tax	90,813	2,445	(70)	93,188
<b>Total</b>	<b>\$ 202,404</b>	<b>\$ 3,483</b>	<b>\$ (77)</b>	<b>\$ 205,810</b>

<b>December 31, 2015</b>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
<b>(Dollars in thousands)</b>				
<b>Securities available-for-sale:</b>				
Agency mortgage-backed securities	\$ 324,077	\$ 2,457	\$ (2,304)	\$ 324,230
U.S. Treasury	30,047		(44)	30,003
Trust preferred securities	15,000	132		15,132
U.S. Government sponsored entities	9,042	13	(14)	9,041
Corporate bonds	6,412	261		6,673
<b>Total</b>	<b>\$ 384,578</b>	<b>\$ 2,863</b>	<b>\$ (2,362)</b>	<b>\$ 385,079</b>

**Securities held-to-maturity:**

Municipals exempt from Federal tax	\$ 93,518	\$ 1,517	\$ (863)	\$ 94,172
Agency mortgage-backed securities	15,793	24	(168)	15,649

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total	\$	109,311	\$	1,541	\$	(1,031)	\$	109,821
-------	----	---------	----	-------	----	---------	----	---------

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****4) Securities (Continued)**

Securities with unrealized losses at September 30, 2016 and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

September 30, 2016	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Dollars in thousands)					
Securities held-to-maturity:						
Agency mortgage-backed securities	\$ 706	\$	\$ 636	\$ (7)	\$ 1,342	\$ (7)
Municipals exempt from Federal tax	5,424	(32)	2,227	(38)	7,651	(70)
<b>Total</b>	<b>\$ 6,130</b>	<b>\$ (32)</b>	<b>\$ 2,863</b>	<b>\$ (45)</b>	<b>\$ 8,993</b>	<b>\$ (77)</b>
December 31, 2015	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 241,067	\$ (2,258)	\$ 2,165	\$ (46)	\$ 243,232	\$ (2,304)
U.S. Treasury	30,003	(44)			30,003	(44)
U.S. Government sponsored entities	4,980	(14)			4,980	(14)
<b>Total</b>	<b>\$ 276,050</b>	<b>\$ (2,316)</b>	<b>\$ 2,165</b>	<b>\$ (46)</b>	<b>\$ 278,215</b>	<b>\$ (2,362)</b>
Securities held-to-maturity:						
Municipals exempt from Federal tax	\$ 9,920	\$ (78)	\$ 24,412	\$ (785)	\$ 34,332	\$ (863)
Agency mortgage-backed securities	7,152	(89)	4,409	(79)	11,561	(168)
<b>Total</b>	<b>\$ 17,072</b>	<b>\$ (167)</b>	<b>\$ 28,821</b>	<b>\$ (864)</b>	<b>\$ 45,893</b>	<b>\$ (1,031)</b>

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

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, 2016, the Company held 460 securities (184 available-for-sale and 276 held-to-maturity), of which 22 had fair values below amortized cost. At September 30, 2016, there were \$2,227,000 of municipal bonds held-to-maturity, and \$636,000 of agency mortgage-backed securities held-to-maturity carried with an unrealized loss for 12 months or more. The total unrealized loss for securities 12 months or more was \$45,000 at September 30, 2016. The unrealized losses were due to higher interest rates. 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, 2016.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****4) Securities (Continued)**

At December 31, 2015, the Company held 460 securities (193 available-for-sale and 267 held-to-maturity), of which 193 had fair values below amortized cost. At December 31, 2015, there were \$2,165,000 of agency mortgage-backed securities available-for-sale, \$4,409,000 of agency mortgage-backed securities held-to-maturity and \$24,412,000 of municipals bonds held-to-maturity carried with an unrealized loss for 12 months or greater. The total unrealized loss for securities 12 months or greater was \$910,000 at December 31, 2015. The unrealized losses were due to higher interest rates. 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 December 31, 2015.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Proceeds	\$	\$	\$ 49,171	\$
Gross gains			544	
Gross losses			(17)	

The amortized cost and estimated fair values of securities as of September 30, 2016, 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 one year through five years	\$ 988	\$ 1,022
Due after ten years	15,000	16,425
Agency mortgage-backed securities	346,001	352,552
Total	\$ 361,989	\$ 369,999

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****4) Securities (Continued)**

	<b>Held-to-maturity</b>	
	<b>Amortized Cost</b>	<b>Estimated Fair Value</b>
	<b>(Dollars in thousands)</b>	
Due 3 months or less	\$ 165	\$ 165
Due after 3 months through one year	1,083	1,087
Due after one year through five years	4,372	4,448
Due after five years through ten years	16,554	17,451
Due after ten years	68,639	70,037
Agency mortgage-backed securities	111,591	112,622
<b>Total</b>	<b>\$ 202,404</b>	<b>\$ 205,810</b>

**5) Loans**

Loans were as follows for the periods indicated:

	<b>September 30, 2016</b>	<b>December 31, 2015</b>
	<b>(Dollars in thousands)</b>	
<b>Loans held-for-investment:</b>		
Commercial	\$ 606,281	\$ 556,522
<b>Real estate:</b>		
Commercial	612,030	625,665
Land and construction	88,371	84,428
Home equity	76,536	76,833
Residential mortgages	49,255	
Consumer	18,328	16,010
<b>Loans</b>	<b>1,450,801</b>	<b>1,359,458</b>
Deferred loan origination fees, net	(625)	(742)
<b>Loans, net of deferred fees</b>	<b>1,450,176</b>	<b>1,358,716</b>
Allowance for loan losses	(20,032)	(18,926)
<b>Loans, net</b>	<b>\$ 1,430,144</b>	<b>\$ 1,339,790</b>

At September 30, 2016 and December 31, 2015, total net loans included in the table above include \$102,921,000, and \$141,343,000, respectively, of the loans acquired in the Focus transaction that were not purchased credit impaired loans.



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****5) Loans (Continued)**

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

	<b>Three Months Ended September 30, 2016</b>			
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
Balance, beginning of period	\$ 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
Balance, end of period	\$ 12,181	\$ 7,763	\$ 88	\$ 20,032

	<b>Three Months Ended September 30, 2015</b>			
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
Balance, beginning of period	\$ 11,193	\$ 7,450	\$ 114	\$ 18,757
Charge-offs	(8)		(9)	(17)
Recoveries	284	14		298
Net (charge-offs) recoveries	276	14	(9)	281
Provision (credit) for loan losses	(941)	672	(32)	(301)
Balance, end of period	\$ 10,528	\$ 8,136	\$ 73	\$ 18,737

	<b>Nine Months Ended September 30, 2016</b>			
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
Balance, beginning of period	\$ 10,748	\$ 8,076	\$ 102	\$ 18,926
Charge-offs	(300)			(300)
Recoveries	182	227		409
Net (charge-offs) recoveries	(118)	227		109

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Provision (credit) for loan losses	1,551	(540)	(14)	997
Balance, end of period	\$ 12,181	\$ 7,763	\$ 88	\$ 20,032

Nine Months Ended September 30, 2015

	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 11,187	\$ 7,070	\$ 122	\$ 18,379
Charge-offs	(229)	(2)	(9)	(240)
Recoveries	766	141	30	937
Net recoveries	537	139	21	697
Provision (credit) for loan losses	(1,196)	927	(70)	(339)
Balance, end of period	\$ 10,528	\$ 8,136	\$ 73	\$ 18,737

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****5) Loans (Continued)**

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

	<b>September 30, 2016</b>			
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
<b>Allowance for loan losses:</b>				
<b>Ending allowance balance attributable to loans:</b>				
Individually evaluated for impairment	\$ 1,668	\$	\$	\$ 1,668
Collectively evaluated for impairment	10,513	7,763	88	18,364
Acquired with deteriorated credit quality				
<b>Total allowance balance</b>	<b>\$ 12,181</b>	<b>\$ 7,763</b>	<b>\$ 88</b>	<b>\$ 20,032</b>
<b>Loans:</b>				
Individually evaluated for impairment	\$ 3,469	\$ 916	\$ 3	\$ 4,388
Collectively evaluated for impairment	602,567	825,276	18,325	1,446,168
Acquired with deteriorated credit quality	245			245
<b>Total loan balance</b>	<b>\$ 606,281</b>	<b>\$ 826,192</b>	<b>\$ 18,328</b>	<b>\$ 1,450,801</b>

	<b>December 31, 2015</b>			
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
<b>Allowance for loan losses:</b>				
<b>Ending allowance balance attributable to loans:</b>				
Individually evaluated for impairment	\$ 174	\$ 112	\$	\$ 286
Collectively evaluated for impairment	10,574	7,964	102	18,640
Acquired with deteriorated credit quality				
<b>Total allowance balance</b>	<b>\$ 10,748</b>	<b>\$ 8,076</b>	<b>\$ 102</b>	<b>\$ 18,926</b>
<b>Loans:</b>				
Individually evaluated for impairment	\$ 2,014	\$ 4,272	\$ 4	\$ 6,290
Collectively evaluated for impairment	554,271	782,654	16,006	1,352,931

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

Acquired with deteriorated credit quality	237	237
---	-----	-----

Total loan balance	\$ 556,522	\$ 786,926	\$ 16,010	\$ 1,359,458
--------------------	------------	------------	-----------	--------------

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of September 30, 2016 and December 31, 2015. 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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****5) Loans (Continued)**

foreclosure according to local requirements of the applicable jurisdiction are not material as of the periods indicated:

	September 30, 2016			December 31, 2015		
	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	\$ 1,857	\$ 1,857	\$	\$ 745	\$ 745	\$
Real estate:						
Commercial	1,299	440		3,851	2,992	
Land and construction	219	201		237	219	
Home Equity	275	275		302	302	
Consumer	3	3		4	4	
Total with no related allowance recorded	3,653	2,776		5,139	4,262	
With an allowance recorded:						
Commercial	1,857	1,857	1,668	1,506	1,506	174
Real estate:						
Home Equity				759	759	112
Total with an allowance recorded	1,857	1,857	1,668	2,265	2,265	286
Total	\$ 5,510	\$ 4,633	\$ 1,668	\$ 7,404	\$ 6,527	\$ 286

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

	Three Months Ended September 30, 2016					
	Commercial	Commercial	Real Estate Land and Construction	Home Equity	Consumer	Total
(Dollars in thousands)						
Average of impaired loans during the period	\$ 2,200	\$ 1,644	\$ 204	\$ 516	\$ 3	\$ 4,567
Interest income during impairment	\$	\$	\$	\$	\$	\$
Cash-basis interest earned	\$	\$	\$	\$	\$	\$

**Three Months Ended September 30, 2015**

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	Commercial	Commercial	Real Estate Land and Construction	Home Equity	Consumer	Total
(Dollars in thousands)						
Average of impaired loans during the period	\$ 1,403	\$ 3,117	\$ 496	\$ 317	\$ 5	\$ 5,338
Interest income during impairment	\$	\$	\$	\$	\$	\$
Cash-basis interest earned	\$	\$	\$	\$	\$	\$

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2016

(Unaudited)

## 5) Loans (Continued)

## Nine Months Ended September 30, 2016

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

## Nine Months Ended September 30, 2015

	Commercial	Commercial	Real Estate Land and Construction	Home Equity	Consumer	Total
(Dollars in thousands)						
Average of impaired loans during the period	\$ 1,605	\$ 3,031	\$ 819	\$ 327	\$ 5	\$ 5,787
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, 2016	September 30, 2015	December 31, 2015
(Dollars in thousands)			
Nonaccrual loans held-for-investment	\$ 4,496	\$ 5,503	\$ 4,716
Restructured and loans over 90 days past due and still accruing			1,662
Total nonperforming loans	4,496	5,503	6,378
Other restructured loans	137	183	149
Impaired loans, excluding loans held-for-sale	\$ 4,633	\$ 5,686	\$ 6,527

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****5) Loans (Continued)**

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

	September 30, 2016			December 31, 2015		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
(Dollars in thousands)						
Commercial	\$ 3,577	\$	\$ 3,577	\$ 724	\$ 1,378	\$ 2,102
Real estate:						
Commercial	440		440	2,992		2,992
Land and construction	201		201	219		219
Home equity	275		275	777	284	1,061
Consumer	3		3	4		4
<b>Total</b>	<b>\$ 4,496</b>	<b>\$</b>	<b>\$ 4,496</b>	<b>\$ 4,716</b>	<b>\$ 1,662</b>	<b>\$ 6,378</b>

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

	September 30, 2016					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
(Dollars in thousands)						
Commercial	\$ 6,258	\$ 3,860	\$	\$ 10,118	\$ 596,163	\$ 606,281
Real estate:						
Commercial	1,872			1,872	610,158	612,030
Land and construction			201	201	88,170	88,371
Home equity	274		1	275	76,261	76,536
Residential mortgages					49,255	49,255
Consumer					18,328	18,328
<b>Total</b>	<b>\$ 8,404</b>	<b>\$ 3,860</b>	<b>\$ 202</b>	<b>\$ 12,466</b>	<b>\$ 1,438,335</b>	<b>\$ 1,450,801</b>

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	December 31, 2015					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	\$ 3,285	\$ 262	\$ 1,704	\$ 5,251	\$ 551,271	\$ 556,522
Real estate:						
Commercial					625,665	625,665
Land and construction	219			219	84,209	84,428
Home equity			284	284	76,549	76,833
Consumer					16,010	16,010
<b>Total</b>	<b>\$ 3,504</b>	<b>\$ 262</b>	<b>\$ 1,988</b>	<b>\$ 5,754</b>	<b>\$ 1,353,704</b>	<b>\$ 1,359,458</b>

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**September 30, 2016**

**(Unaudited)**

**5) Loans (Continued)**

Past due loans 30 days or greater totaled \$12,466,000 and \$5,754,000 at September 30, 2016 and December 31, 2015, respectively, of which \$2,190,000 and \$591,000 were on nonaccrual. At September 30, 2016, there were also \$4,020,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2015, there were also \$4,125,000 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 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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****5) Loans (Continued)**

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, 2016 and December 31, 2015.

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

	September 30, 2016			December 31, 2015		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)					
Commercial	\$ 591,554	\$ 14,727	\$ 606,281	\$ 547,536	\$ 8,986	\$ 556,522
Real estate:						
Commercial	609,179	2,851	612,030	617,865	7,800	625,665
Land and construction	88,170	201	88,371	84,209	219	84,428
Home equity Residential mortgages	75,931	605	76,536	75,511	1,322	76,833
Consumer	49,255		49,255			
	18,311	17	18,328	15,705	305	16,010
Total	\$ 1,432,400	\$ 18,401	\$ 1,450,801	\$ 1,340,826	\$ 18,632	\$ 1,359,458

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.

