

HERITAGE COMMERCE CORP  
Form 10-Q  
May 09, 2011

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 March 31, 2011**

**OR**

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

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

**Heritage Commerce Corp**

(Exact name of Registrant as Specified in its Charter)

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

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

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

**95113**  
(Zip Code)

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

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

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

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

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

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

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

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

The Registrant had 26,233,001 shares of Common Stock outstanding on April 15, 2011.

---

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>	<b><u>3</u></b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<b><u>Item 1.</u></b> <b><u>Consolidated Financial Statements (unaudited):</u></b>	<b><u>5</u></b>
<u>Consolidated Balance Sheets</u>	<u>5</u>
<u>Consolidated Statements of Operations</u>	<u>6</u>
<u>Consolidated Statement of Changes in Shareholders' Equity</u>	<u>7</u>
<u>Consolidated Statements of Cash Flows</u>	<u>8</u>
<u>Notes to Consolidated Financial Statements</u>	<u>9</u>
<b><u>Item 2.</u></b> <b><u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	<b><u>29</u></b>
<b><u>Item 3.</u></b> <b><u>Quantitative and Qualitative Disclosures About Market Risk</u></b>	<b><u>58</u></b>
<b><u>Item 4.</u></b> <b><u>Controls and Procedures</u></b>	<b><u>58</u></b>
<b><u>PART II. OTHER INFORMATION</u></b>	
<b><u>Item 1.</u></b> <b><u>Legal Proceedings</u></b>	<b><u>60</u></b>
<b><u>Item 1A.</u></b> <b><u>Risk Factors</u></b>	<b><u>60</u></b>
<b><u>Item 2.</u></b> <b><u>Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	<b><u>60</u></b>
<b><u>Item 3.</u></b> <b><u>Defaults Upon Senior Securities</u></b>	<b><u>60</u></b>
<b><u>Item 4.</u></b> <b><u>Reserved</u></b>	<b><u>60</u></b>
<b><u>Item 5.</u></b> <b><u>Other Information</u></b>	<b><u>60</u></b>
<b><u>Item 6.</u></b> <b><u>Exhibits</u></b>	<b><u>61</u></b>
<b><u>SIGNATURES</u></b>	<b><u>62</u></b>
<b><u>EXHIBIT INDEX</u></b>	<b><u>63</u></b>

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, and Section 21E of the Securities Exchange Act of 1934, as amended, 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:

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

Local, regional, and national economic conditions and events and the impact they may have on us and our customers, and our assessment of that impact on our estimates including, the allowance for loan losses;

Risks associated with concentrations in real estate related loans;

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;

Stability of funding sources and continued availability of borrowings;

Our compliance with and the effects of the regulatory Written Agreement the Company and Heritage Bank of Commerce, its subsidiary bank, have entered into with their regulators;

The effect of changes in laws and regulations with which the Company and Heritage Bank of Commerce must comply, including any increase in FDIC insurance premiums;

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;

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

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

The impact of the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009 and related rules and regulations on our business operations and competitiveness, including the impact of executive compensation restrictions, which may affect our ability to retain and recruit executives in competition with other firms who do not operate under those restrictions;

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

### Table of Contents

The impact of the Dodd Frank Wall Street Reform and Consumer Protection Act signed by President Obama on July 21, 2010;

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;

Changes in the deferred tax asset valuation allowance in future quarters;

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 ability to increase market share and control expenses; and

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

We are not able to predict all the factors that may affect future results. You should not place undue reliance on any forward looking statement, which speaks only as of the date of this Report on Form 10-K. 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)**

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
	<b>(Dollars in thousands, except per share data)</b>	
<b>Assets</b>		
Cash and due from banks	\$ 18,928	\$ 7,692
Interest-bearing deposits in other financial institutions	88,540	64,485
Total cash and cash equivalents	107,468	72,177
Securities available-for-sale, at fair value	250,132	232,165
Loans held-for-sale SBA, at lower of cost or market, including deferred costs	7,141	8,750
Loans held-for-sale other, at lower of cost or market, including deferred costs	2,223	2,260
Loans, including deferred costs	803,350	846,049
Allowance for loan losses	(24,009)	(25,204)
Loans, net	779,341	820,845
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	9,038	9,174
Company owned life insurance	44,107	43,682
Premises and equipment, net	8,219	8,397
Intangible assets	2,884	3,014
Accrued interest receivable and other assets	44,857	45,905
Total assets	\$ 1,255,410	\$ 1,246,369
<b>Liabilities and Shareholders' Equity</b>		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 325,058	\$ 280,258
Demand, interest-bearing	135,903	153,917
Savings and money market	262,763	272,399
Time deposits under \$100	32,592	33,499
Time deposits \$100 and over	128,156	137,514
Time deposits CDARS	21,025	17,864
Time deposits brokered	97,826	98,467
Total deposits	1,003,323	993,918
Securities sold under agreement to repurchase		5,000
Subordinated debt	23,702	23,702
Short-term borrowings	2,174	2,445
Accrued interest payable and other liabilities	42,979	39,152
Total liabilities	1,072,178	1,064,217
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		
Series A fixed rate cumulative preferred stock, 40,000 shares issued and outstanding (liquidation preference of \$43,310 at March 31, 2011 and	39,846	39,846

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

\$42,810 at December 31, 2010)		
Discount on Series A preferred stock	(1,131)	(1,227)
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at March 31, 2011 and December 31, 2010 (liquidation preference of \$21,004 at March 31, 2011 and December 31, 2010)	19,519	19,519
Common stock, no par value; 60,000,000 shares authorized; 26,233,001 shares issued and outstanding at March 31, 2011 and December 31, 2010	130,682	130,531
Accumulated deficit	(881)	(1,866)
Accumulated other comprehensive loss	(4,803)	(4,651)
<b>Total shareholders' equity</b>	<b>183,232</b>	<b>182,152</b>
Total liabilities and shareholders' equity	\$ 1,255,410	\$ 1,246,369

See notes to consolidated financial statements



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

Three Months Ended March 31,

2011 2010

(Dollars in thousands, except per share data)

Interest income:		
Loans, including fees	\$ 10,989	\$ 13,174
Securities, taxable	1,963	1,162
Interest-bearing deposits in other financial institutions	34	10
<b>Total interest income</b>	<b>12,986</b>	<b>14,346</b>
Interest expense:		
Deposits	1,271	2,364
Subordinated debt	466	466
Repurchase agreements	24	131
Short-term borrowings	29	16
<b>Total interest expense</b>	<b>1,790</b>	<b>2,977</b>
Net interest income before provision for loan losses	11,196	11,369
Provision for loan losses	770	5,095
Net interest income after provision for loan losses	10,426	6,274
Noninterest income:		
Service charges and fees on deposit accounts	567	548
Increase in cash surrender value of life insurance	425	409
Servicing income	411	421
Gain on sales of SBA loans	379	114
Other	135	192
<b>Total noninterest income</b>	<b>1,917</b>	<b>1,684</b>
Noninterest expense:		
Salaries and employee benefits	5,393	5,881
Occupancy and equipment	1,038	959
Professional fees	839	1,278
FDIC deposit insurance premiums	524	1,191
Software subscriptions	255	234
Insurance expense	241	256
Data processing	220	212
Low income housing investment losses	162	225
Other real estate owned expense	21	418
Other	1,738	1,544
<b>Total noninterest expense</b>	<b>10,431</b>	<b>12,198</b>
Income (loss) before income taxes	1,912	(4,240)
Income tax expense (benefit)	331	(120)
Net income (loss)	1,581	(4,120)

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Dividends and discount accretion on preferred stock	(596)	(591)
Net income (loss) allocable to common shareholders	\$ 985	\$ (4,711)
Earnings (loss) per common share:		
Basic	\$ 0.03	\$ (0.40)
Diluted	\$ 0.03	\$ (0.40)