The balance of troubled debt restructurings at September 30, 2016 was \$140,000, which included \$3,000 of nonaccrual loans and \$137,000 of accruing loans. The balance of troubled debt restructurings at December 31, 2015 was \$153,000, which included \$4,000 of nonaccrual loans and \$149,000 of accruing loans. Approximately \$2,000 and \$3,000 in specific reserves were established with respect to these loans as of September 30, 2016 and December 31, 2015, respectively. As of September 30, 2016 and December 31, 2015, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

There were no new loans modified as troubled debt restructurings during the three and nine month periods ended September 30, 2016 and 2015.



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****5) Loans (Continued)**

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, 2016 and 2015.

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) Business Combinations*****Focus Business Bank***

On April 23, 2015, the Company and Focus entered into a definitive agreement and plan of merger and reorganization whereby Focus would merge into HBC. The Company completed the merger of its wholly-owned bank subsidiary HBC with Focus on August 20, 2015 for an aggregate transaction value of \$66,558,000. Shareholders of Focus received a fixed exchange ratio at closing of 1.8235 shares of the Company's common stock for each share of Focus common stock. Upon closing of the transaction, the Company issued 5,456,713 shares of the Company's common stock to Focus shareholders for a total value of \$58,278,000, based on the Company's closing stock price of \$10.68 on August 20, 2015. In addition, the Company paid cash to the Focus holders of in-the-money stock options on August 20, 2015 totaling \$8,280,000.

Focus's results of operations have been included in the Company's results of operations beginning August 21, 2015. Pre-tax severance, retention, acquisition and integration costs totaled \$2,865,000 for the third quarter of 2015, \$3,407,000 for the first nine months of 2015, and \$6,398,000 for the year ended December 31, 2015.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition.

	(Dollars in thousands)	
<b>Assets acquired:</b>		
Cash and cash item	\$	5,651
Federal funds sold and deposits in other financial institutions		168,415
Securities available-for-sale		53,940
Securities held-to-maturity		8,665
Loans held-for-sale		4,416
Net loans		170,353
Goodwill		32,620
Core deposit intangible asset		6,285
Corporate owned life insurance		7,067
Other assets, net		20,250
Total assets acquired		477,662
<b>Liabilities assumed:</b>		
Deposits		405,123
Other liabilities		5,981
Total liabilities		411,104
Net assets acquired	\$	66,558



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****6) Business Combinations (Continued)**

The fair value of net assets acquired includes fair value adjustments to certain receivables of which some were considered impaired and some were not considered impaired as of the acquisition date. The fair value adjustments were determined using discounted contractual cash flows, adjusted for expected losses and prepayments, where appropriate. The gross contractual amount of four purchased credit impaired loans as of the acquisition date totaled \$1,124,000. As of that date, contractual cash flows not expected to be collected on the purchased credit impaired loans totaled \$819,000, which represents 72.9% of their gross outstanding principal balances. The receivables that were not considered impaired at the acquisition date were not subject to the guidance relating to purchased credit impaired loans, which have shown evidence of credit deterioration since origination. Receivables acquired that were not subject to these requirements include nonimpaired loans with a fair value and gross contractual amounts receivable of \$170,048,000 and \$174,660,000 respectively, on the date of acquisition. As of the acquisition date, the purchase discount on these nonimpaired loans totaled \$4,612,000, which represents 2.6% of their gross outstanding principal balances.

Goodwill of \$32,620,000 arising from the acquisition is largely attributable to synergies and cost savings resulting from combining the operations of the companies. As this transaction was structured as a taxfree exchange, the goodwill will not be deductible for tax purposes. 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.

The following table summarizes the consideration paid for Focus:

	<b>August 20, 2015</b>	
	<b>(Dollars in thousands)</b>	
Cash paid for Focus in-the-money stock options	\$	8,280
Common stock issued to Focus shareholders at \$10.68 per share		58,278
<b>Total consideration</b>	<b>\$</b>	<b>66,558</b>

The following table presents pro forma financial information as if the acquisition had occurred on January 1, 2015, which includes the pre-acquisition period for Focus. The historical unaudited pro forma financial information has been adjusted to reflect supportable items that are directly attributable to the acquisition and expected to have a continuing impact on consolidated results of operations, as such, one-time acquisition costs are not included. The unaudited pro forma financial information is provided for informational purposes only. The unaudited pro forma financial information is not necessarily, and should not be assumed to be, an indication of the results that would have been achieved had the acquisition been completed as of the dates indicated or that may be achieved in the

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****6) Business Combinations (Continued)**

future. The preparation of the unaudited pro forma combined consolidated financial statements and related adjustments required management to make certain assumptions and estimates.

	<b>For the Three Months Ended September 30, 2015</b>	<b>For the Nine Months Ended September 30, 2015</b>
	<b>(Dollars in thousands, except per share amounts)</b>	
Net interest income	\$ 21,057	\$ 61,814
Provision (credit) for loan losses	(301)	(289)
Noninterest income	2,863	8,568
Noninterest expense	15,667	46,002
Income before income taxes	8,554	24,669
Income tax expense	3,806	9,932
Net income	\$ 4,748	\$ 14,737

Net income per share basic	\$ 0.13	\$ 0.39
Net income per share diluted	\$ 0.13	\$ 0.39

**(7) Goodwill and Other Intangible Assets*****Goodwill***

At September 30, 2016, 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. During the fourth quarter of 2015, adjustments were made to the purchase price allocations for the Focus transaction that affected the amounts allocated to goodwill and other assets.

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 tests goodwill for impairment on an annual basis as of November 30. Goodwill is also tested for impairment on an interim basis if an event occurs or circumstances change between annual tests that would more-likely-than-not reduce the fair value of the reporting unit below its carrying value. The Company completed its annual impairment analysis on goodwill as of November 30, 2015 with the assistance of an independent valuation firm. Based on the qualitative analysis performed, the Company determined that it is more likely than not that the fair value of the reporting unit



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****(7) Goodwill and Other Intangible Assets (Continued)**

exceeded its reported book value of equity at November 30, 2015. As such, no impairment was indicated and no further testing was required.

***Other Intangible Assets***

Core deposit and customer relationship intangible assets acquired in the June 2007 acquisition of Diablo Valley Bank were \$5,049,000 and \$276,000, respectively. The core deposit intangible asset is amortized over its estimated useful life of 10 years. The customer relationship intangible asset was amortized over its estimated useful life of seven years and was fully amortized at December 31, 2014. Accumulated amortization of these intangible assets was \$5,024,000 and \$4,703,000 at September 30, 2016 and December 31, 2015, respectively.

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 \$912,000 and \$288,000 at September 30, 2016 and December 31, 2015, 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 lives), and a non-compete agreement intangible asset of \$250,000 (amortized over 3 years). Accumulated amortization of these intangible assets was \$592,000 and \$360,000 at September 30, 2016 and December 31, 2015, respectively.

Estimated amortization expense for 2016 and each of the next five years following 2016:

Year	Bay View Funding						Total Amortization Expense
	Diablo Valley Bank Core Deposit Intangible	Focus Core Deposit Intangible	Below Market Value Lease Intangible	Customer & Brokered Relationship Intangible	Non-Compete Agreement Intangible		
	(Dollars in thousands)						
2016	\$ 427	\$ 831	\$ 36	\$ 190	\$ 83	\$ 1,567	
2017	195	875	31	190	70	1,361	
2018		775		190		965	
2019		734		190		924	
2020		716		190		906	
2021		596		190		786	
	\$ 622	\$ 4,527	\$ 67	\$ 1,140	\$ 153	\$ 6,509	

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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****(7) Goodwill and Other Intangible Assets (Continued)**

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, 2016 and December 31, 2015.

**8) 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. In accordance with Accounting Standards Codification (ASC) 740-10 Accounting for Uncertainty in Income Taxes, the Company estimated the need for a reserve for income taxes of \$2,000, net of Federal benefit, for uncertain state income tax positions of Bay View Funding as of September 30, 2016. The Company does not expect this amount to significantly increase or decrease in the next twelve months.

The Company had net deferred tax assets of \$20,320,000, and \$22,218,000, at September 30, 2016, and December 31, 2015, 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, 2016 and December 31, 2015 will be fully realized in future years.

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 as of September 30, 2016 and December 31, 2015:

	<b>September 30, 2016</b>	<b>December 31, 2015</b>
	<b>(Dollars in thousands)</b>	
Low income housing investments	\$ 3,998	\$ 4,304
Future commitments	\$ 380	\$ 1,271

The Company expects \$283,000 of the future commitments to be paid in 2016, \$14,000 in 2017, and \$83,000 in 2018 through 2023.

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2016

(Unaudited)

**8) Income Taxes (Continued)**

For tax purposes, the Company had low income housing tax credits of \$111,000 and \$180,000 for the three months ended September 30, 2016 and September 30, 2015, respectively, and low income housing investment losses of \$118,000 and \$217,000, respectively. For tax purposes, the Company had low income housing tax credits of \$333,000 and \$540,000 for the nine months ended September 30, 2016 and September 30, 2015, respectively, and low income housing investment losses of \$353,000 and \$651,000, respectively. The Company recognized low income housing investment expense as a component of income tax expense.

**9) 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,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Components of net periodic benefit cost:				
Service cost	\$ 134	\$ 216	\$ 400	\$ 648
Interest cost	259	221	777	663
Amortization of net actuarial loss	60	96	180	288
Net periodic benefit cost	\$ 453	\$ 533	\$ 1,357	\$ 1,599

*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, 2016	December 31, 2015
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$ 6,215	\$ 4,641
Interest cost	186	169
Amortization of net actuarial loss		1,405
Projected benefit obligation at end of period	\$ 6,401	\$ 6,215



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****9) Benefit Plans (Continued)**

	<b>September 30, 2016</b>	<b>December 31, 2015</b>
	<b>(Dollars in thousands)</b>	
Net actuarial loss	\$ 2,253	\$ 2,147
Prior transition obligation	1,351	1,418
Accumulated other comprehensive loss	\$ 3,604	\$ 3,565

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
	<b>(Dollars in thousands)</b>			
Amortization of prior transition obligation	\$ (13)	\$ (28)	\$ (39)	\$ (84)
Interest cost	62	42	186	126
Net periodic benefit cost	\$ 49	\$ 14	\$ 147	\$ 42

**10) 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***

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

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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****10) Fair Value (Continued)**

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

	Balance	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(Dollars in thousands)				
Assets at September 30, 2016:				
Available-for-sale securities:				
Agency mortgage-backed securities	\$ 352,552	\$	\$ 352,552	\$
Trust preferred securities	16,425		16,425	
Corporate bonds	1,022		1,022	
I/O strip receivables	1,101		1,101	
Assets at December 31, 2015:				
Available-for-sale securities:				
Agency mortgage-backed securities	\$ 324,230	\$	\$ 324,230	\$
U.S. Treasury	30,003	30,003		
Trust preferred securities	15,132		15,132	
U.S. Government sponsored entities	9,041		9,041	
Corporate bonds	6,673		6,673	
I/O strip receivables	1,367		1,367	

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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****10) Fair Value (Continued)**

adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

	Balance	Fair Value Measurements Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
(Dollars in thousands)			
Assets at September 30, 2016:			
Impaired loans-held-for-investment:			
Commercial	\$ 190		\$ 190
Real estate:			
Commercial	440		440
Land and construction	201		201
	\$ 831		\$ 831
Assets at December 31, 2015:			
Impaired loans-held-for-investment:			
Commercial	\$ 1,333		\$ 1,333
Real estate:			
Commercial	503		503
Land and construction	219		219
Home equity	647		647
	\$ 2,702		\$ 2,702

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****10) Fair Value (Continued)**

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

	<b>September 30, 2016</b>	<b>December 31, 2015</b>
	<b>(Dollars in thousands)</b>	
<b>Impaired loans held-for-investment:</b>		
Book value of impaired loans held-for-investment carried at fair value	\$ 2,499	\$ 2,988
Book value of impaired loans held-for-investment carried at cost	2,134	3,539
<b>Total impaired loans held-for-investment</b>	<b>\$ 4,633</b>	<b>\$ 6,527</b>
<b>Impaired loans held-for-investment carried at fair value:</b>		
Book value of impaired loans held-for-investment carried at fair value	\$ 2,499	\$ 2,988
Specific valuation allowance	(1,668)	(286)
<b>Impaired loans held-for-investment carried at fair value, net</b>	<b>\$ 831</b>	<b>\$ 2,702</b>

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were \$4,633,000 at September 30, 2016. In addition, these loans had a specific valuation allowance of \$1,668,000 at September 30, 2016. Impaired loans held-for-investment totaling \$2,499,000 at September 30, 2016, were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining \$2,134,000 of impaired loans were carried at cost at September 30, 2016, 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 2016 on impaired loans held-for-investment carried at fair value at September 30, 2016 resulted in an additional provision for loan losses of \$1,628,000.

At September 30, 2016, foreclosed assets had a carrying amount of \$292,000, with no valuation allowance at September 30, 2016.

Impaired loans held-for-investment were \$6,527,000 at December 31, 2015. There were no partial charge-offs at December 31, 2015. In addition, these loans had a specific valuation allowance of \$286,000 at December 31, 2015. Impaired loans held-for-investment totaling \$2,988,000 at December 31, 2015 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining \$3,539,000 of impaired loans were carried at cost at December 31, 2015, 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 2015 on impaired loans held-for-investment carried at fair value at December 31, 2015 resulted in an additional provision for loan losses of \$156,000.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****10) Fair Value (Continued)**

At December 31, 2015, foreclosed assets had a carrying amount of \$364,000, with no valuation allowance at December 31, 2015.

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, 2016			Range (Weighted Average)
	Fair Value	Valuation Techniques	Unobservable Inputs	
(Dollars in thousands)				
Impaired loans held-for-investment:				
Commercial	\$ 190	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%
Real estate:				
Commercial	\$ 440	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)
Land and construction	\$ 201	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%

	December 31, 2015			Range (Weighted Average)
	Fair Value	Valuation Techniques	Unobservable Inputs	
(Dollars in thousands)				
Impaired loans held-for-investment:				
Commercial	\$ 1,333	Market Approach	Discount adjustment for differences between comparable sales	0% to 5% (5%)
Real estate:				
Commercial	\$ 503	Market Approach	Discount adjustment for differences between	0% to 3% (3%)

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Land and construction	\$ 219	Market Approach	comparable sales Discount adjustment for differences between comparable sales	Less than 1%
Home equity	\$ 647	Market Approach	comparable sales 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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****10) Fair Value (Continued)**

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.