See notes to consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)**

	Preferred Stock			Common Stock		Retained	Accumulated	Total	Comprehensive
	Shares	Amount	Discount	Shares	Amount	Earnings (Accumulated)	Other Comprehensive Income (Loss)		
(Dollars in thousands, except share data)									
<b>Balance, January 1, 2010</b>	40,000	\$ 39,846	\$ (1,598)	11,820,509	\$ 80,222	\$ 56,389	\$ (2,554)	\$ 172,305	
Net loss						(4,120)		(4,120)	\$ (4,120)
Net change in unrealized gain/loss on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes							127	127	127
Net change in pension and other postretirement obligations, net of deferred income taxes							15	15	15
<b>Total comprehensive loss</b>									\$ (3,978)
Amortization of restricted stock award, net of forfeitures and taxes					(36)			(36)	
Cash dividends accrued on preferred stock						(500)		(500)	
Accretion of discount on preferred stock			91			(91)			
Stock option expense, net of forfeitures and taxes					298			298	
<b>Balance, March 31, 2010</b>	40,000	\$ 39,846	\$ (1,507)	11,820,509	\$ 80,484	\$ 51,678	\$ (2,412)	\$ 168,089	
<b>Balance, January 1, 2011</b>	61,004	\$ 59,365	\$ (1,227)	26,233,001	\$ 130,531	\$ (1,866)	\$ (4,651)	\$ 182,152	
Net income						1,581		1,581	\$ 1,581
Net change in unrealized gain/(loss) on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes							(213)	(213)	(213)
Net change in pension and other postretirement obligations, net of							61	61	61

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

deferred income taxes

Total comprehensive income									\$ 1,429
Amortization of restricted stock awards, net of forfeitures and taxes				(36)					(36)
Cash dividends accrued on Series A preferred stock						(500)			(500)
Accretion of discount on Series A preferred stock			96			(96)			
Stock option expense, net of forfeitures and taxes							187		187
<b>Balance, March 31, 2011</b>	61,004	\$ 59,365	\$ (1,131)	26,233,001	\$ 130,682	\$ (881)	\$ (4,803)	\$	183,232

See notes to consolidated financial statements

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

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(Dollars in thousands)</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ 1,581	\$ (4,120)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization (accretion) of discounts and premiums on securities	271	(224)
Gain on sale of SBA loans	(379)	(114)
Proceeds from sale of SBA loans originated for sale	4,710	2,414
Net change in SBA loans originated for sale	(2,830)	(4,354)
Writedowns on other loans held-for-sale	29	
Provision for loan losses	770	5,095
Increase in cash surrender value of life insurance	(425)	(409)
Depreciation and amortization	197	202
Amortization of other intangible assets	130	144
Writedowns and (gains)/losses on sale of foreclosed assets, net	(10)	406
Stock option expense, net	187	298
Amortization of restricted stock awards, net	(36)	(36)
Effect of changes in:		
Accrued interest receivable and other assets	874	2,994
Accrued interest payable and other liabilities	(4,799)	(3,055)
Net cash provided by (used in) operating activities	270	(759)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of securities available-for-sale	(18,339)	(25,100)
Maturities/paydowns/calls of securities available-for-sale	7,872	4,351
Net change in SBA loans previously transferred to held-for-sale		(269)
Net change in other loans transferred to held-for-sale	8	
Net change in loans	39,924	58,274
Changes in Federal Home Loan Bank stock and other investments	136	
Purchase of premises and equipment	(19)	(57)
Proceeds from sale of foreclosed assets	1,305	
Purchase of restricted stock and other investments		(9)
Net cash provided by investing activities	30,887	37,190
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net change in deposits	9,405	(7,590)
Net change in securities sold under agreement to repurchase	(5,000)	(5,000)
Net change in short-term borrowings	(271)	(16,108)
Net cash provided by (used in) financing activities	4,134	(28,698)
Net increase in cash and cash equivalents	35,291	7,733
Cash and cash equivalents, beginning of period	72,177	45,562

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Cash and cash equivalents, end of period	\$ 107,468	\$ 53,295
--	------------	-----------

Supplemental disclosures of cash flow information:

Interest paid	\$ 1,425	\$ 2,551
---------------	----------	----------

Supplemental schedule of non-cash investing activity:

Due to broker for securities purchased	\$ 8,231	\$ 8,201
--	----------	----------

Transfer of loans held-for-sale to loan portfolio		1,942
---	--	-------

Loans transferred to foreclosed assets	918	
--	-----	--

Cash dividend accrued on Series A preferred stock	500	500
---	-----	-----

See notes to consolidated financial statements

Table of Contents

**HERITAGE COMMERCE CORP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**March 31, 2011**

**(Unaudited)**

**1) Basis of Presentation**

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company") and its wholly owned subsidiary, Heritage Bank of Commerce (sometimes referred to as "HBC"), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes that were included in the Company's Form 10-K for the year ended December 31, 2010. The Company has also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III which are Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities.

HBC is a commercial bank serving customers located in Santa Clara, Alameda, and Contra Costa counties of California. No customer accounts for more than 10 percent of revenue for HBC or the Company. Management evaluates the Company's performance as a whole and does not allocate resources based on the performance of different lending or transaction activities. Accordingly, the Company and its subsidiary operate as one business segment.

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

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

The results for the three months ended March 31, 2011 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2011.

***Reclassifications***

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

***Adoption of New Accounting Standards***

In July 2010, the FASB updated disclosure requirements with respect to the credit quality of financing receivables and the allowance for credit losses. According to the guidance there are two levels of detail at which credit information will be presented the portfolio segment and class levels. The portfolio segment level is defined as the level where financing receivables are aggregated in developing a Company's systematic method for calculating its allowance for credit losses. The class level is the second level at which credit information will be presented and represents the categorization of

Table of Contents

**HERITAGE COMMERCE CORP**

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

**March 31, 2011**

**(Unaudited)**

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

financing related receivables at a slightly less aggregated level than the portfolio segment level. Companies will now be required to provide the following disclosures as a result of this update: a rollforward of the allowance for credit losses at the portfolio segment level with the ending balances further categorized according to impairment method along with the balance reported in the related financing receivables at period end; additional disclosure of nonaccrual and impaired financing receivables by class as of period end; credit quality and past due/aging information by class as of period end; information surrounding the nature and extent of loan modifications and troubled-debt restructurings and their effect on the allowance for credit losses during the period; and detail of any significant purchases or sales of financing receivables during the period. The increased period-end disclosure requirements became effective for periods ending on or after December 15, 2010, with the exception of additional disclosures surrounding troubled-debt restructurings, which were deferred in December 2010 and become effective for periods ending on or after June 15, 2011. The increased disclosures for activity within a reporting period became effective for periods beginning on or after December 15, 2010. The provisions of this update expanded the Company's current disclosures with respect to the allowance for loan losses.

***Newly Issued But Not Yet Effective Accounting Standards:***

In April 2011, the FASB issued an accounting standard updated to amend previous guidance with respect to troubled debt restructurings. This updated guidance is designed to assist creditors with determining whether or not a restructuring constitutes a troubled debt restructuring. In particular, additional guidance has been added to help creditors determine whether a concession has been granted and whether a debtor is experiencing financial difficulties. Both of these conditions are required to be met for a restructuring to constitute a troubled debt restructuring. The amendments in the update are effective for the first interim period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. The provisions of this update are not expected to have a material impact on the Company's financial position, results or operations or cash flows.

**2) Earnings Per Share**

Basic earnings (loss) per common share is computed by dividing net income (loss), less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. The 21,004 shares of Series C Preferred Stock are convertible into 5,601,000 shares of common stock. The Series C Preferred Stock participates in the earnings of the Company and, therefore, the shares issued on the conversion of the Series C Preferred Stock would be considered outstanding under the two-class method of computing basic earnings per common share during periods of earnings. Diluted earnings (loss) per share reflect potential dilution from outstanding stock options and common stock warrants, using the treasury stock method. Due to the Company's net loss allocable to common shareholders for the three months ended March 31, 2010, all stock options and common stock warrants were excluded



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2011****(Unaudited)****2) Earnings Per Share (Continued)**

from the computation of diluted loss per average common share. A reconciliation of the weighted average shares used in computing basic and diluted earnings (loss) per common share is as follows:

	<b>For the Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Weighted average common shares outstanding	26,233,001	11,820,509
Effect of convertible preferred stock	5,601,000	
Shares used in computing basic earnings (loss) per common share	31,834,001	11,820,509
Dilutive effect of stock options outstanding, using the treasury stock method	7,161	N/A
Shares used in computing diluted earnings (loss) per common share	31,841,162	11,820,509

**3) Securities**

The amortized cost and estimated fair value of securities at March 31, 2011 and December 31, 2010 were as follows:

<b>March 31, 2011</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	\$ 253,527	\$ 1,230	\$ (4,625)	\$ 250,132
<b>December 31, 2010</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	\$ 235,099	\$ 1,079	\$ (4,013)	\$ 232,165

At March 31, 2011 and December 31, 2010, all agency mortgage backed securities were issued by Fannie Mae, Freddie Mac, or the Government National Mortgage Association ("Ginnie Mae"), and 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 March 31, 2011, the Company held 119 securities, of which 58 had fair values below amortized cost. No securities had been carried with an unrealized loss for over 12 months. 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 intend to sell any



Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2011****(Unaudited)****3) Securities (Continued)**

securities with an unrealized loss and 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 March 31, 2011.