The carrying amounts and estimated fair values of financial instruments at September 30, 2016 are as follows:

	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Estimated Fair Value		Total
			Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
(Dollars in thousands)					
<b>Assets:</b>					
Cash and cash equivalents	\$ 344,392	\$ 344,392	\$	\$	\$ 344,392
Securities available-for-sale	369,999		369,999		369,999
Securities held-to-maturity	202,404		205,810		205,810
Loans (including loans held-for-sale), net	1,436,885		6,741	1,499,495	1,506,236
FHLB and FRB stock	15,196				N/A
Accrued interest receivable	6,708		2,118	4,590	6,708
I/O strips receivables	1,101		1,101		1,101
<b>Liabilities:</b>					
Time deposits	\$ 234,293	\$	\$ 234,647	\$	\$ 234,647
Other deposits	1,984,341		1,984,341		1,984,341
Accrued interest payable	187		187		187

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****10) Fair Value (Continued)**

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2015:

	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Estimated Fair Value		Total
			Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
(Dollars in thousands)					
<b>Assets:</b>					
Cash and cash equivalents	\$ 344,092	\$ 344,092	\$	\$	\$ 344,092
Securities available-for-sale	385,079	30,003	355,076		385,079
Securities held-to-maturity	109,311		109,821		109,821
Loans (including loans held-for-sale), net	1,347,087		7,297	1,337,939	1,345,236
FHLB stock, FRB stock, and other investments	12,694				N/A
Accrued interest receivable	5,924	14	1,640	4,270	5,924
I/O strips receivables	1,367		1,367		1,367
<b>Liabilities:</b>					
Time deposits	\$ 244,861	\$	\$ 245,279	\$	\$ 245,279
Other deposits	1,817,914		1,817,914		1,817,914
Short-term borrowings	3,000		3,000		3,000
Accrued interest payable	170		170		170

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 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

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**September 30, 2016**

**(Unaudited)**

**10) Fair Value (Continued)**

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.

***Short-term Borrowings***

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

***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.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****11) 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"). 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, 2016, the Company granted 300,500 shares of nonqualified stock options and 85,024 shares of restricted stock. There were 597,009 shares available for the issuance of equity awards under the 2013 Plan as of September 30, 2016.

Stock option activity under the equity plans is as follows:

<b>Total Stock Options</b>	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life (Years)</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at January 1, 2016	1,775,027	\$ 10.62		
Granted	300,500	\$ 10.36		
Exercised	(118,885)	\$ 6.49		
Forfeited or expired	(184,520)	\$ 20.08		
<b>Outstanding at September 30, 2016</b>	<b>1,772,122</b>	<b>\$ 9.86</b>	<b>6.1</b>	<b>\$ 4,560,918</b>
<b>Vested or expected to vest</b>	<b>1,683,516</b>		<b>6.1</b>	<b>\$ 4,332,872</b>
<b>Exercisable at September 30, 2016</b>	<b>1,199,679</b>		<b>4.9</b>	<b>\$ 3,691,857</b>

As of September 30, 2016, there was \$1,627,000 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 2.70 years.

Restricted stock activity under the equity plans is as follows:

<b>Total Restricted Stock Award</b>	<b>Number of Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Nonvested shares at January 1, 2016	167,605	\$ 9.28
Granted	85,024	\$ 10.34
Vested	(29,714)	\$ 10.48

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Forfeited or expired	(2,652)	\$	9.36
Nonvested shares at September 30, 2016	220,263	\$	9.64

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**September 30, 2016**

**(Unaudited)**

**11) Equity Plan (Continued)**

As of September 30, 2016, there was \$1,742,000 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 2.69 years.

**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.

As of January 1, 2015, HCC and HBC along with other community banking organizations became subject to new capital requirements. The implementation of the capital conservation buffer began 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 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, 2016.

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, 2016 and December 31, 2015, the Company and HBC met all capital adequacy guidelines to which they were subject.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****12) Capital Requirements (Continued)**

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, 2016, and December 31, 2015.

	<b>Actual</b>		<b>Required For Capital Adequacy Purposes Under Basel III</b>	
	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio(1)</b>
<b>(Dollars in thousands)</b>				
<b>As of September 30, 2016:</b>				
Total Capital (to risk-weighted assets)	\$ 230,697	12.7%	\$ 156,339	8.625%
Tier 1 Capital (to risk-weighted assets)	\$ 210,021	11.6%	\$ 120,086	6.625%
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 210,021	11.6%	\$ 92,897	5.125%
Tier 1 Capital (to average assets)	\$ 210,021	8.9%	\$ 94,807	4.000%

(1)

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

	<b>Actual</b>		<b>Required For Capital Adequacy Purposes Under Basel III</b>	
	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>
<b>(Dollars in thousands)</b>				
<b>As of December 31, 2015:</b>				
Total Capital (to risk-weighted assets)	\$ 218,915	12.5%	\$ 140,041	8.0%
Tier 1 Capital (to risk-weighted assets)	\$ 199,299	11.4%	\$ 105,031	6.0%
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 181,221	10.4%	\$ 78,773	4.5%
Tier 1 Capital (to average assets)	\$ 199,299	8.6%	\$ 92,918	4.0%

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****12) Capital Requirements (Continued)**

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, 2016, and December 31, 2015.

	Actual		To Be Well-Capitalized Under Basel III Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel III	
	Amount	Ratio	Amount	Ratio	Amount	Ratio(1)
(Dollars in thousands)						
As of September 30, 2016:						
Total Capital (to risk-weighted assets)	\$ 227,746	12.6%	\$ 181,220	10.0%	\$ 156,303	8.625%
Tier 1 Capital (to risk-weighted assets)	\$ 207,070	11.4%	\$ 144,976	8.0%	\$ 120,059	6.625%
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 207,070	11.4%	\$ 117,793	6.5%	\$ 92,875	5.125%
Tier 1 Capital (to average assets)	\$ 207,070	8.7%	\$ 118,472	5.0%	\$ 94,777	4.000%

(1) Includes 0.625% capital conservation buffer, effective January 1, 2016, 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	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
As of December 31, 2015:						
Total Capital (to risk-weighted assets)	\$ 219,943	12.6%	\$ 175,022	10.0%	\$ 140,018	8.0%
Tier 1 Capital (to risk-weighted assets)	\$ 200,327	11.4%	\$ 140,018	8.0%	\$ 105,013	6.0%
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 200,327	11.4%	\$ 113,764	6.5%	\$ 78,760	4.5%
Tier 1 Capital (to average assets)	\$ 200,327	8.6%	\$ 116,112	5.0%	\$ 92,889	4.0%

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:

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**September 30, 2016**

**(Unaudited)**

**12) Capital Requirements (Continued)**

(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 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, 2016, HBC would not be required to obtain regulatory approval, and the amount available for cash dividends is \$8,361,000. Similar restrictions applied to the amount and sum of loan advances and other transfers of funds from HBC to the parent company. During the third, second and first quarters of 2016, HBC distributed dividends of \$4,000,000, \$4,000,000 and \$6,000,000, respectively, for a total of \$14,000,000 during the first nine months of 2016.

**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 have 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. The complaints have been consolidated for trial, which is set for trial in early 2017. The Company has reached a tentative settlement on two of the complaints, which is not considered to be material. As to all claims, it is not possible to determine the amount of the loss, if any, arising from the claim in excess of the legal expenses expected to be incurred in defense of the litigation. The Company intends to vigorously defend the litigation.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****14) Noninterest Expense**

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
	<b>(Dollars in thousands)</b>			
Salaries and employee benefits(1)	\$ 8,363	\$ 10,358	\$ 26,052	\$ 26,112
Occupancy and equipment	1,120	1,063	3,277	3,135
Professional fees	1,086	612	2,619	946
Software subscriptions	401	292	1,118	883
Amortization of intangible assets	392	277	1,176	655
Data processing	372	411	1,143	950
Insurance expense	319	273	924	855
FDIC deposit insurance premiums	308	251	966	727
Foreclosed assets	10	113	14	(93)
Acquisition and integration related costs		688		1,265
Other	1,925	2,081	6,073	5,877
<b>Total noninterest expense</b>	<b>\$ 14,296</b>	<b>\$ 16,419</b>	<b>\$ 43,362</b>	<b>\$ 41,312</b>

(1)

Salaries and employee benefits included pre-tax severance and retention costs related to the Focus transaction of \$2,177,000 for the three months ended September 30, 2015, and \$2,887,000 for the nine months ended September 30, 2015.

**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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****15) Business Segment Information (Continued)**

consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring originated by Bay View Funding.

	<b>Three Months Ended September 30, 2016</b>		
	<b>Banking(1)</b>	<b>Factoring</b>	<b>Consolidated</b>
	<b>(Dollars in thousands)</b>		
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
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**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****15) Business Segment Information (Continued)**

	<b>Three Months Ended September 30, 2015</b>		
	<b>Banking(1)</b>	<b>Factoring</b>	<b>Consolidated</b>
	<b>(Dollars in thousands)</b>		
Interest income	\$ 17,117	\$ 3,189	\$ 20,306
Intersegment interest allocations	280	(280)	
Total interest expense	623		623
Net interest income	16,774	2,909	19,683
Provision (credit) for loan losses	(291)	(10)	(301)
Net interest income after provision	17,065	2,919	19,984
Noninterest income	1,869	197	2,066
Noninterest expense	14,616	1,803	16,419
Intersegment expense allocations	112	(112)	
Income before income taxes	4,430	1,201	5,631
Income tax expense	1,668	504	2,172
Net income	\$ 2,762	\$ 697	\$ 3,459
Total assets	\$ 2,204,963	\$ 57,244	\$ 2,262,207
Loans, net of deferred fees	\$ 1,290,062	\$ 42,343	\$ 1,332,405
Goodwill	\$ 31,854	\$ 13,044	\$ 44,898

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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****15) Business Segment Information (Continued)**

	<b>Nine Months Ended September 30, 2016</b>		
	<b>Banking(1)</b>	<b>Factoring</b>	<b>Consolidated</b>
	<b>(Dollars in thousands)</b>		
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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2016****(Unaudited)****15) Business Segment Information (Continued)**

	<b>Nine Months Ended September 30, 2015</b>		
	<b>Banking(1)</b>	<b>Factoring</b>	<b>Consolidated</b>
	<b>(Dollars in thousands)</b>		
Interest income	\$ 46,458	\$ 9,389	\$ 55,847
Intersegment interest allocations	822	(822)	
Total interest expense	1,664		1,664
Net interest income	45,616	8,567	54,183
Provision (credit) for loan losses	(328)	(11)	(339)
Net interest income after provision	45,944	8,578	54,522
Noninterest income	5,581	575	6,156
Noninterest expense	35,930	5,382	41,312
Intersegment expense allocations	266	(266)	
Income before income taxes	15,861	3,505	19,366
Income tax expense	5,820	1,472	7,292
Net income	\$ 10,041	\$ 2,033	\$ 12,074
Total assets	\$ 2,204,963	\$ 57,244	\$ 2,262,207
Loans, net of deferred fees	\$ 1,290,062	\$ 42,343	\$ 1,332,405
Goodwill	\$ 31,854	\$ 13,044	\$ 44,898

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

**16) Subsequent Events**

On October 27, 2016, the Company announced that its Board of Directors declared a \$0.09 per share quarterly cash dividend to holders of common stock. The dividend will be paid on November 22, 2016, to shareholders of record on November 8, 2016.

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, 2015. There are no changes to these policies as of September 30, 2016.

**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, 2016, net income was \$6.8 million, or \$0.18 per average diluted common share, compared to \$3.5 million, or \$0.10 per average diluted common share, for the three months ended September 30, 2015. The Company's annualized return on average tangible assets was 1.13% and annualized return on average tangible equity was 13.06% for the three months ended September 30, 2016, compared to 0.71% and 7.46%, respectively, for the three months ended September 30, 2015.

For the nine months ended September 30, 2016, net income was \$20.2 million, or \$0.53 per average diluted common share, compared to \$12.1 million, or \$0.36 per average diluted common share, for the nine months ended September 30, 2015. The Company's annualized return on average tangible assets was 1.16% and annualized return on average tangible equity was 13.45% for the nine months ended September 30, 2016, compared to 0.93% and 9.22%, respectively, for the nine months ended September 30, 2015.

***Bay View Funding Acquisition***

On November 1, 2014, the Company acquired Bay View Funding, by purchasing all of the outstanding common stock from the stockholders of Bay View Funding for an aggregate purchase price

Table of Contents

of \$22.52 million. Bay View Funding became a wholly owned subsidiary of HBC. 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 at or for the periods indicated:

	September 30, 2016	September 30, 2015
(Dollars in thousands)		
Total factored receivables	\$ 47,846	\$ 42,343
Average factored receivables:		
For the three months ended	\$ 49,427	\$ 43,364
For the nine months ended	\$ 45,381	\$ 41,791
Total full time equivalent employees	35	37

**Focus Business Bank Merger**

On August 20, 2015 ("acquisition date"), the Company completed the merger of HBC with Focus Business Bank ("Focus") for an aggregate transaction value of \$66.6 million. Shareholders of Focus received a fixed exchange ratio at closing of 1.8235 shares of the Company's common stock for each share of Focus common stock. The Company issued 5,456,713 shares of the Company's common stock to Focus shareholders for a total value of \$58.3 million based on the Company's closing stock price of \$10.68 on August 20, 2015. In addition, the Company paid cash to the Focus holders of in-the-money stock options totaling \$8.3 million.

The Focus acquisition added total (at fair market value) assets of approximately \$438.8 million, loans of approximately \$174.8 million (including loans held-for-sale), and deposits of approximately \$405.1 million at August 20, 2015. Focus's results of operations were included in the Company's results of operations beginning August 21, 2015.

**Third Quarter 2016 Highlights**

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

The fully tax equivalent ("FTE") net interest margin contracted 29 basis points to 4.10% for the third quarter of 2016, from 4.39% for the third quarter of 2015, primarily due to lower yields on loans and securities. For the nine months ended September 30, 2016, the net interest margin declined 35 basis points to 4.19%, from 4.54% for the nine months ended September 30, 2015, primarily due to higher average balances of lower yielding funds at the Federal Reserve Bank and lower yields on loans and securities, which was partially offset by an increase in the accretion of the loan purchase discount from the Focus transaction.

The accretion of the loan purchase discount into loan interest income from the Focus transaction was \$299,000 for the third quarter of 2016, and \$262,000 for the third quarter of 2015. The accretion of the loan purchase discount in loan interest income from the Focus transaction was \$1.1 million for the first nine months of 2016, compared to \$262,000 for the first nine months of 2015. The total purchase discount on non-impaired loans from the Focus loan portfolio was \$4.6 million as of the acquisition date, of which \$2.5 million has been accreted into loan interest income from the acquisition date through September 30, 2016.

The yield on the loan portfolio was 5.60% for the third quarter of 2016, compared to 5.70% for the third quarter of 2015. The yield on the loan portfolio was 5.61% for the nine months ended September 30, 2016, compared to 5.69% for the nine months ended September 30, 2015. The decrease in the yield on the loan portfolio for the third quarter and first nine months of 2016, compared to the respective periods in 2015, primarily reflects the addition of the lower yielding

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

### Table of Contents

Focus loan portfolio and growth in the Company's legacy portfolio, partially offset by the accretion of the loan purchase discount from the Focus transaction.

Net interest income increased 17% to \$23.0 million for the third quarter of 2016, compared to \$19.7 million for the third quarter of 2015. Net interest income increased 26% to \$68.1 million for the nine months ended September 30, 2016, compared to \$54.2 million for the nine months ended September 30, 2015. Net interest income increased for the third quarter and first nine months of 2016, compared to the respective periods in 2015, primarily due to organic growth in the loan portfolio, the accretion of the loan purchase discount from the Focus transaction, and an increase in the average balance of investment securities.