At December 31, 2010, the Company held 106 securities, of which 54 had fair values below amortized cost. No securities have been carried with an unrealized loss for over 12 months. The Company did not consider these securities to be other-than-temporarily impaired at December 31, 2010.

The amortized cost and estimated fair values of securities as of March 31, 2011, by weighted average life, are shown below. The weighted average life will differ from contractual maturities because borrowers may have the right to call or pre-pay obligations with or without call or pre-payment penalties.

	Available-for-sale	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due within one year	\$	\$
Due after one through five years	104,749	105,482
Due after five through ten years	105,730	103,025
Due after ten years	43,048	41,625
<b>Total</b>	<b>\$ 253,527</b>	<b>\$ 250,132</b>

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2011****(Unaudited)****4) Loans**

Loans were as follows:

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
	<b>(Dollars in thousands)</b>	
<b>Loans held-for-sale:</b>		
Loans held-for-sale SBA	\$ 7,141	\$ 8,750
Loans held-for-sale other	2,223	2,260
 Total loans held-for-sale	 \$ 9,364	 \$ 11,010
<b>Loans held-for-investment:</b>		
Commercial	\$ 365,748	\$ 378,412
<b>Real estate:</b>		
Commercial and residential	320,950	337,457
Land and construction	50,496	62,356
Home equity	52,129	53,697
Consumer	13,174	13,244
 Loans	 802,497	 845,166
Deferred loan origination costs and fees, net	853	883
 Loans, including deferred costs	 803,350	 846,049
Allowance for loan losses	(24,009)	(25,204)
 Loans, net	 \$ 779,341	 \$ 820,845

At March 31, 2011, the balance of loans held-for-sale included \$2,174,000 of SBA loans that were transferred to third parties. Prior to February 15, 2011 these loans were subject to an SBA warranty for a period of 90 days. In accordance with generally accepted accounting principles, the Company treats these loans as secured borrowings during the warranty period. The secured borrowings are classified as "short-term borrowings" on the unaudited consolidated balance sheets. The warranty period for these loans expires in the following quarter. Provided the loans remain current through the end of the warranty period all elements necessary to record the sale will have been met. The Company has deferred gains of \$192,000 associated with these loans at March 31, 2011, which are included in other liabilities on the unaudited consolidated balance sheets. Effective February 15, 2011, the SBA no longer requires a warranty period in loan sales agreements. Therefore, gains on loan sales completed after February 15, 2011 are recognized upon completion of the transaction. At December 31, 2010, there were \$2,445,000 of SBA loans that were transferred to third parties, with associated deferred gains of \$194,000.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2011****(Unaudited)****4) Loans (Continued)**

Changes in the allowance for loan losses were as follows:

	<b>Three Months Ended March 31, 2011</b>				<b>Three Months Ended</b>
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>	<b>March 31, 2010</b>
					<b>Total</b>
	(Dollars in thousands)				
Balance, beginning of period	\$ 13,952	\$ 10,363	\$ 889	\$ 25,204	\$ 28,768
Charge-offs	(1,119)	(995)		(2,114)	(7,702)
Recoveries	139	10		149	366
Net charge-offs	(980)	(985)		(1,965)	(7,336)
Provision for loan losses	622	161	(13)	770	5,095
Balance, end of period	\$ 13,594	\$ 9,539	\$ 876	\$ 24,009	\$ 26,527

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 as of March 31, 2011 and December 31, 2010:

	<b>March 31, 2011</b>			
	<b>Commercial</b>	<b>Real Estate</b>	<b>Consumer</b>	<b>Total</b>
	(Dollars in thousands)			
<b>Allowance for loan losses:</b>				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 3,385	\$ 668	\$ 748	\$ 4,801
Collectively evaluated for impairment	10,209	8,871	128	19,208
<b>Total ending allowance balance</b>	<b>\$ 13,594</b>	<b>\$ 9,539</b>	<b>\$ 876</b>	<b>\$ 24,009</b>
<b>Loans:</b>				
Individually evaluated for impairment	\$ 13,254	\$ 10,420	\$ 893	\$ 24,567
Collectively evaluated for impairment	352,494	413,155	12,281	777,930
<b>Total ending loan balance</b>	<b>\$ 365,748</b>	<b>\$ 423,575</b>	<b>\$ 13,174</b>	<b>\$ 802,497</b>

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2011****(Unaudited)****4) Loans (Continued)**

	<b>December 31, 2010</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>				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 3,427	\$ 1,855	\$ 778	\$ 6,060
Collectively evaluated for impairment	10,525	8,508	111	19,144
<b>Total ending allowance balance</b>	<b>\$ 13,952</b>	<b>\$ 10,363</b>	<b>\$ 889</b>	<b>\$ 25,204</b>
<b>Loans:</b>				
Individually evaluated for impairment	\$ 14,374	\$ 16,041	\$ 898	\$ 31,313
Collectively evaluated for impairment	364,038	437,469	12,346	813,853
<b>Total ending loan balance</b>	<b>\$ 378,412</b>	<b>\$ 453,510</b>	<b>\$ 13,244</b>	<b>\$ 845,166</b>

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of March 31, 2011 and December 31, 2010. 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.

	<b>March 31, 2011</b>			<b>December 31, 2010</b>		
	<b>Unpaid Principal Balance</b>	<b>Recorded Investment</b>	<b>Allowance for Loan Losses Allocated</b>	<b>Unpaid Principal Balance</b>	<b>Recorded Investment</b>	<b>Allowance for Loan Losses Allocated</b>
	<b>(Dollars in thousands)</b>					
<b>With no related allowance recorded:</b>						
Commercial	\$ 3,400	\$ 3,400	\$	\$ 5,557	\$ 5,125	\$
<b>Real estate:</b>						
Commercial and residential	3,513	2,873	4,392	2,431		
Land and construction	2,171	2,171	6,138	3,429		
Consumer	15	15				
<b>Total with no related allowance recorded</b>	<b>9,099</b>	<b>8,459</b>	<b>16,087</b>	<b>10,985</b>		
<b>With an allowance recorded:</b>						
Commercial	10,561	9,854	3,385	9,695	9,249	3,427
<b>Real estate:</b>						
Commercial and residential	93	93	54	4,753	4,753	1,002
Land and construction	5,356	5,001	601	6,862	5,428	853
Home Equity	282	282	13			
Consumer	878	878	748	898	898	778

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Total with an allowance recorded	17,170	16,108	4,801	22,208	20,328	6,060
Total	\$ 26,269	\$ 24,567	\$ 4,801	\$ 38,295	\$ 31,313	\$ 6,060

[Table of Contents](#)

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2011

(Unaudited)

## 4) Loans (Continued)

The following table presents interest recognized and cash-basis interest earned on impaired loans:

	Three Months Ended March 31, 2011						Three Months Ended March 31, 2010 Total
	Real Estate						
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total	
	(Dollars in thousands)						
Average of impaired loans during the period	\$ 13,814	\$ 5,076	\$ 8,015	\$ 141	\$ 895	\$ 27,941	\$ 64,789
Interest income during impairment	\$ 1	\$	\$	\$ 1	\$	\$ 2	\$ 17
Cash-basis interest earned	\$ 1	\$	\$	\$	\$	\$ 1	\$ 1

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:

	March 31,		December 31,
	2011	2010	2010
	(Dollars in thousands)		
Nonaccrual loans held-for-sale	\$ 1,989	\$	\$ 2,026
Nonaccrual loans held-for-investment	22,896	65,026	28,821
Restructured and loans over 90 days past due and still accruing	1,671	2,176	2,492
Total	\$ 26,556	\$ 67,202	\$ 33,339

The following table presents the nonperforming loans by class as of March 31, 2011 and December 31, 2010:

	March 31, 2011			December 31, 2010		
	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	\$ 11,865	\$ 1,389	\$ 13,254	\$ 13,545	\$ 829	\$ 14,374
Real estate:						
Commercial and residential	3,866		3,866	6,450	1,663	8,113
Land and construction	8,261		8,261	9,954		9,954



Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Home equity		282	282			
Consumer	893		893	898		898
Total	\$ 24,885	\$ 1,671	\$ 26,556	\$ 30,847	\$ 2,492	\$ 33,339

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2011****(Unaudited)****4) Loans (Continued)**

The following table presents the aging of past due loans as of March 31, 2011 by class of loans:

	March 31, 2011					
	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	\$ 1,927	\$ 2,206	\$ 5,645	\$ 9,778	\$ 355,970	\$ 365,748
Real estate:						
Commercial and residential	1,208		1,467	2,675	318,275	320,950
Land and construction			7,172	7,172	43,324	50,496
Home equity			282	282	51,847	52,129
Consumer			893	893	12,281	13,174
<b>Total</b>	<b>\$ 3,135</b>	<b>\$ 2,206</b>	<b>\$ 15,459</b>	<b>\$ 20,800</b>	<b>\$ 781,697</b>	<b>\$ 802,497</b>

The following table presents the aging of past due loans as of December 31, 2010 by class of loans:

	December 31, 2010					
	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	\$ 3,176	\$ 807	\$ 14,374	\$ 18,357	\$ 360,055	\$ 378,412
Real estate:						
Commercial and residential	1,078	1,595	7,184	9,857	327,600	337,457
Land and construction			8,857	8,857	53,499	62,356
Home equity	80			80	53,617	53,697
Consumer			898	898	12,346	13,244
<b>Total</b>	<b>\$ 4,334</b>	<b>\$ 2,402</b>	<b>\$ 31,313</b>	<b>\$ 38,049</b>	<b>\$ 807,117</b>	<b>\$ 845,166</b>

Past due loans totaled \$20,800,000 and \$38,049,000 at March 31, 2011 and December 31, 2010, respectively, of which \$16,520,000 and \$28,821,000 were on nonaccrual. At March 31, 2011, there were also \$6,376,000 current loans included in nonaccrual loans held-for-investment. There were no current loans included in nonaccrual loans held-for-investment at December 31, 2010. 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.

Table of Contents

**HERITAGE COMMERCE CORP**

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

**March 31, 2011**

**(Unaudited)**

**4) Loans (Continued)**

*Credit Quality Indicators*

Concentrations of credit risk arise when a number of clients 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 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 continued 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. 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.

*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.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2011****(Unaudited)****4) Loans (Continued)**

The following table provides a summary of the loan portfolio by loan type and credit quality classification at March 31, 2011 and December 31, 2010:

	March 31, 2011			December 31, 2010		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)					
Commercial	\$ 328,500	\$ 37,248	\$ 365,748	\$ 340,319	\$ 38,093	\$ 378,412
Real estate:						
Commercial and residential	307,389	13,561	320,950	320,867	16,590	337,457
Land and construction	24,846	25,650	50,496	32,664	29,692	62,356
Home equity	51,198	931	52,129	50,757	2,940	53,697
Consumer	12,281	893	13,174	12,346	898	13,244
<b>Total</b>	<b>\$ 724,214</b>	<b>\$ 78,283</b>	<b>\$ 802,497</b>	<b>\$ 756,953</b>	<b>\$ 88,213</b>	<b>\$ 845,166</b>

**5) Preferred Stock***Series A Preferred Stock*

On November 21, 2008, the Company issued 40,000 shares of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") to the U.S. Treasury under the terms of the U.S. Treasury Capital Purchase Program for \$40,000,000 with a liquidation preference of \$1,000 per share. The Series A Preferred Stock carries a coupon of 5% for five years and 9% thereafter. On February 15, 2011, the Company suspended payment of dividends on its Series A Preferred Stock for the sixth consecutive quarter, and therefore, the U.S. Treasury has the right to appoint two members to the Company's Board of Directors. If the U.S. Treasury exercises its rights, these directors would serve on the Company's Board of Directors until such time as the Company has paid in full all dividends not previously paid. So long as payment of dividends on the Series A Preferred Stock remain suspended, we may not, among other things and with limited exceptions, pay cash dividends on or repurchase our common stock or preferred stock. As of the date of this filing, the Company has not been advised whether the U.S. Treasury will exercise its rights to elect two members to the Board of Directors. Effective during the first quarter of 2011, the Company has permitted the U.S. Treasury to allow an observer employed by the U. S. Treasury to attend meetings of the Company's Board of Directors.

*Private Placement*

On June 21, 2010, the Company issued to various institutional investors 53,996 shares of Series B Mandatory Convertible Perpetual Preferred Stock ("Series B Preferred Stock") and 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") for an aggregate purchase price of \$75,000,000. The Series B Preferred Stock was mandatorily convertible into common stock, upon approval by the shareholders, at a conversion price of \$3.75 per share. The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon both approval by the shareholders and thereafter, a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. The Series B Preferred Stock

Table of Contents

**HERITAGE COMMERCE CORP**

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

**March 31, 2011**

**(Unaudited)**

**5) Preferred Stock (Continued)**

and the Series C Preferred Stock did not include a beneficial conversion feature, as the conversion price of \$3.75 per share was not below the fair market value of the Company's common stock on the commitment date.

At the Company's Special Meeting of shareholders held on September 15, 2010, the Company's shareholders approved the issuance of common stock upon the conversion of the Series B Preferred Stock and upon the conversion of the Series C Preferred Stock, as required by the NASDAQ Stock Market and California corporate law. As a result, on September 16, 2010, the Series B Preferred Stock was converted into 14,398,992 shares of common stock of the Company and the shares of Series B Preferred Stock ceased to be outstanding.

The Series C Preferred Stock remains outstanding until it has been converted into common stock in accordance with its terms. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock and ranks on parity with the Company's Series A Preferred Stock.

**6) 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 tax liability and the amount accrued for this liability based on book income. These temporary differences comprise the "deferred" portion of the Company's tax expense or benefit, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as they reverse. At March 31, 2011, the Company had a net deferred tax asset of approximately \$26,913,000, compared to \$27,361,000 at December 31, 2010. The deferred tax asset at March 31, 2011 and December 31, 2010 is net of a \$3,700,000 partial valuation allowance.

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

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2011****(Unaudited)****7) Supplemental Retirement Plan**

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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(Dollars in thousands)</b>	
Components of net periodic benefit cost:		
Service cost	\$ 236	\$ 244
Interest cost	206	209
Amortization of prior service cost	9	9
Amortization of net actuarial loss	31	17
 Net periodic benefit cost	 \$ 482	 \$ 479

**8) Fair Value**

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

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

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

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

***Financial Assets and Liabilities Measured on a Recurring Basis***

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

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2011

(Unaudited)

**8) 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 Unobservable Inputs (Level 2)
(Dollars in thousands)			
Assets at March 31, 2011:			
Available-for-sale securities:			
Agency Mortgage-Backed Securities	\$ 250,132		\$ 250,132
I/O strip receivables	2,193		2,193
Assets at December 31, 2010:			
Available-for-sale securities:			
Agency Mortgage-Backed Securities	\$ 232,165		\$ 232,165
I/O strip receivables	2,140		2,140

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 loans held-for-sale is generally based on obtaining bids and broker indications on the estimated value of these loans held-for-sale, resulting in a Level 2 classification.

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.

Nonrecurring adjustments to certain commercial and residential estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3

Table of Contents

## HERITAGE COMMERCE CORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2011

(Unaudited)

## 8) Fair Value (Continued)

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

	Balance	Fair Value Measurements Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
(Dollars in thousands)			
Assets at March 31, 2011:			
Impaired loans held-for-sale other:			
Real estate:			
Commercial and residential	\$ 900		\$ 900
Land and construction	1,089		1,089
	\$ 1,989		\$ 1,989
Impaired loans held-for-investment:			
Commercial	\$ 8,124		\$ 8,124
Real estate:			
Commercial and residential	1,902		1,902
Land and construction	4,685		4,685
Consumer	145		145
	\$ 14,856		\$ 14,856
Other real estate owned	\$ 918		\$ 918
Assets at December 31, 2010:			
Loans held-for-sale other:			
Real estate:			
Commercial and residential	\$ 929		\$ 929
Land and construction	1,097		1,097
	\$ 2,026		\$ 2,026
Impaired loans held-for-investment:			
Commercial	\$ 6,725		\$ 6,725
Real estate:			
Commercial and residential	5,982		5,982
Land and construction	8,005		8,005
Consumer	120		120



Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	\$ 20,832		\$ 20,832
Other real estate owned	\$ 1,296	23	\$ 1,296

---

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2011****(Unaudited)****8) 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>March 31, 2011</b>	<b>December 31, 2010</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	\$ 19,657	\$ 26,892
Book value of impaired loans held-for-investment carried at cost	4,910	4,421
Total impaired loans held-for-investment	\$ 24,567	\$ 31,313
 <b>Impaired loans held-for-investment carried at fair value:</b>		
Book value of impaired loans held-for-investment carried at fair value	\$ 19,657	\$ 26,892
Specific valuation allowance	(4,801)	(6,060)
Impaired loans held-for-investment carried at fair value, net	\$ 14,856	\$ 20,832

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were \$24,567,000 at March 31, 2011, after partial charge-offs of \$1,702,000 in the first three months of 2011. In addition, these loans had a specific valuation allowance of \$4,801,000 at March 31, 2011. Impaired loans held-for-investment totaling \$19,657,000 at March 31, 2011 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining \$4,910,000 of impaired loans were carried at cost at March 31, 2011, 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 three months of 2011 on impaired loans held-for-investment carried at fair value at March 31, 2011 resulted in an additional provision for loan losses of \$676,000.