There was a \$245,000 provision for loan losses for the third quarter of 2016, compared to a \$301,000 credit provision for loan losses for the third quarter of 2015. For the nine months ended September 30, 2016, there was a \$997,000 provision for loan losses compared to a \$339,000 credit provision for loan losses for the nine months ended September 30, 2015.

Noninterest income increased to \$2.3 million for the third quarter of 2016, compared to \$2.1 million for the third quarter of 2015. For the nine months ended September 30, 2016, noninterest income was \$8.6 million, compared to \$6.2 million for the nine months ended September 30, 2015. The increase in noninterest income for the first nine months of 2016, compared to the first nine months of 2015, was primarily due to a \$1.0 million gain on proceeds from company owned life insurance and higher gains on sales of securities.

Total noninterest expense for the third quarter of 2016 was \$14.3 million, compared to \$16.4 million for the third quarter of 2015. The decrease in noninterest expense in the third quarter, compared to the third quarter of 2015, was primarily due to pre-tax acquisition, severance and retention costs incurred by the Company related to the Focus transaction totaling \$2.9 million for the third quarter of 2015. Noninterest expense for the nine months ended September 30, 2016 increased to \$43.4 million, compared to \$41.3 million for the nine months ended September 30, 2015, primarily due to additional employees retained from Focus and an increase in amortization of the core deposit intangible assets as a result of the Focus acquisition, annual salary increases, newly hired employees and higher professional fees, partially offset by \$3.4 million of pre-tax acquisition, severance and retention costs incurred by the Company for the first nine months of 2015.

The efficiency ratio for the third quarter of 2016 was 56.37%, compared to 75.49% for the third quarter of 2015. The efficiency ratio for the nine months ended September 30, 2016 was 56.55%, compared to 68.47% for the nine months ended September 30, 2015. The higher efficiency ratio in the third quarter of 2015 and nine months ended September 30, 2015 was primarily due to the Focus acquisition, severance and retention costs. Excluding the Focus acquisition, severance and retention costs, the efficiency ratio was 62.32% for the third quarter of 2015, and 62.76% for the nine months ended September 30, 2015.

Income tax expense for the third quarter of 2016 was \$4.1 million, compared to \$2.2 million for the third quarter of 2015. The effective tax rate for the third quarter of 2016 was 37.5%, compared to 38.6% for the third quarter of 2015. The effective tax rate for the third quarter of 2015 was higher primarily due to the impact of non-deductible merger related expenses. Income tax expense for the nine months ended September 30, 2016 was \$12.1 million, compared to \$7.3 million for the nine months ended September 30, 2015. The effective tax rate for the nine months ended September 30, 2016 was 37.6%, compared to 37.7% for the nine months ended September 30, 2015.

The return on average tangible assets was 1.13%, and the return on average tangible equity was 13.06%, for the third quarter of 2016, compared to 0.71% and 7.46%, respectively, for the third

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

### Table of Contents

quarter of 2015. The return on average tangible assets was 1.16%, and the return on average tangible equity was 13.45%, for the first nine months of 2016, compared to 0.93% and 9.22%, respectively, for the first nine months of 2015.

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

Cash, interest-bearing deposits in other financial institutions and securities available-for-sale increased 10% to \$714.4 million at September 30, 2016, from \$650.3 million at September 30, 2015, and decreased 2% from \$729.2 million at December 31, 2015.

At September 30, 2016, investment securities held-to-maturity totaled \$202.4 million, compared to \$111.0 million at September 30, 2015, and \$109.3 million at December 31, 2015.

Loans (excluding loans held-for-sale) increased \$117.8 million, or 9%, to \$1.45 billion at September 30, 2016, compared to \$1.33 billion at September 30, 2015, which included an increase of \$68.5 million, or 5% in the Company's legacy portfolio, and \$49.3 million of purchased residential mortgage loans at September 30, 2016. Loans increased \$91.5 million, or 7%, at September 30, 2016, compared to \$1.36 billion at December 30, 2015.

During the second and third quarters of 2016, the Company purchased jumbo single family residential mortgage loans totaling \$51.6 million, all of which are domiciled in California. The average loan principal amount is approximately \$834,000, and the weighted average yield on the portfolio is 3.00%, net of servicing fees to the servicer. Residential mortgages outstanding at September 30, 2016 totaled \$49.3 million.

Nonperforming assets were \$4.8 million, or 0.19% of total assets, at September 30, 2016, compared to \$5.9 million, or 0.26% of total assets, at September 30, 2015, and \$6.7 million, or 0.29% of total assets, at December 31, 2015.

Classified assets were \$18.7 million at September 30, 2016, compared to \$18.0 million at September 30, 2015, and \$19.0 million at December 31, 2015.

Net charge-offs totaled \$134,000 for the third quarter of 2016, compared to net recoveries of \$281,000 for the third quarter 2015, and net charge-offs of \$182,000 for the fourth quarter of 2015.

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 September 30, 2015 was \$18.7 million, or 1.41% of total loans, representing 340.49% of nonperforming loans. The allowance for loan losses at December 31, 2015 was \$18.9 million, or 1.39% of total loans, representing 296.74% of nonperforming loans.

Total deposits increased \$256.6 million, or 13%, to \$2.22 billion at September 30, 2016, compared to \$1.96 billion at September 30, 2015, and increased \$155.9 million, or 8%, from \$2.06 billion at December 31, 2015. Deposits excluding all time deposits and CDARS deposits increased \$291.2 million, or 17%, to \$1.98 billion at September 30, 2016, from \$1.69 billion at September 30, 2015, and increased \$166.2 million, or 9%, from \$1.81 billion at December 31, 2015.

The ratio of noncore funding (which consists of time deposits of \$250,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase and short-term borrowings) to total assets was 7.13% at September 30, 2016, compared to 9.19% at September 30, 2015, and 8.01% at December 31, 2015.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

The loan to deposit ratio was 65.36% at September 30, 2016, compared to 67.91% at September 30, 2015, and 65.87% at December 31, 2015.

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

### Table of Contents

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, 2016.

CAPITAL RATIOS	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
Total Risk-Based	12.7%	12.6%	10.0%	10.5%
Tier 1 Risk-Based	11.6%	11.4%	8.0%	8.5%
Common Equity Tier 1 Risk-Based	11.6%	11.4%	6.5%	7.0%
Leverage	8.9%	8.7%	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 \$256.6 million, or 13%, to \$2.22 billion at September 30, 2016, compared to \$1.96 billion at September 30, 2015, and increased \$155.9 million, or 8%, from \$2.06 billion at December 31, 2015. Deposits excluding all time deposits and CDARS deposits increased \$291.2 million, or 17%, to \$1.98 billion at September 30, 2016, from \$1.69 billion at September 30, 2015, and increased \$166.2 million, or 9%, from \$1.81 billion at December 31, 2015.

The Company had \$3.0 million in brokered deposits at September 30, 2016, compared to \$24.2 million at September 30, 2015 and \$17.8 million at December 31, 2015. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators were \$54.5 million at September 30, 2016, compared to \$24.6 million at September 30, 2015, and \$49.1 million at December 31, 2015. Certificates of deposit from the State of California totaled \$85.1 million at September 30, 2016, compared to \$98.0 million at September 30, 2015 and \$78.0 million at December 31, 2015.

### **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, 2016, we had \$344.4 million in cash and cash equivalents and approximately \$557.3 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 \$438.3 million at fair value in unpledged

Table of Contents

securities available at September 30, 2016. Our loan to deposit ratio was 63.36% at September 30, 2016, compared to 67.91% at September 30, 2015, and 65.87% at December 31, 2015.

***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 \$117.8 million, or 9%, to \$1.45 billion at September 30, 2016, compared to \$1.33 billion at September 30, 2015, which included an increase of \$68.5 million, or 5%, in the Company's legacy loan portfolio, and \$49.3 million of purchased residential mortgage loans. Loans increased \$91.5 million, or 7%, at September 30, 2016, compared to \$1.36 billion at December 31, 2015, which included an increase of \$42.2 million, or 3%, in the Company's legacy portfolio, and \$49.3 million of purchased residential real estate loans. The loan portfolio remains well-diversified with commercial and industrial ("C&I") loans accounting for 42% of the loan portfolio at September 30, 2016, which included \$47.8 million of factored receivables at Bay View Funding. Commercial real estate loans accounted for 42% of the total loan portfolio, of which 43% were owner-occupied by businesses. Consumer and home equity loans accounted for 7% of total loans, land and construction loans accounted for 6% of total loans, and residential mortgage loans accounted for the remaining 3% of total loans at September 30, 2016.

During the second and third quarters of 2016, the Company purchased jumbo single family residential mortgage loans totaling \$51.6 million, all of which are domiciled in California. The average loan principal amount is approximately \$834,000, and the weighted average yield on the portfolio is 3.00%, net of servicing fees to the servicer. Residential mortgages outstanding at September 30, 2016 totaled \$49.3 million.

***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 17% to \$23.0 million for the third quarter of 2016, compared to \$19.7 million for the third quarter of 2015. Net interest income increased 26% to \$68.1 million for the nine months ended September 30, 2016, compared to \$54.2 million for the nine months ended September 30, 2015. The increase in the net interest income for the third quarter and the first nine months of 2016, compared to the respective periods in 2015, was primarily due to organic growth in the loan portfolio, the accretion of the loan portfolio purchase discount from the Focus transaction, and an increase in the average balance of 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.

Table of Contents

***Management of Credit Risk***

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

***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. Noninterest expense for the third quarter of 2016 was \$14.3 million, compared to \$16.4 million for the third quarter of 2015. The decrease in noninterest expense in the third quarter of 2016, compared to the third quarter of 2015, was primarily due to pre-tax acquisition, severance and retention costs incurred by the Company related to the Focus transaction totaling \$2.9 million for the third quarter of 2015. Noninterest expense for the nine months ended September 30, 2016 increased to \$43.4 million, compared to \$41.3 million for the nine months ended September 30, 2015, primarily due to additional employees retained from Focus and an increase in amortization of the core deposit intangible assets as a result of the Focus acquisition, annual salary increases, newly hired employees and higher professional fees, partially offset by \$3.4 million of pre-tax acquisition, severance and retention costs incurred by the Company for the first nine months of 2015.

***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.

Table of Contents

**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**

NET INTEREST INCOME AND NET INTEREST MARGIN	Three Months Ended September 30, 2016			Three Months Ended September 30, 2015		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
(Dollars in thousands)						
<b>Assets:</b>						
Loans, gross(1)	\$ 1,442,006	\$ 20,312	5.60%	\$ 1,232,989	\$ 17,713	5.70%
Securities taxable	497,821	2,401	1.92%	244,313	1,670	2.71%
Securities exempt from Federal tax(2)	91,241	875	3.82%	91,127	874	3.80%
Federal funds sold and interest-bearing deposits in other financial institutions	232,929	592	1.01%	237,372	355	0.59%
Total interest earning assets(2)	2,263,997	24,180	4.25%	1,805,801	20,612	4.53%
Cash and due from banks	32,628			34,921		
Premises and equipment, net	7,595			7,374		
Intangible assets	53,258			30,135		
Other assets	73,825			77,816		
Total assets	\$ 2,431,303			\$ 1,956,047		
<b>Liabilities and shareholders' equity:</b>						
<b>Deposits:</b>						
Demand, noninterest-bearing	\$ 842,565			\$ 652,529		
Demand, interest-bearing	515,296	259	0.20%	326,922	144	0.17%
Savings and money market	516,570	289	0.22%	444,702	240	0.21%
Time deposits under \$100	21,707	16	0.29%	20,681	15	0.29%
Time deposits \$100 and over	212,201	251	0.47%	206,909	173	0.33%
Time deposits brokered	4,874	10	0.82%	24,861	50	0.80%
CDARS money market and time deposits	8,256	1	0.05%	16,678	1	0.02%
Total interest-bearing deposits	1,278,904	826	0.26%	1,040,753	623	0.24%
Total deposits	2,121,469	826	0.15%	1,693,282	623	0.15%
Short-term borrowings	55		0.00%	166		0.00%
Total interest-bearing liabilities	1,278,959	826	0.26%	1,040,919	623	0.24%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	2,121,524	826	0.15%	1,693,448	623	0.15%
Other liabilities	50,384			48,494		
Total liabilities	2,171,908			1,741,942		
Shareholders' equity	259,395			214,105		
Total liabilities and shareholders' equity	\$ 2,431,303			\$ 1,956,047		

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Net interest income(2) / margin	23,354	4.10%	19,989	4.39%
Less tax equivalent adjustment(2)	(306)		(306)	
Net interest income	\$ 23,048		\$ 19,683	

---

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

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

---

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

NET INTEREST INCOME AND NET INTEREST MARGIN	Nine Months Ended September 30, 2016			Nine Months Ended September 30, 2015		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
(Dollars in thousands)						
<b>Assets:</b>						
Loans, gross(1)	\$ 1,409,637	\$ 59,235	5.61%	\$ 1,136,208	\$ 48,360	5.69%
Securities taxable	500,497	8,004	2.14%	230,608	4,828	2.80%
Securities exempt from Federal tax(2)	92,194	2,651	3.84%	84,286	2,444	3.88%
Federal funds sold and interest-bearing deposits in other financial institutions	195,850	1,478	1.01%	171,503	1,070	0.83%
Total interest earning assets(2)	2,198,178	71,368	4.34%	1,622,605	56,702	4.67%
Cash and due from banks	32,927			28,647		
Premises and equipment, net	7,638			7,388		
Intangible assets	53,641			20,721		
Other assets	83,574			73,417		
Total assets	\$ 2,375,958			\$ 1,752,778		
<b>Liabilities and shareholders' equity:</b>						
Deposits:						
Demand, noninterest-bearing	\$ 800,049			\$ 578,117		
Demand, interest-bearing	505,442	731	0.19%	265,095	349	0.18%
Savings and money market	506,998	829	0.22%	403,385	623	0.21%
Time deposits under \$100	22,534	48	0.28%	19,812	45	0.30%
Time deposits \$100 and over	212,300	660	0.42%	202,512	485	0.32%
Time deposits brokered	9,503	59	0.83%	26,578	157	0.79%
CDARS money market and time deposits	8,344	5	0.08%	13,711	5	0.05%
Total interest-bearing deposits	1,265,121	2,332	0.25%	931,093	1,664	0.24%
Total deposits	2,065,170	2,332	0.15%	1,509,210	1,664	0.15%
Short-term borrowings	601	12	2.67%	80		0.00%
Total interest-bearing liabilities	1,265,722	2,344	0.25%	931,173	1,664	0.24%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	2,065,771	2,344	0.15%	1,509,290	1,664	0.15%
Other liabilities	56,325			47,757		
Total liabilities	2,122,096			1,557,047		
Shareholders' equity	253,862			195,731		
Total liabilities and shareholders' equity	\$ 2,375,958			\$ 1,752,778		
Net interest income(2) / margin		69,024	4.19%		55,038	4.54%

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Less tax equivalent adjustment(2)	(928)	(855)
Net interest income	\$ 68,096	\$ 54,183

---

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

(2) Reflects tax equivalent adjustment for 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.