Total other real estate owned, consisting of two properties, had a fair value of \$918,000 at March 31, 2011.

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral totaled \$31,313,000 at December 31, 2010, after partial charge-offs of \$6,982,000 in 2010. In addition, these loans had a specific valuation allowance of \$6,060,000 at December 31, 2010. Impaired loans held-for-investment totaling \$26,892,000 at December 31, 2010 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining \$4,421,000 of impaired loans were carried at cost at December 31, 2010, 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 2010 on impaired loans held-for-investment carried at fair value at December 31, 2010 resulted in an additional provision for loan losses of \$9,791,000.

Total other real estate owned, consisting of one property, had a fair value of \$1,296,000 at December 31, 2010.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2011****(Unaudited)****8) Fair Value (Continued)**

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

	March 31, 2011		December 31, 2010	
	Carrying Amounts	Estimated Fair Value	Carrying Amounts	Estimated Fair Value
(Dollars in thousands)				
<b>Assets:</b>				
Cash and cash equivalents	\$ 107,468	\$ 107,468	\$ 72,177	\$ 72,177
Securities available-for-sale	250,132	250,132	232,165	232,165
Loans (including loans held-for-sale), net	788,705	817,275	831,855	855,327
FHLB and FRB stock	9,038	N/A	9,174	N/A
Accrued interest receivable	3,205	3,205	3,215	3,215
Loan servicing rights and I/O strips receivables	3,062	5,493	3,055	5,340
<b>Liabilities:</b>				
Time deposits	\$ 279,599	\$ 280,360	\$ 287,344	\$ 288,798
Other deposits	723,724	723,724	706,574	706,574
Securities sold under agreement to repurchase			5,000	5,018
Short-term borrowings	2,174	2,174	2,445	2,445
Subordinated debt	23,702	14,665	23,702	14,445
Accrued interest payable	3,175	3,175	2,810	2,810

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

***Cash and Cash Equivalents and Accrued Interest Receivable and Payable***

The carrying amount approximates fair value because of the short maturities of these instruments.

***Loans***

Loans with similar financial characteristics are grouped together for purposes of estimating their fair value. Loans are segregated by type such as commercial, term real estate, construction and land development, and consumer. Each loan category is further segmented into fixed and adjustable rate interest terms.

The fair value of performing, fixed rate loans is calculated by discounting scheduled future cash flows using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The fair value of variable rate loans approximates the carrying amount as these loans generally reprice within 90 days.

The fair value of loans held-for-sale is based on estimated market values from third party investors.

Table of Contents

**HERITAGE COMMERCE CORP**

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

**March 31, 2011**

**(Unaudited)**

**8) Fair Value (Continued)**

***FHLB and FRB Stock***

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

***Deposits***

The fair value of deposits with no stated maturity, such as demand deposits, savings, and money market accounts, approximates the amount payable on demand. The carrying amount approximates the fair value of time deposits with a remaining maturity of less than 90 days. The fair value of all other time deposits is calculated based on discounting the future cash flows using rates currently offered for time deposits with similar remaining maturities.

***Subordinated debt and Securities Sold Under Agreement to Purchase***

The fair values of subordinated debt and securities sold under agreement to repurchase were determined based on the current market value for like kind instruments of a similar maturity and structure.

***Short-term Borrowings and Note Payable***

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

***Off-Balance Sheet Items***

The fair value of off-balance sheet items, such as commitments to extend credit, is not considered material and therefore is not included in the table above.

***Limitations***

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

**9) Regulatory Matters**

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

Table of Contents

**HERITAGE COMMERCE CORP**

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

**March 31, 2011**

**(Unaudited)**

**9) Regulatory Matters (Continued)**

related subordinated debt; (iii) incur, increase or guarantee any debt; (iv) redeem any outstanding stocks, or; (v) take dividends or any other form of payment that represents a reduction in capital from HBC. The Written Agreement required the Company to submit written plans within certain timeframes to the Federal Reserve and the DFI that addresses the following items (i) strengthening credit risk management practices; (ii) improving HBC's position with respect to problem loans in excess of \$2 million; (iii) maintaining adequate reserves for loan and lease losses; (iv) maintaining sufficient capital at HCC and HBC; (v) improving the management of HBC's liquidity position and funds management practices; and (vi) improving the Company's earnings and overall condition through a business plan and budget. All plans were submitted to the appropriate regulatory agencies, and all plans requiring approval by such agencies were approved.

In addition, the Agreement (i) required HBC's Board of Directors or a designated committee thereof to approve any extension, renewal or restructuring of any credit to any borrower whose loans have been "criticized"; (ii) requires HBC to charge off loans classified as "loss" by the Federal Reserve and/or DFI; (iii) requires the Company to notify the Federal Reserve and DFI no more than 30 days after the end of any quarter in which the capital ratios of HCC or HBC fall below the approved capital plan' minimum levels; (iv) requires HCC and HBC to comply with the notice provisions of Section 32 of the Federal Deposit Insurance Act and Subpart H of Regulation Y of the Board of Governors of the Federal Reserve System in connection with appointing any new director or senior executive officer or changing the responsibilities of any senior executive officer so that the officer would assume a different senior executive officer position; (v) requires HCC and HBC to comply with the restrictions on indemnification and severance payments of Section 18(k) of the Federal Deposit Insurance Act and Part 359 of the FDIC's regulations; and (vi) requires the Company to provide quarterly progress reports to the Federal Reserve and the DFI.

The Board of Directors and management of the Company are committed to addressing and resolving the matters raised in the Written Agreement on a timely basis and actions have been undertaken to comply with the various items addressed by the Written Agreement. A new joint compliance committee was formed by the Board of Directors to oversee HCC's and HBC's response to the Written Agreement. The committee reports monthly to the Board of Directors.

Prior to entering into the Written Agreement in February 2010, HCC had already ceased paying dividends on its common stock (in the second quarter of 2009), suspended interest payments on its trust preferred securities and related subordinated debt (in the fourth quarter of 2009), and suspended dividend payments on its Series A Preferred Stock (also in the fourth quarter of 2009). As a result, the Company has accrued but has not paid approximately \$2.9 million in interest on its subordinated debt, and approximately \$3.3 million in dividends on its Series A Preferred Stock as of March 31, 2011.

The Company submitted specific plans to the FRB and DFI relating to improving asset quality and credit risk management, improving profitability, liquidity management and its capital plan. All of these plans have been accepted as satisfactory by the FRB and DFI. With respect to credit risk management, management has developed and utilizes risk of loss and loss given default models to evaluate risk exposure limits and potential changes in market conditions and conducts monthly reviews of credit risk management reports with the Boards of Directors of HCC and HBC. With respect to asset

Table of Contents

**HERITAGE COMMERCE CORP**

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

**March 31, 2011**

**(Unaudited)**

**9) Regulatory Matters (Continued)**

improvement, the Company has taken steps to mitigate risk on each real estate loan upon renewal, or sooner based on facts and circumstances, to ensure that HBC has updated appraisals or evaluations which may result in additional collateral or guarantees. If necessary, the loan will be downgraded, placed on nonaccrual status, or foreclosed upon. In addition, the Company has reduced nonperforming loans as evidenced by a 60% decline in nonperforming loans at March 31, 2011 to \$26.6 million compared to nonperforming loans at March 31, 2010 of \$67.2 million. With respect to allowance for loan and lease losses, the Company's current methodology considers HBC's loan grading system, the volume and severity of criticized loans, concentrations, historical losses, and the impact of overall economic and market conditions on loan and collateral values that could result in probable losses within the portfolio, and the methodology is monitored as events and circumstances change. With respect to capital, HCC issued \$75 million of preferred stock on June 21, 2010 and subsequently contributed \$40 million of capital to HBC. In addition, the Company has developed a capital stress testing methodology that is updated each quarter and reviewed by the Finance and Investment Committee of the Board of Directors. With respect to liquidity funds management, the Company has a contingent liquidity plan and updates the contingent liquidity plan and its liquidity models each quarter which are reviewed by the Finance and Investment Committee of the Board of Directors. With respect to earnings and overall condition, the Company's Board of Directors has approved a 2011 budget for the Company.

As of this filing date, HCC and HBC believe they are in compliance with the requirements of the Written Agreement. However, compliance with the Written Agreement is determined solely by the Company's regulators. Failure to comply with the Written Agreement may subject the Company and HBC to additional supervisory actions and orders.

Table of Contents

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

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources of Heritage Commerce Corp (the "Company") and its wholly owned subsidiary, Heritage Bank of Commerce (sometimes referred to as "HBC"). This information is intended to facilitate the understanding and assessment of significant changes and trends related to our financial condition and the results of operations. This discussion and analysis should be read in conjunction with our consolidated financial statements and the accompanying notes presented elsewhere in this report. Unless we state otherwise or the context indicates otherwise, references to the "Company," "Heritage," "we," "us," and "our," in this Report on Form 10-Q refer to Heritage Commerce Corp and Heritage Bank of Commerce. Reference to "HCC" refers only to Heritage Commerce Corp, the holding company of HBC.

**EXECUTIVE SUMMARY**

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

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

On February 17, 2010 HCC and HBC entered into a Written Agreement with the Federal Reserve Bank of San Francisco, and the California Department of Financial Institutions. The Board of Directors and management of the Company are committed to addressing and resolving the matters raised in the Written Agreement on a timely basis and actions have been undertaken to comply with the various items addressed by the Written Agreement. As of the date of this filing, both HCC and HBC believe they are in compliance with all of the provisions of the Written Agreement. However, compliance with the Written Agreement is determined solely by the Company's regulators. Further discussion of the Written Agreement appears under Note 9 to the unaudited consolidated financial statements located elsewhere herein.

***Performance Overview***

For the three months ended March 31, 2011, net income was \$1.6 million. Net income allocable to common shareholders was \$985,000, or \$0.03 per diluted common share for the quarter ended March 31, 2011, which included a \$770,000 provision for loan losses and \$596,000 in dividends and discount accretion on preferred stock. In the quarter ended March 31, 2010, the net loss was (\$4.1) million. The net loss allocable to common shareholders was (\$4.7) million, or (\$0.40) per diluted common share for the quarter ended March 31, 2010, which included a \$5.1 million provision for loan losses and \$591,000 in dividends and discount accretion on preferred stock. The Company's annualized return on average assets was 0.51% and annualized return on average equity was 3.51% for the first quarter of 2011, compared to -1.23% and -9.61% a year ago.

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

### Table of Contents

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

The net interest margin increased 13 basis points to 3.95% for the first quarter of 2011, compared with 3.82% for the first quarter of 2010, and increased 36 basis points compared with 3.59% for the fourth quarter of 2010. The increase in the net interest margin was primarily due to a lower cost of deposits as a result of maturing higher-cost wholesale funding and growth in noninterest-bearing deposits.

Net interest income decreased to \$11.2 million for the first quarter of 2011, from \$11.4 million for the first quarter of 2010 primarily due to a decrease in loan balances, which was partially offset by an increase in investment securities.

The provision for loan losses was \$770,000 for the first quarter of 2011, compared to \$5.1 million for the first quarter of 2010. The decrease in provision for loan losses in the first quarter of 2011 compared to the first quarter of 2010 reflects a lower volume of classified assets and nonperforming loans, a decrease in loan charge-offs, and contraction of the loan portfolio.

Noninterest income increased 14% to \$1.9 million for the first quarter of 2011 from \$1.7 million for the first quarter of 2010, primarily due to the gain on sale of SBA loans of \$379,000 in the first quarter of 2011, compared to \$114,000 in gain on sale of SBA loans in the first quarter of 2010.

Noninterest expense decreased 14% to \$10.4 million for the first quarter of 2011 from \$12.2 million for the first quarter of 2010. The decrease in noninterest expense was primarily due to a decline in salaries and employee benefits expense, professional fees related to problem loans, expenses related to OREO properties, and FDIC insurance premiums in the first quarter of 2011.

The efficiency ratio was 79.55% for the first quarter of 2011, compared to 93.45% for the first quarter of 2010. The improvement was primarily due to lower noninterest expense as management continues to focus on controlling expenses and an increase in gains on sales of SBA loans.

The income tax expense for the first quarter of 2011 was \$331,000, as compared to an income tax benefit of \$120,000 for the first quarter of 2010. The effective income tax rate was 17% for first quarter of 2011, compared to an effective income tax rate of -3% for the first quarter of 2010. The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes, and tax credits related to investments in low income housing limited partnerships.

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

Cash, Federal funds sold, interest-bearing deposits in other financial institutions and securities available-for-sale increased 86% to \$357.6 million at March 31, 2011, from \$192.7 million at March 31, 2010, and increased 17% from \$304.3 million at December 31, 2010. The substantial increase in liquid assets from March 31, 2010 is primarily due to proceeds from the June 2010 private placement, proceeds from loan sales, and loan paydowns.

Total loans, excluding loans held-for-sale, decreased \$203.1 million, or 20%, to \$803.4 million at March 31, 2011, compared to \$1.01 billion at March 31, 2010, and decreased \$42.7 million, or 5%, from December 31, 2010. Land and construction loans decreased \$103.3 million, or 67%, to \$50.5 million at March 31, 2011, compared to \$153.8 million at March 31, 2010, and decreased \$11.9 million, or 19%, from \$62.4 million at December 31, 2010.



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

### Table of Contents

Classified assets decreased to \$81.4 million at March 31, 2011, compared to \$171.2 million at March 31, 2010, and \$91.8 million at December 31, 2010.

The allowance for loan losses was \$24.0 million, or 2.99% of total loans at March 31, 2011, compared to \$26.5 million or 2.64% of total loans at March 31, 2010, and \$25.2 million, or 2.98% of total loans at December 31, 2010.

The allowance for loan losses to total nonperforming loans, or coverage ratio, increased to 90.41% at March 31, 2011, compared to 39.47% at March 31, 2010, and 80.49% at December 31, 2010.

Nonperforming assets were \$27.5 million, or 2.19% of total assets at March 31, 2011, compared to \$69.0 million or 5.17% of total assets at March 31, 2010 and \$34.6 million, or 2.78% of total assets at December 31, 2010.

Net loan charge-offs were \$2.0 million for the first quarter of 2011, compared to \$7.3 million for the first quarter of 2010, and \$1.1 million for the fourth quarter of 2010.

Noninterest-bearing demand deposits increased 25% to \$325.1 million at March 31, 2011, from \$261.0 million at March 31, 2010, and increased 16% from \$280.3 million at December 31, 2010.

Brokered deposits decreased 44% to \$97.8 million at March 31, 2011, from \$174.5 million at March 31, 2010, and decreased 1% from \$98.5 million at December 31, 2010.

The ratio of noncore funding (which consists of time deposits \$100,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase and short-term borrowings) to total assets was 19.85% at March 31, 2011, compared to 26.04% at March 31, 2010, and 20.96% at December 31, 2010.

The liquidity position improved with a loan to deposit ratio of 80.07% at March 31, 2011, compared to 93.04% at March 31, 2010, and 85.12% at December 31, 2010.

Capital ratios substantially exceed regulatory requirements for a well-capitalized financial institution, both on a consolidated basis and at the bank level at March 31, 2011. The leverage ratio at the holding company was 15.3%, with a Tier 1 risk-based capital ratio of 19.9%, and a total risk-based capital ratio of 21.2% at March 31, 2011. The leverage ratio for HBC was 13.3%, with a Tier 1 risk-based capital ratio of 17.3%, and a total risk-based capital ratio of 18.5% at March 31, 2011. The regulatory well-capitalized guidelines are a minimum of a 5% leverage ratio, a 6% Tier 1 risk-based capital ratio, and a 10% total risk-based capital 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. The Company had \$97.8 million in brokered deposits at March 31, 2011, compared to \$174.5 million at March 31, 2010, and \$98.5 million at December 31, 2010. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators increased to \$34.7 million at March 31, 2011, compared to \$21.6 million at March 31, 2010, and decreased from \$39.0 million at December 31, 2010. The Company has a policy to monitor all deposits that may be sensitive to interest rate changes to help assure that liquidity risk does not become excessive due to concentrations. Deposits at March 31, 2011 were \$1.00 billion, compared to \$1.08 billion at March 31, 2010, and \$993.9 million at December 31, 2010.



Table of Contents

HBC is a member of the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program allows customers with deposits in excess of FDIC insured limits to obtain coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through this program are considered brokered deposits under regulatory guidelines. Deposits in the CDARS program totaled \$21.0 million at March 31, 2011, compared to \$18.5 million at March 31, 2010, and \$17.9 million at December 31, 2010.