	<b>Three Months Ended September 30, 2016 vs. 2015</b>		
	<b>Increase (Decrease) Due to Change In:</b>		
	<b>Average Volume</b>	<b>Average Rate</b>	<b>Net Change</b>
<b>(Dollars in thousands)</b>			
<b>Income from interest earning assets:</b>			
Loans, gross	\$ 2,956	\$ (357)	\$ 2,599
Securities taxable	1,222	(491)	731
Securities exempt from Federal tax(1)		1	1
Federal funds sold and interest-bearing deposits in other financial institutions	(11)	248	237
<b>Total interest income from interest earnings assets(1)</b>	<b>4,167</b>	<b>(599)</b>	<b>3,568</b>
<b>Expense on interest-bearing liabilities:</b>			
Demand, interest-bearing	95	20	115
Savings and money market	43	6	49
Time deposits under \$100	1		1
Time deposits \$100 and over	7	71	78
Time deposits brokered	(41)	1	(40)
CDARS money market and time deposits	(1)	1	
<b>Total interest expense on interest-bearing liabilities</b>	<b>104</b>	<b>99</b>	<b>203</b>
<b>Net interest income(1)</b>	<b>\$ 4,063</b>	<b>\$ (698)</b>	<b>3,365</b>
 Less tax equivalent adjustment(1)			
<b>Net interest income</b>			<b>\$ 3,365</b>

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

	<b>Nine Months Ended September 30, 2016 vs. 2015</b>		
	<b>Increase (Decrease) Due to</b>		
	<b>Change In:</b>		
	<b>Average</b>	<b>Average</b>	<b>Net</b>
	<b>Volume</b>	<b>Rate</b>	<b>Change</b>
	<b>(Dollars in thousands)</b>		
<b>Income from interest earning assets:</b>			
Loans, gross	\$ 11,516	\$ (641)	\$ 10,875
Securities taxable	4,309	(1,133)	3,176
Securities exempt from Federal tax(1)	228	(21)	207
Federal funds sold and interest-bearing deposits in other financial institutions	181	227	408
<b>Total interest income from interest earnings assets(1)</b>	<b>16,234</b>	<b>(1,568)</b>	<b>14,666</b>
<b>Expense on interest-bearing liabilities:</b>			
Demand, interest-bearing	354	\$ 28	\$ 382
Savings and money market	165	41	206
Time deposits under \$100	6	(3)	3
Time deposits \$100 and over	23	152	175
Time deposits brokered	(106)	8	(98)
CDARS money market and time deposits	(3)	3	
Short-term borrowings	10	2	12
<b>Total interest expense on interest-bearing liabilities</b>	<b>449</b>	<b>231</b>	<b>680</b>
<b>Net interest income(1)</b>	<b>\$ 15,785</b>	<b>\$ (1,799)</b>	<b>13,986</b>
<b>Less tax equivalent adjustment(1)</b>			<b>(73)</b>
<b>Net interest income</b>			<b>\$ 13,913</b>

(1) Reflects tax equivalent adjustment for 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 29 basis points to 4.10% for the third quarter of 2016, compared to 4.39% for the third quarter of 2015, primarily due lower yields on loans and securities. For the nine months ended September 30, 2016, net interest margin decreased 35 basis points to 4.19%, from 4.54% for the nine months ended September 30, 2015, primarily due to higher average balances of lower yielding funds at the Federal Reserve Bank, and lower yields on loans and securities, which was partially offset by an increase in the accretion of the loan purchase discount from the Focus transaction.

The accretion of the loan purchase discount in loan interest income from the Focus transaction was \$299,000 for the third quarter of 2016, compared to \$262,000 for the third quarter of 2015. The accretion of the loan purchase discount in loan interest income from the Focus transaction was \$1.1 million for the first nine months of 2016, compared to \$262,000 for the first nine months of 2015. The total purchase discount on non-impaired loans from the Focus loan portfolio was \$4.6 million as of the acquisition date, of which \$2.5 million has been accreted to loan interest income from the acquisition date through September 30, 2016.

The yield on the loan portfolio was 5.60% for the third quarter of 2016, compared to 5.70% for the third quarter of 2015. The yield on the loan portfolio for the nine months ended September 30, 2016 was 5.61%, compared to 5.69% for the nine months ended September 30, 2015. The decrease in the yield on the loan portfolio for the third quarter and the first nine months of 2016, compared to the respective periods in 2015, was primarily due to a decrease in the proportion of loans in the higher



Table of Contents

yielding Bay View Funding factored receivables portfolio relative to the addition of the Focus loans and growth in the Company's legacy portfolio, partially offset by an increase in the accretion of the loan purchase discount from the Focus transaction.

Net interest income increased 17% to \$23.0 million for the third quarter of 2016, compared to \$19.7 million for the third quarter of 2015. Net interest income increased 26% to \$68.1 million for the nine months ended September 30, 2016, compared to \$54.2 million for the nine months ended September 30, 2015. Net interest income increased for the third quarter and first nine months of 2016, compared to the respective periods in 2015, primarily due to organic growth in the loan portfolio, the accretion of the loan purchase discount from the Focus transaction, and an increase in the average balance of investment securities.

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

***Provision for Loan Losses***

Credit risk is inherent in the business of making loans. The Company establishes an allowance for loan losses through charges to earnings, which are 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 \$245,000 provision for loan losses for the third quarter of 2016, compared to a credit provision for loan losses of \$301,000 for the third quarter of 2015. For the nine months ended September 30, 2016, there was a \$997,000 provision for loan losses, compared to a \$339,000 credit provision for loan losses for the nine months ended September 30, 2015. The allowance for loan losses, related to the commercial loan portfolio increased \$1.4 million at September 30, 2016 from December 31, 2015, as a result of a provision for loan losses of \$1.6 million, and net charge-offs of \$118,000. The increase in the allowance for loan losses was primarily due to an increase in commercial loans outstanding and one commercial relationship that went nonaccrual during the third quarter of 2016, and was fully reserved for. The allowance for loan losses related to the real estate portfolio decreased \$313,000 at September 30, 2016 from December 31, 2015, as a result of net recoveries of \$227,000, partially offset by a credit provision for loan losses of \$540,000 as a result of improving credit quality factors.

The allowance for loan losses totaled \$20.0 million, or 1.38% of total loans at September 30, 2016, compared to \$18.7 million, or 1.41% of total loans at September 30, 2015, and \$18.9 million, or 1.39% of total loans at December 31, 2015. Net charge-offs totaled \$134,000 for the third quarter of 2016, compared to net recoveries of \$281,000 for the third quarter of 2015, and net charge-offs of \$182,000 for the fourth quarter of 2015. The allowance for loan losses to total nonperforming loans was 445.55% at September 30, 2016, compared to 340.49% at September 30, 2015, and 296.74% at December 31, 2015. Provisions for loan losses are charged to operations to bring the allowance for loan losses to a

Table of Contents

level deemed appropriate by the Company based on the factors discussed under "Allowance for Loan Losses".

**Noninterest Income**

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

	Three Months Ended September 30,		Increase (Decrease) 2016 versus 2015	
	2016	2015	Amount	Percent
(Dollars in thousands)				
Service charges and fees on deposit accounts	\$ 798	\$ 748	\$ 50	7%
Increase in cash surrender value of life insurance	428	429	(1)	0%
Servicing income	364	214	150	70%
Gain on sales of SBA loans	69	267	(198)	74%
Other	653	408	245	60%
Total noninterest income	\$ 2,312	\$ 2,066	\$ 246	12%

	Nine Months Ended September 30,		Increase (Decrease) 2016 versus 2015	
	2016	2015	Amount	Percent
(Dollars in thousands)				
Service charges and fees on deposit accounts	\$ 2,348	\$ 2,086	\$ 262	13%
Increase in cash surrender value of life insurance	1,317	1,225	92	8%
Servicing income	1,106	819	287	35%
Gain on sales of SBA loans	653	660	(7)	1%
Gain on proceeds from company owned life insurance	1,019		1,019	N/A
Gain on sales of securities	527		527	N/A
Other	1,616	1,366	250	18%
Total noninterest income	\$ 8,586	\$ 6,156	\$ 2,430	39%

Noninterest income increased to \$2.3 million for the third quarter of 2016, compared to \$2.1 million for the third quarter of 2015. For the nine months ended September 30, 2016, noninterest income increased to \$8.6 million, compared to \$6.2 million for the nine months ended September 30, 2015, primarily due to a \$1.0 million gain on proceeds from company owned life insurance and a \$527,000 gain on sales of securities.

The Company maintains life insurance policies for some directors and officers that are subject to split-dollar life insurance agreements, which continue after the participant's employment termination or retirement. During the second quarter of 2016, the Company received death benefit proceeds of \$3.1 million from the life insurance policy of a former officer of a bank acquired by the Company. The cash surrender value of the policy was \$2.1 million, which resulted in a gain on proceeds from company owned life insurance of \$1.0 million.

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. The gain on sales of SBA loans was \$198,000 lower in the third quarter of 2016, compared to the third quarter of 2015, primarily as a result of closing fewer loans to sell in the third quarter of 2016, and retaining some loans held-for-sale on the balance sheet due to lower market premiums.



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

### Table of Contents

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 September 30,		Increase (Decrease) 2016 versus 2015	
	2016	2015	Amount	Percent
	(Dollars in thousands)			
Salaries and employee benefits(1)	\$ 8,363	\$ 10,358	\$ (1,995)	19%
Occupancy and equipment	1,120	1,063	57	5%
Professional fees	1,086	612	474	77%
Software subscriptions	401	292	109	37%
Amortization of intangible assets	392	277	115	42%
Data processing	372	411	(39)	9%
Insurance expense	319	273	46	17%
FDIC deposit insurance premiums	308	251	57	23%
Foreclosed assets	10	113	(103)	91%
Acquisition and integration related costs		688	(688)	100%
Other	1,925	2,081	(156)	7%
Total noninterest expense	\$ 14,296	\$ 16,419	\$ (2,123)	13%

	Nine Months Ended September 30,		Increase (Decrease) 2016 versus 2015	
	2016	2015	Amount	Percent
	(Dollars in thousands)			
Salaries and employee benefits(1)	\$ 26,052	\$ 26,112	\$ (60)	0%
Occupancy and equipment	3,277	3,135	142	5%
Professional fees	2,619	946	1,673	177%
Software subscriptions	1,118	883	235	27%
Amortization of intangible assets	1,176	655	521	80%
Data processing	1,143	950	193	20%
Insurance expense	924	855	69	8%
FDIC deposit insurance premiums	966	727	239	33%
Foreclosed assets	14	(93)	107	115%
Acquisition and integration related costs		1,265	(1,265)	100%
Other	6,073	5,877	196	3%
Total noninterest expense	\$ 43,362	\$ 41,312	\$ 2,050	5%

(1)

Salaries and employee benefits included pre-tax severance and retention costs related to the Focus transaction of \$2.2 million for the three months ended September 30, 2015, and \$2.9 million for the nine months ended September 30, 2015.



Table of Contents

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

*Noninterest Expense by Category*

	For the Three Months Ended September 30,			
	2016	Percent of Total	2015	Percent of Total
(Dollars in thousands)				
Salaries and employee benefits(1)	\$ 8,363	58%	\$ 10,358	63%
Occupancy and equipment	1,120	8%	1,063	6%
Professional fees	1,086	8%	612	4%
Software subscriptions	401	3%	292	2%
Amortization of intangible assets	392	3%	277	2%
Data processing	372	3%	411	2%
Insurance expense	319	2%	273	2%
FDIC deposit insurance premiums	308	2%	251	1%
Foreclosed assets	10	0%	113	1%
Acquisition and integration related costs		0%	688	4%
Other	1,925	13%	2,081	13%
Total noninterest expense	\$ 14,296	100%	\$ 16,419	100%

	For the Nine Months Ended September 30,			
	2016	Percent of Total	2015	Percent of Total
(Dollars in thousands)				
Salaries and employee benefits(1)	\$ 26,052	60%	\$ 26,112	63%
Occupancy and equipment	3,277	7%	3,135	8%
Professional fees	2,619	6%	946	2%
Software subscriptions	1,118	3%	883	2%
Amortization of intangible assets	1,176	3%	655	2%
Data processing	1,143	3%	950	2%
Insurance expense	924	2%	855	2%
FDIC deposit insurance premiums	966	2%	727	2%
Foreclosed assets	14	0%	(93)	0%
Acquisition and integration related costs		0%	1,265	3%
Other	6,073	14%	5,877	14%
Total noninterest expense	\$ 43,362	100%	\$ 41,312	100%

(1)

Salaries and employee benefits included pre-tax severance and retention costs related to the Focus transaction of \$2.2 million for the three months ended September 30, 2015, and \$2.9 million for the nine months ended September 30, 2015.

Total noninterest expense for the third quarter of 2016 was \$14.3 million, compared to \$16.4 million for the third quarter of 2015. The decrease in noninterest expense in the third quarter of 2016, compared to the third quarter of 2015, was primarily due to pre-tax acquisition,

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

severance and retention costs incurred by the Company related to the Focus transaction totaling \$2.9 million for the third quarter of 2015, which included severance and retention expense of \$2.2 million in salaries and employee benefits expense, and \$688,000 in other acquisition and integration costs. Noninterest expense

Table of Contents

for the nine months ended September 30, 2016 increased to \$43.4 million, compared to \$41.3 million for the nine months ended September 30, 2015, primarily due to additional employees retained from Focus and an increase in amortization of the core deposit intangible assets as a result of the Focus acquisition, annual salary increases, newly hired employees and higher professional fees. Professional fees were significantly lower for the first nine months ended September 30, 2015 due to recoveries of legal fees on problem loans that were paid off. These increases in noninterest expense for the nine months ended September 30, 2016 were partially offset by \$3.4 million of pre-tax acquisition, severance and retention costs incurred by the Company for the nine months ended September 30, 2015, which included severance and retention expense of \$2.2 million in salaries and employee benefits expense, and \$1.2 million in other acquisition and integration costs. Full time equivalent employees were 264, 272, and 260 at September 30, 2016, September 30, 2015, and December 31, 2015, respectively.

In the normal course of business the Company becomes a party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. These financial instruments include commitments to extend credit in the form of loans, commercial or standby letters of credit, and financial guarantees. These instruments represent varying degrees of exposure to risk in excess of the amounts included in the accompanying condensed consolidated balance sheets. The Company calculates an off-balance sheet credit risk reserve for all unfunded commitments.