***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 March 31, 2011, we had \$107.5 million in cash and cash equivalents and approximately \$269.6 million in available borrowing capacity from various sources including the Federal Home Loan Bank ("FHLB"), the Federal Reserve Bank of San Francisco ("FRB"), and Federal funds facilities with several financial institutions. The Company also had \$215.7 million in unpledged securities available at March 31, 2011. Our loan to deposit ratio decreased to 80.07% at March 31, 2010, compared to 93.04% at March 31, 2010, and 85.12% at December 31, 2010, primarily due to a reduction in the loan portfolio.

***Lending***

Our lending business originates primarily through our branch offices located in our primary market. The Company also has an additional SBA loan production office in Santa Rosa, California. The total loan portfolio remains well diversified with commercial loans accounting for 46% of the portfolio at March 31, 2011. Commercial and residential real estate loans accounted for 40% of the total loan portfolio at March 31, 2011, of which 53% were owner-occupied by businesses. We have actively lowered our exposure to land and construction loans and our overall credit risk on these portfolios has been reduced. Land and construction loans decreased \$103.3 million to \$50.5 million at March 31, 2011, compared to \$153.8 million at March 31, 2010, and accounted for 6% of our total loan portfolio. Consumer and home equity loans accounted for the remaining 8% of total loans at March 31, 2011. The yield on the loan portfolio was 5.28% in the first quarter of 2011, compared to 5.02% in the first quarter of 2010. The decline in gross loans in the first quarter of 2011 was primarily due to diminished loan demand, loan payoffs exceeding draw downs of loan commitments and the result of efforts to reduce classified loans. Lower volume of loan originations can be attributed in part to lower demand for certain types of credit as well as more selectivity with respect to the types of loans the Company chooses to originate.

***Net Interest Income***

The management of interest income and expense is fundamental to the performance of the Company. Net interest income, the difference between interest income and interest expense, is the largest component of the Company's total revenue. Management closely monitors both total net interest income and the net interest margin (net interest income divided by average earning assets).

Because of our focus on commercial lending to closely held businesses, the Company will continue to have a high percentage of floating rate loans and other assets. Given the current volume, mix and repricing characteristics of our interest-bearing liabilities and interest-earning assets, we believe our interest rate spread is expected to increase in a rising rate environment, and decrease in a declining interest rate environment.

The Company, through its asset and liability policies and practices, seeks to maximize net interest income without exposing the Company to an excessive level of interest rate risk. Interest rate risk is managed by monitoring the pricing, maturity and repricing options of all classes of interest bearing assets and liabilities. This is discussed in more detail under "*Liquidity and Asset/Liability Management.*" In addition, we believe there are measures and initiatives we can take to improve the net interest

Table of Contents

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.

The net interest margin expanded during the first quarter of 2011 primarily attributed to a shift from our excess funds at the Federal Reserve Bank to our securities portfolio, along with a lower level of nonaccrual loans and a lower cost of deposits as a result of higher noninterest-bearing demand deposit balances.

***Management of Credit Risk***

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

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

***Noninterest Income***

While net interest income remains the largest single component of total revenues, noninterest income is an important component.

A significant percentage 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. Prior to February 15, 2011 these loans were subject to an SBA warranty for a period of 90 days. In accordance with generally accepted accounting principles, the Company treats the SBA loans sold as secured borrowings during the warranty period. Effective February 15, 2011, the SBA no longer requires a warranty period in loan sales agreements. Therefore, gains on loan sales completed after February 15, 2011 are recognized upon completion of the transaction.

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.

Table of Contents

*Noninterest Expense*

Management considers the control of operating expenses to be a critical element of the Company's performance. Over the last several quarters the Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. Operating expenses decreased \$1.8 million in the first three months of 2011, compared to the first three months of 2010, primarily due to lower salaries and benefits, FDIC deposit insurance premiums, professional fees related to problem loans, and expenses related to OREO properties.

*Capital Management*

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

On November 21, 2008, the Company issued to the U.S. Treasury under its Capital Purchase Program 40,000 shares of Series A Preferred Stock for \$40.0 million and issued a warrant to purchase 462,963 shares of common stock at an exercise price of \$12.96. The terms of the U.S. Treasury Capital Purchase Program could reduce investment returns to our shareholders by restricting dividends to common shareholders, diluting existing shareholders' interests, and restricting capital management practices.

Under the terms of the Capital Purchase Program with the U.S. Treasury, so long as our Series A Preferred Stock is outstanding, we are prohibited from increasing quarterly dividends on our common stock in excess of \$0.08 per share, and from making certain repurchases of equity securities, including our common stock, without the U.S. Treasury consent until the third anniversary of the U.S. Treasury investment or until the U.S. Treasury has transferred all of the Series A Preferred Stock it purchased under the Capital Purchase Program to third parties. As long as the Series A Preferred Stock is outstanding, dividend payments and repurchases or redemptions relating to certain equity securities, including our common stock, and the Series C Preferred Stock, are also prohibited until all accrued and unpaid dividends are paid on such preferred stock, subject to certain limited exceptions. On November 6, 2009, we suspended dividend payments on our Series A Preferred Stock. As a result, the Company has accrued but has not paid approximately \$3.3 million in dividends on its Series A Preferred Stock as of March 31, 2011. The Company's dividend payment on its outstanding Series A Preferred Stock issued to the U.S. Treasury that was due on February 15, 2011 was the sixth consecutive dividend payment suspended. Under the terms of the Series A Preferred Stock, if the Company fails to pay dividends on the Series A Preferred Stock for a total of six quarters, whether or not consecutive, the U.S. Treasury has the right to elect two members of the Company's Board of Directors. These directors would serve on the Company's Board of Directors until such time as the Company has paid in full all dividends not previously paid. Although the U.S. Treasury has not indicated if or when it may exercise its right to have two members appointed to the Board of Directors, effective during the first quarter of 2011, the Company has permitted the U.S. Treasury to allow an observer employed by the U. S. Treasury to attend meetings of the Company's Board of Directors. So long as payment of dividends on the Series A Preferred Stock remain suspended, we may not, among other things and with limited exceptions, pay cash dividends on or repurchase our common stock or preferred stock.

On June 21, 2010, the Company issued Series B Mandatorily Convertible Cumulative Perpetual Preferred Stock ("Series B Preferred Stock") and Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") to a limited number of institutional investors for an aggregate amount of \$75.0 million. HCC then downstreamed \$40 million of the proceeds from the private placement to the capital of HBC.

Table of Contents

After receiving shareholder approval in September 2010, the outstanding Series B Preferred Stock converted into approximately 14.4 million shares of the Company's common stock. The Series C Preferred Stock remains outstanding until converted to common stock upon the transfer of the Series C Preferred Stock in accordance with its terms. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock.

We have supported our growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt that we issued to the trusts is senior to our shares of common stock, Series A Preferred Stock, and Series C Preferred Stock. As a result, we must make payments on the subordinated debt before any dividends can be paid on our common stock, Series A Preferred Stock, and Series C Preferred Stock. Under the terms of the subordinated debt, we may defer interest payments for up to five years. On November 6, 2009, we exercised our right to defer regularly scheduled interest payments on our \$23.7 million of subordinated debt relating to our trust preferred securities. As a result the Company has accrued but has not paid approximately \$2.9 million in interest on its subordinated debt as of March 31, 2011. So long as interest payments remain deferred, we may not pay cash dividends on or repurchase our common stock or preferred stock.

Under the Written Agreement with our regulators we are required to obtain the prior approval of the Federal Reserve Bank of San Francisco and the Director of the Division of Banking Supervision and Regulation of the Federal Reserve to make any interest payments on our outstanding trust preferred securities and related subordinate debt, or to pay any dividends on our common stock or preferred stock. At March 31, 2011, HBC's total risk-based capital ratio was 18.5%, compared to the 10% regulatory requirement for well-capitalized banks under the regulatory framework for prompt corrective actions. HBC's Tier 1 risk-based capital ratio of 17.3% and leverage ratio of 13.3% at March 31, 2011 also exceeded regulatory guidelines for well-capitalized banks under the prompt corrective actions framework. On a consolidated basis, the Company has a total risk-based capital ratio of 21.2%, a Tier 1 risk-based capital ratio of 19.9%, and a leverage ratio of 15.3% at March 31, 2011.