**Income Tax Expense**

The Company computes its provision for income taxes on a monthly basis. The effective tax rate is determined by applying the Company's statutory income tax rates to pre-tax book income as adjusted for permanent differences between pre-tax book income and actual taxable income. These permanent differences include, but are not limited to, 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 the nine months ended September 30, 2016 was \$4.1 million and \$12.2 million, respectively. The income tax expense was \$2.2 million and \$7.3 million for the same periods in 2015. The following table shows the Company's effective income tax rates for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Effective income tax rate	37.5%	38.6%	37.6%	37.7%

The effective tax rate for the third quarter of 2016 was lower, compared to the third quarter of 2015, primarily due to the impact of non-deductible merger related expenses in the third quarter of 2015. 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.

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

Table of Contents

temporary differences and utilization of tax credit carryforwards and the net operating loss carryforwards for Federal and California state income tax purposes. The amount of deferred tax assets considered realizable is subject to adjustment in future periods based on estimates of future taxable income. Under generally accepted accounting principles a valuation allowance is required to be recognized if it is "more likely than not" that 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 \$20.3 million at September 30, 2016, and \$22.2 million at December 31, 2015. 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, 2016 and December 31, 2015 will be fully realized in future years.

***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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring originated by Bay View Funding.

<b>Three Months Ended September 30, 2016</b>			
	<b>Banking(1)</b>	<b>Factoring</b>	<b>Consolidated</b>
<b>(Dollars in thousands)</b>			
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
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

<b>Three Months Ended September 30, 2015</b>			
	<b>Banking(1)</b>	<b>Factoring</b>	<b>Consolidated</b>
<b>(Dollars in thousands)</b>			
Interest income	\$ 17,117	\$ 3,189	\$ 20,306
Intersegment interest allocations	280	(280)	
Total interest expense	623		623
Net interest income	16,774	2,909	19,683
Provision (credit) for loan losses	(291)	(10)	(301)
Net interest income after provision	17,065	2,919	19,984
Noninterest income	1,869	197	2,066
Noninterest expense	14,616	1,803	16,419
Intersegment expense allocations	112	(112)	
Income before income taxes	4,430	1,201	5,631
Income tax expense	1,668	504	2,172
Net income	\$ 2,762	\$ 697	\$ 3,459

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total assets	\$	2,204,963	\$	57,244	\$	2,262,207
Loans, net of deferred fees	\$	1,290,062	\$	42,343	\$	1,332,405
Goodwill	\$	31,854	\$	13,044	\$	44,898

---

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

---

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

	<b>Nine Months Ended September 30, 2016</b>		
	<b>Banking(1)</b>	<b>Factoring</b>	<b>Consolidated</b>
	<b>(Dollars in thousands)</b>		
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

	<b>Nine Months Ended September 30, 2015</b>		
	<b>Banking(1)</b>	<b>Factoring</b>	<b>Consolidated</b>
	<b>(Dollars in thousands)</b>		
Interest income	\$ 46,458	\$ 9,389	\$ 55,847
Intersegment interest allocations	822	(822)	
Total interest expense	1,664		1,664
Net interest income	45,616	8,567	54,183
Provision (credit) for loan losses	(328)	(11)	(339)
Net interest income after provision	45,944	8,578	54,522
Noninterest income	5,581	575	6,156
Noninterest expense	35,930	5,382	41,312
Intersegment expense allocations	266	(266)	
Income before income taxes	15,861	3,505	19,366
Income tax expense	5,820	1,472	7,292
Net income	\$ 10,041	\$ 2,033	\$ 12,074
Total assets	\$ 2,204,963	\$ 57,244	\$ 2,262,207
Loans, net of deferred fees	\$ 1,290,062	\$ 42,343	\$ 1,332,405

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Goodwill	\$	31,854	\$	13,044	\$	44,898
----------	----	--------	----	--------	----	--------

---

(1)

Includes the holding company's results of operations

---

*Banking.* Our banking segment's net income increased to \$6.3 million for the three months ended September 30, 2016, compared to net income of \$2.8 million for the three months ended September 30, 2015. For the nine months ended September 30, 2016, our banking segment's net income was \$18.5 million, compared to \$10.0 million for the nine months ended September 30, 2015. Net interest

Table of Contents

income increased to \$20.2 million for the three months ended September 30, 2016, compared to \$16.8 million for the three months ended September 30, 2015. For the nine months ended September 30, 2016, net interest income increased to \$59.8 million, compared to \$45.6 million for the nine months ended September 30, 2015. The increase in net interest income for the three months and nine months ended September 30, 2016, compared to the comparable periods in 2015, was primarily as a result of the Focus acquisition and organic growth in the loan portfolio and an increase in the average balance of investment securities. The provision for loan losses was \$237,000 for the three months ended September 30, 2016, compared to a credit provision for loan losses of \$291,000 for the three months ended September 30, 2015. For the nine months ended September 30, 2016, the provision for loan losses was \$949,000, compared with a credit provision for loan losses of \$328,000 for the nine months ended September 30, 2015. The increase in the provision for loan losses was primarily due to an increase in loan balances in the banking segment's commercial loan portfolio and one commercial relationship that went on nonaccrual during the third quarter, and was fully reserved for. Noninterest income increased to \$2.2 million for the three months ended September 30, 2016, compared to \$1.9 million for the three months ended September 30, 2015. Noninterest income increased to \$8.1 million for the nine months ended September 30, 2016, compared to \$5.6 million for the nine months ended September 30, 2015. Noninterest income for the third quarter and first nine months of 2016 increased compared to the respective periods in 2015, primarily due to a \$1.0 million gain from company owned life insurance and gains on sales of securities. Noninterest expense decreased to \$12.4 million for the three months ended September 30, 2016, compared to \$14.6 million for the three months ended September 30, 2015, primarily due to pre-tax acquisition, severance and retention costs incurred by the Company related to the Focus transaction totaling \$2.9 million for the third quarter of 2015. For the nine months ended September 30, 2016, noninterest expense was \$38.0 million, compared to \$35.9 million for the nine months ended September 30, 2015. The increase in noninterest expense for the nine months ended September 30, 2016, compared to the nine months ended September 30, 2015, was primarily due to additional employees retained from Focus, an increase in amortization of the core deposit intangible assets as a result of the Focus acquisition, annual salary increases and additional newly hired employees. The increase in noninterest expense for the nine months ended September 30, 2016 was partially offset by \$3.4 million of pre-tax acquisition, severance and retention costs incurred by the Company for the nine months ended September 30, 2015.

*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 or service and the incurrence of operating costs required to provide for such good or service. The average life of the factored receivables is 34 days. The balance of the purchased receivables as of September 30, 2016 and 2015 was \$47.8 million and \$42.3 million, respectively. Bay View Funding's net income was \$471,000 for the three months ended September 30, 2016, compared \$697,000 for the three months ended September 30, 2015. For the nine months ended September 30, 2016, Bay View Funding's net income was \$1.7 million, compared to \$2.0 million for the nine months ended September 30, 2015. Net interest income was \$2.8 million for the three months ended September 30, 2016, and \$2.9 million for the three months ended September 30, 2015. For the nine months ended September 30, 2016, net interest income was \$8.3 million, compared to \$8.6 million for the nine months ended September 30, 2015. The decrease in net interest income for the three months and nine months ended September 30, 2016, compared to the respective periods in 2015, was primarily due to a decrease in the average yield on the factored receivables portfolio, partially offset by an increase in the average balance of factored receivables outstanding. The provision for loan losses was \$8,000 for the three months ended September 30, 2016, compared to a credit provision for loan losses of \$10,000 for the three months ended September 30,

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

### Table of Contents

2015. For the nine months ended September 30, 2016, the provision for loan losses was \$48,000, compared to a credit provision for loan losses of \$11,000 for the nine months ended September 30, 2015. Noninterest income was \$152,000 for the three months ended September 30, 2016, compared to \$197,000 for the three months ended September 30, 2015. For the nine months ended September 30, 2016, noninterest income was \$517,000, compared to \$575,000 for the nine months ended September 30, 2015. Noninterest expense was \$1.9 million for the three months ended September 30, 2016, and \$1.8 million for the three months ended September 30, 2015. For the nine months ended September 30, 2016, noninterest expense was \$5.3 million, compared to \$5.4 million for the nine months ended September 30, 2015.

### **FINANCIAL CONDITION**

As of September 30, 2016, total assets increased to \$2.53 billion, compared to \$2.26 billion at September 30, 2015, and \$2.36 billion at December 31, 2015. Securities available-for-sale (at fair value) were \$370.0 million at September 30, 2016, an increase of 44% from \$257.4 million at September 30, 2015, and decreased 4% from \$385.1 million at December 31, 2015. Securities held-to-maturity (at amortized cost) were \$202.4 million at September 30, 2016, an increase of 82% from \$111.0 million at September 30, 2015, and an increase of 85% from \$109.3 million at December 31, 2015. Total loans (excluding loans held-for-sale) increased \$117.8 million, or 9%, to \$1.45 billion at September 30, 2016, compared to \$1.33 billion at September 30, 2015, which included an increase of \$68.5 million, or 5%, in the Company's legacy loan portfolio, and \$49.3 million of purchased residential mortgage loans. Loans increased \$91.5 million, or 7%, at September 30, 2016, compared to \$1.36 billion at December 31, 2015, which included an increase of \$42.2 million, or 3%, in the Company's legacy portfolio, and \$49.3 million of purchased residential mortgage loans.

Total deposits increased \$256.6 million, or 13%, to \$2.22 billion at September 30, 2016, compared to \$1.96 billion at September 30, 2015, and increased \$155.9 million, or 8%, from \$2.06 billion at December 31, 2015. Deposits excluding all time deposits and CDARS deposits increased \$291.2 million, or 17%, to \$1.98 billion at September 30, 2016, from \$1.69 billion at September 30, 2015, and increased \$166.2 million, or 9% from \$1.81 billion at December 31, 2015.

### ***Securities Portfolio***

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

	September 30,		December 31,	
	2016	2015	2015	
	(Dollars in thousands)			
<b>Securities available-for-sale (at fair value):</b>				
Agency mortgage-backed securities	\$ 352,552	\$ 170,399	\$	324,230
Trust preferred securities	16,425	15,000		15,132
Corporate bonds	1,022	36,608		6,673
Collateralized mortgage obligations		11,791		
U.S. Government sponsored entities		11,125		9,041
Municipals exempt from Federal tax		5,765		
U.S. Treasury		4,039		30,003
Municipals taxable		2,683		
<b>Total</b>	<b>\$ 369,999</b>	<b>\$ 257,410</b>	<b>\$</b>	<b>385,079</b>
<b>Securities held-to-maturity (at amortized cost):</b>				
Agency mortgage-backed securities	\$ 111,591	\$ 16,300	\$	15,793
Municipals exempt from Federal tax	90,813	94,704		93,518
<b>Total</b>	<b>\$ 202,404</b>	<b>\$ 111,004</b>	<b>\$</b>	<b>109,311</b>



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

### Table of Contents

The following table summarizes the weighted average life and weighted average yields of securities at September 30, 2016:

	Within One Year or Less		After One and Within Five Years		Weighted Average Life After Five and Within Ten Years		After Ten Years		Total		
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	
(Dollars in thousands)											
Securities available-for-sale (at fair value):											
Agency mortgage-backed securities	\$		\$ 333,154	2.07%	\$ 19,398	2.23%	\$		\$ 352,552	2.08%	
Trust preferred securities							16,425	5.95%	16,425	5.95%	
Corporate bonds			1,022	4.50%					1,022	4.50%	
<b>Total</b>	<b>\$</b>		<b>\$ 334,176</b>	<b>2.08%</b>	<b>\$ 19,398</b>	<b>2.23%</b>	<b>\$ 16,425</b>	<b>5.95%</b>	<b>\$ 369,999</b>	<b>2.26%</b>	
Securities held-to-maturity (at amortized cost):											
Agency mortgage-backed securities	\$	2,581	3.19%	\$ 98,557	1.60%	\$ 2,823	2.07%	\$ 7,630	3.26%	\$ 111,591	1.76%
Municipals exempt from Federal tax(1)		1,747	2.39%	39,676	3.80%	43,692	3.99%	5,698	3.67%	90,813	3.86%
<b>Total</b>	<b>\$</b>	<b>4,328</b>	<b>2.87%</b>	<b>\$ 138,233</b>	<b>2.23%</b>	<b>\$ 46,515</b>	<b>3.88%</b>	<b>\$ 13,328</b>	<b>3.44%</b>	<b>\$ 202,404</b>	<b>2.70%</b>

(1)

Reflects tax equivalent yield 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; and (iv) single entity issue trust preferred securities, which generally 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.

The investment securities available-for-sale portfolio totaled \$370.0 million at September 30, 2016, an increase of 44% from \$257.4 million at September 30, 2015, and decreased 4% from \$385.1 million at December 31, 2015. At September 30, 2016, the Company's securities available-for-sale portfolio was comprised of \$352.6 million agency mortgage-backed securities (all issued by U.S. Government sponsored entities), \$16.4 million of single entity issue trust preferred securities, and \$1.0 million of corporate bonds. The pre-tax unrealized gain on

securities available-for-sale at September 30, 2016 was

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

### Table of Contents

\$8.0 million, compared to a pre-tax unrealized gain on securities available-for-sale of \$4.5 million at September 30, 2015, and a pre-tax unrealized gain on securities available-for-sale of \$501,000 at December 31, 2015.

The Company received gross proceeds of \$49.2 million on investment securities available-for-sale it sold during the nine months ended September 30, 2016 with a book value totaling \$48.7 million, resulting in a gain on sale of securities of \$527,000. The \$48.7 million book value of investment securities sold included \$30.1 million of U.S. Treasury securities, \$9.0 million of U.S. Government sponsored entities, \$5.5 million of corporate bonds, and \$4.1 million of agency mortgage-backed securities.

During the nine months ended September 30, 2016, the Company purchased \$75.8 million of investment securities available-for-sale, which consisted of \$51.8 million of Federal Home Loan Mortgage Corporation ("FHLMC") securities, with an average book yield of 1.96%, and \$24.0 million of Federal National Mortgage Association ("FNMA") securities, with an average book yield of 1.95%.

At September 30, 2016, investment securities held-to-maturity totaled \$202.4 million, compared to \$111.0 million at September 30, 2015, and \$109.3 million at December 31, 2015. At September 30, 2016, the Company's securities held-to-maturity portfolio, at amortized cost, was comprised of \$111.6 million agency mortgage-backed securities, and \$90.8 million tax-exempt municipal bonds.

During the nine months ended September 30, 2016, the Company purchased \$31.3 million of Government National Mortgage Association ("GNMA") securities held-to-maturity, with an average book yield of 1.49%.

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 57% of total assets at September 30, 2016, represented 59% at September 30, 2015, and represented 58% at December 31, 2015. The ratio of loans to deposits was 65.36% at September 30, 2016, compared to 67.91% at September 30, 2015, and 65.87% at December 31, 2015.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

**Loan Distribution**

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

	September 30, 2016		September 30, 2015		December 31, 2015	
	Balance	% of Total	Balance	% of Total	Balance	% of Total
(Dollars in thousands)						
Commercial	\$ 606,281	42%	\$ 554,169	42%	\$ 556,522	41%
Real estate:						
Commercial	612,030	42%	606,819	45%	625,665	46%
Land and construction	88,371	6%	84,867	6%	84,428	6%
Home equity	76,536	5%	74,624	6%	76,833	6%
Residential mortgages	49,255	3%		0%		0%
Consumer	18,328	2%	12,595	1%	16,010	1%
Total loans	1,450,801	100%	1,333,074	100%	1,359,458	100%
Deferred loan (fees) costs, net	(625)		(669)		(742)	
Loans, including deferred fees and costs	1,450,176	100%	1,332,405	100%	1,358,716	100%
Allowance for loan losses	(20,032)		(18,737)		(18,926)	
Loans, net	\$ 1,430,144		\$ 1,313,668		\$ 1,339,790	

The Company's loan portfolio is concentrated in commercial loans, primarily manufacturing, wholesale, and services, and commercial real estate, with other portfolios in land development and construction, home equity and consumer loans. During the second and third quarters of 2016, the Company purchased jumbo single family residential mortgage loans totaling \$51.6 million, all of which are domiciled in California. The average loan principal amount is approximately \$834,000, and the weighted average yield on the portfolio is 3.00%, net of servicing fees to the servicer. Residential mortgages outstanding at September 30, 2016 totaled \$49.3 million. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 57% of its gross loans were secured by real property at September 30, 2016, and September 30, 2015, and 58% at December 31, 2015. 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.

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



Table of Contents

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, 2016, loans were sold resulting in a gain on sales of SBA loans of \$69,000, and \$653,000, 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 commercial loan portfolio increased \$49.8 million to \$606.3 million at September 30, 2016, compared to \$556.5 million at December 31, 2015, which was primarily the result of an increase of \$23.2 million in the asset-based lending portfolio, \$18.8 million in the C&I portfolio, and \$7.8 million in the factored receivables portfolio. C&I line usage increased to 41% at September 30, 2016, compared to 39% at December 31, 2015.

As of September 30, 2016, commercial real estate mortgage loans of \$612.0 million consist primarily of adjustable and fixed-rate loans secured by deeds of trust on commercial and residential property. The real estate mortgage loans at September 30, 2016, consist of \$266.1 million, or 43%, of commercial owner occupied properties, \$345.8 million, or 57%, of commercial investment properties, and \$91,000 of other properties. Properties securing the commercial real estate mortgage loans are generally located in the Greater San Francisco Bay Area, the Company's primary market.

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

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Construction loans are provided only in our market area, and the Company has extensive controls for the disbursement process. Land and construction loans increased \$3.5 million to \$88.4 million, at September 30, 2016, from \$84.9 million, at September 30, 2015. Land and construction loans increased \$3.9 million at September 30, 2016, from \$84.4 million at December 31, 2015.

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. Home equity lines are reviewed semi-annually, with specific emphasis on loans with a loan to value ratio greater than 70%. The Company takes measures to work with customers to reduce line commitments and minimize potential losses.

During the second and third quarters of 2016, the Company purchased jumbo single family residential mortgage loans totaling \$51.6 million, all of which are domiciled in California. The average loan principal amount is approximately \$834,000, and the weighted average yield on the portfolio is

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

### Table of Contents

3.00%, net of servicing fees to the servicer. Residential mortgages outstanding at September 30, 2016 totaled \$49.3 million.

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 \$41.7 million and \$69.6 million at September 30, 2016, respectively.

### *Loan Maturities*

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale) as of September 30, 2016. 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, 2016, approximately 57% of the Company's loan portfolio consisted of floating interest rate loans.

	Due in One Year or Less	Over One Year But Less than Five Years	Over Five Years	Total
(Dollars in thousands)				
Commercial	\$ 508,507	\$ 84,508	\$ 13,266	\$ 606,281
Real estate:				
Commercial	105,094	222,843	284,093	612,030
Land and construction	88,371			88,371
Home equity	70,060	1,637	4,839	76,536
Residential mortgages	1,226		48,029	49,255
Consumer	16,604	1,724		18,328
 Loans	 \$ 789,862	 \$ 310,712	 \$ 350,227	 \$ 1,450,801
 Loans with variable interest rates	 \$ 705,518	 \$ 65,081	 \$ 59,308	 \$ 829,907
Loans with fixed interest rates	84,344	245,631	290,919	620,894
 Loans	 \$ 789,862	 \$ 310,712	 \$ 350,227	 \$ 1,450,801

### *Loan Servicing*

As of September 30, 2016 and 2015, \$169.6 million and \$116.6 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,	
	2016	2015	2016	2015
(Dollars in thousands)				
Beginning of period balance	\$ 2,101	\$ 510	\$ 2,209	\$ 565
Additions	20	1,993	183	2,084
Amortization	(127)	(124)	(398)	(270)
 End of period balance	 \$ 1,994	 \$ 2,379	 \$ 1,994	 \$ 2,379



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, 2016 and 2015, 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 September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Beginning of period balance	\$ 1,154	\$ 1,441	\$ 1,367	\$ 1,481
Unrealized holding gain	(53)		(266)	(40)
End of period balance	\$ 1,101	\$ 1,441	\$ 1,101	\$ 1,441

**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 \$12.5 million and \$5.9 million at September 30, 2016 and December 31, 2015, respectively, of which \$2.2 million and \$591,000 were on nonaccrual. At September 30, 2016, there were also \$4.0 million loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2015, there were also \$4.1 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

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

### Table of Contents

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.

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

	September 30,		December 31,
	2016	2015	2015
	(Dollars in thousands)		
Nonaccrual loans-held-for-investment	\$ 4,496	\$ 5,503	\$ 4,716
Restructured and loans over 90 days past due and still accruing			1,662
<b>Total nonperforming loans</b>	<b>4,496</b>	<b>5,503</b>	<b>6,378</b>
Foreclosed assets	292	393	364
<b>Total nonperforming assets</b>	<b>\$ 4,788</b>	<b>\$ 5,896</b>	<b>\$ 6,742</b>
Nonperforming assets as a percentage of loans plus foreclosed assets	0.33%	0.44%	0.50%
Nonperforming assets as a percentage of total assets	0.19%	0.26%	0.29%

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

	September 30, 2016			December 31, 2015		
	Restructured and Loans Over 90 Days Past Due and Still Accruing			Restructured and Loans Over 90 Days Past Due and Still Accruing		
	Nonaccrual	Still Accruing	Total	Nonaccrual	Still Accruing	Total
	(Dollars in thousands)					
Commercial	\$ 3,577	\$	\$ 3,577	\$ 724	\$ 1,378	\$ 2,102
Real estate:						
Commercial	440		440	2,992		2,992
Land and construction	201		201	219		219
Home equity	275		275	777	284	1,061
Consumer	3		3	4		4
<b>Total</b>	<b>\$ 4,496</b>	<b>\$</b>	<b>\$ 4,496</b>	<b>\$ 4,716</b>	<b>\$ 1,662</b>	<b>\$ 6,378</b>

Nonperforming assets were \$4.8 million, or 0.19% of total assets, at September 30, 2016, compared to \$5.9 million, or 0.26% of total assets, at September 30, 2015, and \$6.7 million, or 0.29% of total assets, at December 31, 2015. Included in total nonperforming assets were foreclosed assets of \$292,000 at September 30, 2016, compared to \$393,000 at September 30, 2015, and \$364,000 at December 31, 2015.

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 \$18.4 million at September 30, 2016, \$17.6 million at September 30, 2015, and \$18.6 million at December 31, 2015. There were no loans held-for-sale included in classified loans at September 30, 2016, September 30, 2015, and December 31, 2015. Loans

held-for-sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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

	September 30, 2016			September 30, 2015			December 31, 2015		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total	Nonclassified	Classified	Total
(Dollars in thousands)									
Commercial	\$ 591,554	\$ 14,727	\$ 606,281	\$ 543,879	\$ 10,290	\$ 554,169	\$ 547,536	\$ 8,986	\$ 556,522
Real estate:									
Commercial	609,179	2,851	612,030	601,671	5,148	606,819	617,865	7,800	625,665
Land and construction	88,170	201	88,371	84,375	492	84,867	84,209	219	84,428
Home equity	75,931	605	76,536	73,286	1,338	74,624	75,511	1,322	76,833
Residential mortgages	49,255		49,255						
Consumer	18,311	17	18,328	12,279	316	12,595	15,705	305	16,010
Total	\$ 1,432,400	\$ 18,401	\$ 1,450,801	\$ 1,315,490	\$ 17,584	\$ 1,333,074	\$ 1,340,826	\$ 18,632	\$ 1,359,458

Classified commercial loans increased to \$14.7 million at September 30, 2016, from \$9.0 million at December 31, 2015, primarily due to commercial loan downgrades in excess of upgrades during the nine months ended September 30, 2016. Classified commercial real estate loans decreased to \$2.9 million at September 30, 2016, compared to December 31, 2015, mainly as a result of upgrades and payoffs in the commercial real estate loan portfolio.

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

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

	Nine Months Ended September 30, 2015		
	Performing TDRs	Nonperforming TDRs	Total
(Dollars in thousands)			
Balance at January 1, 2015	\$ 167	\$ 916	\$ 1,083
Principal repayments	16	(912)	(896)
Balance at September 30, 2015	\$ 183	\$ 4	\$ 187

**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

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

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

Table of Contents

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 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.

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

### Table of Contents

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:

	<b>Three Months Ended September 30, 2016</b>			
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
Balance, beginning of period	\$ 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
Balance, end of period	\$ 12,181	\$ 7,763	\$ 88	\$ 20,032

#### **RATIOS:**

Annualized net charge-offs to average loans(1)	0.04%	0.00%	0.00%	0.04%
Allowance for loan losses to nonperforming loans	270.93%	172.66%	1.96%	445.55%

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

	<b>Three Months Ended September 30, 2015</b>			
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
Balance, beginning of period	\$ 11,193	\$ 7,450	\$ 114	\$ 18,757
Charge-offs	(8)		(9)	(17)
Recoveries	284	14		298
Net (charge-offs) recoveries	276	14	(9)	281
Provision (credit) for loan losses	(941)	672	(32)	(301)
Balance, end of period	\$ 10,528	\$ 8,136	\$ 73	\$ 18,737

#### **RATIOS:**

Annualized net charge-offs (recoveries) to average loans(1)	0.09%	0.00%	0.00%	0.09%
Allowance for loan losses to nonperforming loans	191.31%	147.85%	1.33%	340.49%

(1)

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

---

85

---

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

	Nine Months Ended September 30, 2016			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 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
Balance, end of period	\$ 12,181	\$ 7,763	\$ 88	\$ 20,032

**RATIOS:**

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

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

	Nine Months Ended September 30, 2015			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 11,187	\$ 7,070	\$ 122	\$ 18,379
Charge-offs	(229)	(2)	(9)	(240)
Recoveries	766	141	30	937
Net recoveries	537	139	21	697
Provision (credit) for loan losses	(1,196)	927	(70)	(339)
Balance, end of period	\$ 10,528	\$ 8,136	\$ 73	\$ 18,737

**RATIOS:**

Annualized net charge-offs (recoveries) to average loans(1)	0.06%	0.02%	0.00%	0.08%
Allowance for loan losses to nonperforming loans	191.31%	147.85%	1.33%	340.49%

(1) 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,					
	2016		2015		December 31, 2015	
	Allowance	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
(Dollars in thousands)						
Commercial	\$ 12,181	42%	\$ 10,528	42%	\$ 10,748	41%
Real estate:						
Commercial	4,704	42%	5,094	45%	4,980	46%
Land and construction	1,367	6%	1,571	6%	1,504	6%
Home equity	1,496	5%	1,471	6%	1,592	6%
Residential mortgages	196	3%		0%		0%
Consumer	88	2%	73	1%	102	1%
Total	\$ 20,032	100%	\$ 18,737	100%	\$ 18,926	100%

The allowance for loan losses totaled \$20.0 million, or 1.38% of total loans at September 30, 2016, compared to \$18.7 million, or 1.41% of total loans at September 30, 2015, and \$18.9 million, or 1.39% of total loans at December 31, 2015. The Company had net charge-offs of \$134,000, or 0.04% of average loans, for the third quarter of 2016, compared to net recoveries of \$281,000, or 0.09% of average loans, for the third quarter of 2015, and net recoveries of \$515,000, or 0.04% of average loans, for the fourth quarter of 2015.

The allowance for loan losses related to the commercial portfolio increased \$1.4 million, at September 30, 2016 from December 31, 2015, primarily due to an increase in commercial loans outstanding and net charge-offs of \$118,000, resulting in a provision to the allowance for loan losses of \$1.5 million. The allowance for loan losses balance attributed to commercial loans individually evaluated for impairment increased to \$1.7 million at September 30, 2016, from \$174,000 at December 31, 2015, primarily due to one commercial relationship that went on nonaccrual during the third quarter of 2016, which was fully reserved for. The allowance for loan losses related to the real estate portfolio decreased \$313,000 at September 30, 2016 from December 31, 2015, as a result of net recoveries of \$227,000, partially offset by a credit provision for loan losses of \$540,000, as a result of improving credit quality factors.

***Goodwill and Other Intangible Assets***

On November 1, 2014, estimated goodwill of \$13.0 million resulted from the acquisition 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, 2016 and December 31, 2015 was \$45.6 million, which was consisted of \$32.6 million related to the Focus acquisition, and \$13.0 million related to the Bay View Funding 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, than 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

Table of Contents

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 tests goodwill for impairment on an annual basis as of November 30. Goodwill is also tested for impairment on an interim basis if an event occurs or circumstances change between annual tests that would more-likely-than-not reduce the fair value of the reporting unit below its carrying value. The Company completed its annual impairment analysis on the goodwill as of November 30, 2015 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, 2015. As such, no impairment was indicated and no further testing was required.

Other intangible assets were \$7.3 million at September 30, 2016, compared to \$8.5 million at December 31, 2015. Core deposit and customer relationship intangible assets arising from the acquisition of Diablo Valley Bank in June 2007 were \$301,000 at September 30, 2016 and \$621,000 at December 31, 2015, net of accumulated amortization. The core deposit intangible asset arising from the acquisition of Focus was \$5.4 million at September 30, 2016 and \$6.0 million at December 31, 2015, 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 \$1.7 million at September 30, 2016 and \$1.9 million at December 31, 2015, 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, 2016		September 30, 2015		December 31, 2015	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
(Dollars in thousands)						
Demand, noninterest-bearing	\$ 889,075	40%	\$ 758,440	39%	\$ 821,405	40%
Demand, interest-bearing	536,541	24%	440,517	22%	496,278	24%
Savings and money market	555,156	24%	490,572	25%	496,843	24%
Time deposits under \$250	57,718	2%	65,629	3%	62,026	3%
Time deposits \$250 and over	169,485	8%	174,700	9%	160,815	8%
Time deposits brokered	3,000	1%	24,150	1%	17,825	1%
CDARS money market and time deposits	7,659	1%	8,015	1%	7,583	0%
Total deposits	\$ 2,218,634	100%	\$ 1,962,023	100%	\$ 2,062,775	100%

Table of Contents

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 4% of deposits at September 30, 2016, and 5% at September 30, 2015, and 4% at December 31, 2015.

Total deposits increased \$256.6 million, or 13%, to \$2.22 billion at September 30, 2016, compared to \$1.96 billion at September 30, 2015, and increased \$155.9 million, or 8%, at September 30, 2016, compared to \$2.06 billion at December 31, 2015. Noninterest-bearing demand deposits increased \$130.6 million at September 30, 2016 from September 30, 2015, and increased \$67.7 million from December 31, 2015. Interest-bearing demand deposits increased \$96.0 million at September 30, 2016 from September 30, 2015, and increased \$40.3 million from December 31, 2015. Savings and money market deposits increased \$64.6 million at September 30, 2016 from September 30, 2015, and increased \$58.3 million from December 31, 2015. Brokered deposits decreased \$21.2 million at September 30, 2016 from September 30, 2015, and decreased \$14.8 million from December 31, 2015. Deposits excluding all time deposits and CDARS deposits increased \$291.2 million, or 17%, to \$1.98 billion at September 30, 2016, from \$1.69 billion at September 30, 2015, and increased \$166.2 million, or 9%, from \$1.81 billion at December 31, 2015.

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 September 30, 2015, the Company had \$108.8 million (at fair value) of securities pledged for \$98.0 million in certificates of deposits from the State of California. At December 31, 2015, the Company had \$93.0 million (at fair value) of securities pledged for \$78.0 million in certificates of deposits from the State of California.

CDARS deposits were comprised of \$4.1 million of money market accounts and \$3.6 million of time deposits at September 30, 2016. CDARS deposits were comprised of \$2.9 million of money market accounts and \$5.1 million of time deposits at September 30, 2015. CDARS deposits were comprised of \$3.4 million of money market accounts and \$4.2 million of time deposits at December 31, 2015.

The following table indicates the contractual maturity schedule of the Company's time deposits of \$250,000 and over, and all CDARS time deposits and brokered deposits as of September 30, 2016:

	<b>Balance</b>	<b>% of Total</b>
	<b>(Dollars in thousands)</b>	
Three months or less	\$ 74,474	42%
Over three months through six months	66,294	38%
Over six months through twelve months	26,280	15%
Over twelve months	9,527	5%
<b>Total</b>	<b>\$ 176,575</b>	<b>100%</b>

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.

Table of Contents**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 Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Annualized return on average assets	1.11%	0.70%	1.13%	0.92%
Annualized return on average tangible assets	1.13%	0.71%	1.16%	0.93%
Annualized return on average equity	10.38%	6.41%	10.61%	8.25%
Annualized return on average tangible equity	13.06%	7.46%	13.45%	9.22%
Average equity to average assets ratio	10.67%	10.95%	10.68%	11.17%

**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 \$601.1 million at September 30, 2016, compared to \$579.0 million at September 30, 2015, and \$573.7 million at December 31, 2015. Unused commitments represented 41% outstanding gross loans at September 30, 2016, 43% outstanding gross loans at September 30, 2015, and 42% at December 31, 2015.

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,					
	2016		2015		December 31, 2015	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)					
Unused lines of credit and commitments to make loans	\$ 18,748	\$ 566,902	\$ 18,082	\$ 548,361	\$ 16,917	\$ 539,897
Standby letters of credit	3,479	12,019	3,402	8,569	3,402	13,458
	\$ 22,227	\$ 578,921	\$ 21,484	\$ 556,930	\$ 20,319	\$ 553,355

**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

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

### Table of Contents

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.

The loan to deposit ratio is one of the measures we analyze for liquidity. Our loan to deposit ratio was 65.36% at September 30, 2016, compared to 67.91% at September 30, 2015, and 65.87% at December 31, 2015.

### ***FHLB and FRB Borrowings and Available Lines of Credit***

The Company has off-balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. The Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. The Company had no overnight borrowings from the FHLB at September 30, 2016, September 30, 2015 and December 31, 2015. The Company had \$219.5 million of loans pledged to the FHLB as collateral on an available line of credit of \$182.4 million at September 30, 2016.

The Company can also borrow from the FRB's discount window. The Company had \$479.3 million of loans pledged to the FRB as collateral on an available line of credit of \$314.9 million at September 30, 2016, none of which was outstanding.

At September 30, 2016, the Company had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at September 30, 2016, September 30, 2015, and December 31, 2015.

The Company has a \$5.0 million line of credit with a correspondent bank, of which none was outstanding at September 30, 2016.

The Company may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase at September 30, 2016, September 30, 2015, and December 31, 2015.

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

	September 30,		December 31,	
	2016	2015	2015	
	(Dollars in thousands)			
Average balance year-to-date	\$ 558	\$ 36	\$ 578	
Average interest rate year-to-date	2.57%	0.36%	3.14%	
Maximum month-end balance during the quarter	\$ 1,000	\$ 3,000		
Average rate at period-end	N/A	N/A	3.00%	

### ***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.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of the consolidated Company under the Basel III requirements as of September 30, 2016, September 30, 2015 and December 31, 2015:

	September 30, 2016	September 30, 2015	December 31, 2015
(Dollars in thousands)			
<b>Capital components:</b>			
Common equity Tier 1 capital	\$ 210,021	\$ 180,353	\$ 181,222
Additional Tier 1 capital		17,367	18,077
Tier 1 capital	210,021	197,720	199,299
Tier 2 capital	20,676	19,480	19,616
Total risk-based capital	\$ 230,697	\$ 217,200	\$ 218,915
Risk-weighted assets	\$ 1,812,623	\$ 1,763,709	\$ 1,750,515
Average assets for capital purposes	\$ 2,370,179	\$ 1,901,985	\$ 2,322,940
<b>Capital ratios:</b>			
Total risk-based capital	12.7%	12.3%	12.5%
Tier 1 risk-based capital	11.6%	11.2%	11.4%
Common equity Tier 1 risk-based capital	11.6%	10.2%	10.4%
Leverage(1)	8.9%	10.4%	8.6%

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

The following table summarizes risk based capital, risk weighted assets, and risk based capital ratios of HBC under the Basel III requirements as of September 30, 2016, of September 30, 2015 and December 31, 2015:

	September 30, 2016	September 30, 2015	December 31, 2015
(Dollars in thousands)			
<b>Capital components:</b>			
Common equity Tier 1 capital	\$ 207,070	\$ 194,039	\$ 200,327
Additional Tier 1 capital			
Tier 1 capital	207,070	194,039	200,327
Tier 2 capital	20,676	19,480	19,616
Total risk-based capital	\$ 227,746	\$ 213,519	\$ 219,943
Risk-weighted assets	\$ 1,812,204	\$ 1,760,434	\$ 1,750,222
Average assets for capital purposes	\$ 2,369,430	\$ 1,900,304	\$ 2,322,232
<b>Capital ratios:</b>			
Total risk-based capital	12.6%	12.1%	12.6%
Tier 1 risk-based capital	11.4%	11.0%	11.4%
Common equity Tier 1 risk-based capital	11.4%	11.0%	11.4%
Leverage(1)	8.7%	10.2%	8.6%

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

---

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

### Table of Contents

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

<b>Capital Ratios</b>	<b>Transitional Minimum Regulatory Requirement(1) Effective January 1, 2016</b>	<b>Fully Phased-in Minimum Regulatory Requirement(2) Effective January 1, 2019</b>	<b>Well-capitalized Financial Institution Regulatory Guidelines</b>
Total Risk-Based	8.625%	10.5%	10.0%
Tier 1 Risk-Based	6.625%	8.5%	8.0%
Common Equity Tier 1 Risk-based	5.125%	7.0%	6.5%
Leverage	4.000%	4.0%	5.0%

(1) Includes 0.625% 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 Company's common equity Tier 1 risk-based capital ratio increased at September 30, 2016, compared to September 30, 2015, and December 31, 2015, primarily due to the conversion 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 during the third quarter of 2016, as discussed below. The conversion of the Company's Series C Preferred Stock into common stock had no effect on HBC's common equity Tier 1 risk-based capital ratio. During the third, second and first quarters of 2016, HBC distributed dividends of \$4.0 million, \$4.0 million, and \$6.0 million, respectively, for a total of \$14.0 million for the first nine months of 2016.

At September 30, 2016, 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, 2016, September 30, 2015, and December 31, 2015, the Company and HBC met all capital adequacy guidelines to which they were subject. There are no conditions or events since September 30, 2016, that management believes have changed the categorization of the Company or HBC as well-capitalized.

At September 30, 2016, the Company had total shareholders' equity of \$261.3 million, compared to \$248.0 million at September 30, 2015, and \$245.4 million at December 31, 2015. At September 30, 2016, total shareholders' equity included \$214.6 million in common stock, \$48.7 million in retained earnings, and (\$2.0) million of accumulated other comprehensive loss.

Table of Contents

The accumulated other comprehensive loss was (\$2.0) million at September 30, 2016, compared to accumulated other comprehensive loss of (\$2.0) million at September 30, 2015, and an accumulated other comprehensive loss of (\$6.2) million at December 31, 2015. The unrealized gain on securities available-for-sale, net of taxes, included in accumulated other comprehensive loss was an unrealized gain of \$4.7 million, at September 30, 2016, compared to an unrealized gain of \$2.6 million, at September 30, 2015, and an unrealized gain of \$296,000, at December 31, 2015. The components of accumulated other comprehensive loss, net of taxes, at September 30, 2016 include the following: an unrealized gain on available-for-sale securities of \$4.7 million; the remaining unamortized unrealized gain on securities available-for-sale transferred to held-to-maturity of \$342,000; a split dollar insurance contracts liability of (\$3.6) million; a supplemental executive retirement plan liability of (\$4.0) million; and an unrealized gain on interest-only strip from SBA loans of \$639,000.

***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 21,003.75 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.

As a result of the exchange transaction, the Company had 37,915,736 shares of common stock issued and outstanding on September 30, 2016. Castle Creek owns 3,763,225 shares, or 9.9% of the issued and outstanding shares; and Patriot Financial and Patriot Parallel own together 4,437,204 shares, or 11.7% of the issued and outstanding shares. 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, 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.

The book value per common share was \$6.89 at September 30, 2016, compared to \$7.12 at September 30, 2015, and \$7.03 at December 31, 2015. The tangible book value per common share was \$5.49 at September 30, 2016, compared to \$5.44 at September 30, 2015, and \$5.35 at December 31, 2015. On a full conversion of the Series C Preferred stock into common stock at September 30, 2015, and December 31, 2015: (i) the book value per common share would have been reduced to \$6.58 and \$6.51, respectively; and (ii) the tangible book value per common share would have been reduced to \$5.15 and \$5.07, respectively.

**Market Risk**

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

**Interest Rate Management**

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

Table of Contents

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, 2016. Computations of prospective effects of hypothetical interest rate changes are based

Table of Contents

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.

	<b>Increase/(Decrease) in Estimated Net Interest Income</b>	
	<b>Amount</b>	<b>Percent</b>
	<b>(Dollars in thousands)</b>	
<b>Change in Interest Rates (basis points)</b>		
+400	\$ 29,225	32.9%
+300	\$ 23,075	26.0%
+200	\$ 16,670	18.8%
+100	\$ 9,433	10.6%
0	\$	0.0%
100	\$ (11,363)	12.8%
200	\$ (21,663)	24.4%

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, 2016. 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

Table of Contents

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, 2016, the period covered by this report on Form 10-Q.

During the three and nine months ended September 30, 2016, 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, 2015, which could materially affect our business, financial condition and/or operating results. There were no material changes from risk factors previously disclosed in our 2015 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**

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 21,003.75 shares of the Company's Series C convertible perpetual preferred stock, no par value, ("Preferred Stock") for 5,601,000 shares of the Company's common stock, no par value. The common stock issued upon exchange of the Preferred Stock was offered and exchanged with the Preferred Stockholders in reliance on exemptions from registration provided by Sections 3(a)(9) and 18(b)(4) of the Securities Act of 1933, as amended ("Securities Act"). The Company did not receive any proceeds as a result of the exchange.

**ITEM 3 DEFAULTS UPON SENIOR SECURITIES**

None

**ITEM 4 MINE SAFETY DISCLOSURES**

None

**ITEM 5 OTHER INFORMATION**

None

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

### Table of Contents

#### ITEM 6 EXHIBITS

<b>Exhibit</b>	<b>Description</b>
3.1	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 4, 2010)
3.2	Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp as filed with the California Secretary of State on June 1, 2010 (incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-1 filed July 23, 2010).
3.3	Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 28, 2013)
10.1	Exchange Agreement, dated September 12, 2016, by and between Heritage Commerce Corp and Patriot Financial Partners, L.P. (incorporated by reference to the Registrant's Current Report on Form 8-K filed September 12, 2016)
10.2	Exchange Agreement, dated September 12, 2016, by and between Heritage Commerce Corp and Patriot Financial Partners Parallel, L.P. (incorporated by reference to the Registrant's Current Report on Form 8-K filed September 12, 2016)
10.3	Exchange Agreement, dated September 12, 2016, by and between Heritage Commerce Corp and Castle Creek Capital Partners IV, LP (incorporated by reference to the Registrant's Current Report on Form 8-K filed September 12, 2016)
31.1	Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350
32.2	Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350
101.INS	XBRL Instance Document, furnished herewith
101.SCH	XBRL Taxonomy Extension Schema Document, furnished herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, furnished herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, furnished herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, furnished herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, furnished herewith

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.

Date: November 4, 2016

Heritage Commerce Corp (Registrant)

/s/ WALTER T. KACZMAREK

---

Walter T. Kaczmarek  
*Chief Executive Officer*

Date: November 4, 2016

/s/ LAWRENCE D. MCGOVERN

---

Lawrence D. McGovern  
*Chief Financial Officer*

100

---

Table of Contents

**EXHIBIT INDEX**

<b>Exhibit</b>	<b>Description</b>
3.1	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 4, 2010)
3.2	Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp as filed with the California Secretary of State on June 1, 2010 (incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-1 filed July 23, 2010).
3.3	Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 28, 2013)
10.1	Exchange Agreement, dated September 12, 2016, by and between Heritage Commerce Corp and Patriot Financial Partners, L.P. (incorporated by reference to the Registrant's Current Report on Form 8-K filed September 12, 2016)
10.2	Exchange Agreement, dated September 12, 2016, by and between Heritage Commerce Corp and Patriot Financial Partners Parallel, L.P. (incorporated by reference to the Registrant's Current Report on Form 8-K filed September 12, 2016)
10.3	Exchange Agreement, dated September 12, 2016, by and between Heritage Commerce Corp and Castle Creek Capital Partners IV, LP (incorporated by reference to the Registrant's Current Report on Form 8-K filed September 12, 2016)
31.1	Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350
32.2	Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350
101.INS	XBRL Instance Document, herewith
101.SCH	XBRL Taxonomy Extension Schema Document, herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, herewith