**RESULTS OF OPERATIONS**

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

***Net Interest Income and Net Interest Margin***

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

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

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

**Distribution, Rate and Yield**

NET INTEREST INCOME AND NET INTEREST MARGIN	For the Three Months Ended March 31, 2011			For the Three Months Ended March 31, 2010		
	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)	\$ 843,777	\$ 10,989	5.28%	\$ 1,063,928	\$ 13,174	5.02%
Securities	245,861	1,963	3.24%	127,004	1,162	3.71%
Federal funds sold and interest-bearing deposits in other financial institutions	60,423	34	0.23%	17,650	10	0.23%
<b>Total interest earning assets</b>	<b>1,150,061</b>	<b>12,986</b>	<b>4.58%</b>	<b>1,208,582</b>	<b>14,346</b>	<b>4.81%</b>
Cash and due from banks	20,551			21,185		
Premises and equipment, net	8,330			8,957		
Goodwill and other intangible assets	2,961			46,714		
Other assets	66,430			68,593		
<b>Total assets</b>	<b>\$ 1,248,333</b>			<b>\$ 1,354,031</b>		
<b>Liabilities and shareholders' equity:</b>						
<b>Deposits:</b>						
Demand, interest-bearing	\$ 135,756	67	0.20%	\$ 149,360	86	0.23%
Savings and money market	267,749	266	0.40%	301,634	398	0.54%
Time deposits under \$100	33,207	71	0.87%	39,564	148	1.52%
Time deposits \$100 and over	133,849	419	1.27%	132,371	499	1.53%
Time deposits CDARS	21,525	25	0.47%	19,373	53	1.11%
Time deposits brokered	95,064	423	1.80%	177,420	1,180	2.70%
Subordinated debt	23,702	466	7.97%	23,702	466	7.97%
Securities sold under agreement to repurchase	2,889	24	3.37%	22,722	131	2.34%
Short-term borrowings	2,734	29	4.30%	20,860	16	0.31%
<b>Total interest-bearing liabilities</b>	<b>716,475</b>	<b>1,790</b>	<b>1.01%</b>	<b>887,006</b>	<b>2,977</b>	<b>1.36%</b>
<b>Demand, noninterest-bearing</b>	<b>312,041</b>			<b>254,415</b>		
<b>Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds</b>	<b>1,028,516</b>	<b>1,790</b>	<b>0.71%</b>	<b>1,141,421</b>	<b>2,977</b>	<b>1.06%</b>
Other liabilities	37,366			38,821		
<b>Total liabilities</b>	<b>1,065,882</b>			<b>1,180,242</b>		
Shareholders' equity	182,451			173,789		
<b>Total liabilities and shareholders' equity</b>	<b>\$ 1,248,333</b>			<b>\$ 1,354,031</b>		

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Net interest income / margin	\$ 11,196	3.95%	\$ 11,369	3.82%
------------------------------	-----------	-------	-----------	-------

---

(1)

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



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 March 31, 2011 vs. 2010</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	\$ (2,862)	\$ 677	\$ (2,185)
Securities	948	(147)	801
Federal funds sold and interest-bearing deposits in other financial institutions	24		24
<b>Total interest income from interest earnings assets</b>	<b>(1,890)</b>	<b>530</b>	<b>(1,360)</b>
<b>Expense on interest-bearing liabilities:</b>			
Demand, interest-bearing	(7)	(12)	(19)
Savings and money market	(32)	(100)	(132)
Time deposits under \$100	(14)	(63)	(77)
Time deposits \$100 and over	4	(84)	(80)
Time deposits CDARS	3	(31)	(28)
Time deposits brokered	(364)	(393)	(757)
Securities sold under agreement to repurchase	(165)	58	(107)
Short-term borrowings	(192)	205	13
<b>Total interest expense on interest-bearing liabilities</b>	<b>(767)</b>	<b>(420)</b>	<b>(1,187)</b>
<b>Net interest income</b>	<b>\$ (1,123)</b>	<b>\$ 950</b>	<b>\$ (173)</b>

The Company's net interest margin expressed as a percentage of average earning assets was 3.95% for the first quarter of 2011, an increase of 13 basis points from 3.82% for the first quarter of 2010, and an increase of 36 basis points from 3.59% for the fourth quarter of 2010. The increase in the net interest margin was primarily attributed to deploying excess funds at the Federal Reserve for the purchase of securities, a reduction in nonaccrual loans, an increase in the yield on loans, and a lower cost of deposits as a result of higher noninterest-bearing demand deposit balances.

Net interest income for the first quarter of 2011 decreased \$173,000, or 2% from first quarter of 2010. The decrease in the first quarter of 2011 was primarily due to a decrease in average loan balances, partially offset by an increase in average investment securities, an increase in average noninterest-bearing demand deposits, as well as a lower cost of deposits.

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



Table of Contents**Provision for Loan Losses**

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

In the first quarter of 2011, the Company had a provision for loan losses of \$770,000, compared to \$5.1 million in the first quarter of 2010. The decrease in provision for loan losses in the first quarter of 2011 compared to the same period in 2010 reflects a lower volume of classified assets and nonperforming loans, lower charge-offs and a decrease in the size of the loan portfolio.

The allowance for loan losses represented 2.99%, 2.64% and 2.98% of total loans at March 31, 2011, March 31, 2010, and December 31, 2010, respectively. Provisions for loan losses are charged to operations to bring the allowance for loan losses to a level deemed appropriate by the Company based on the factors discussed under "Allowance for Loan Losses".

**Noninterest Income**

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

	For the Three Months Ended March 31,		Increase (decrease) 2011 versus 2010	
	2011	2010	Amount	Percent
(Dollars in thousands)				
Service charges and fees on deposit accounts	\$ 567	\$ 548	\$ 19	3%
Increase in cash surrender value of life insurance	426	409	17	4%
Servicing income	411	421	(10)	-2%
Gain on sales of SBA loans	379	114	265	232%
Other	134	192	(58)	-30%
<b>Total noninterest income</b>	<b>\$ 1,917</b>	<b>\$ 1,684</b>	<b>\$ 233</b>	<b>14%</b>

The increase in noninterest income in the first quarter of 2011 from the first quarter of 2010 was primarily attributable to the gain on sales of SBA loans. Other sources of noninterest income include loan servicing fees, service charges and fees, and cash surrender value from company owned life insurance policies.

A significant percentage of the Company's noninterest income is associated with its SBA lending activity, consisting of gains on sale of loans sold in the secondary market and servicing income from loans sold with servicing retained. Prior to February 15, 2011, when the Company sold SBA loans to third parties, the loans were subject to a 90 day SBA warranty. In accordance with generally accepted accounting principles, the Company treats the SBA loans sold as secured borrowings during the warranty period. Included in the balance of loans held-for-sale at March 31, 2011 were \$2.2 million of

Table of Contents

SBA loans that were transferred to third parties. The Company has deferred gains of \$192,000 associated with these loans at March 31, 2011, which are included in other liabilities on the unaudited consolidated balance sheets. Effective February 15, 2011, the SBA no longer requires a warranty period in loan sales agreements. Therefore, gains on loan sales completed after February 15, 2011 are recognized upon completion of the transaction. During the first quarter of 2011, SBA loan sales resulted in a \$379,000 gain, compared to an \$114,000 gain on sale of SBA loans in the first quarter of 2010. The servicing assets that result from the sale of SBA loans, with servicing retained, are amortized over the expected term of the loans using a method approximating the interest method. Servicing income generally declines as the respective loans are repaid.

The increase in cash surrender value of life insurance approximates a 3.95% after tax yield on the policies. To realize this tax advantaged yield, the policies must be held until death of the insured individuals, who are current and former officers and directors of the Company.

***Noninterest Expense***

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

	For the Three Months Ended March 31,		Increase (decrease) 2011 versus 2010	
	2011	2010	Amount	Percent
	(Dollars in thousands)			
Salaries and employee benefits	\$ 5,393	\$ 5,881	\$ (488)	-8%
Occupancy and equipment	1,038	959	79	8%
Professional fees	839	1,278	(439)	-34%
FDIC deposit insurance premiums	524	1,191	(667)	-56%
Software subscriptions	255	234	21	9%
Insurance expense	241	256	(15)	-6%
Data processing	220	212	8	4%
Low income housing investment losses	162	225	(63)	-28%
Other real estate owned expense	21	418	(397)	-95%
Other	1,738	1,544	194	13%
<b>Total noninterest expense</b>	<b>\$ 10,431</b>	<b>\$ 12,198</b>	<b>\$ (1,767)</b>	<b>-14%</b>

Table of Contents

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

***Noninterest Expense by Category***

	<b>For The Three Months Ended March 31,</b>			
	<b>2011</b>	<b>Percent of Total</b>	<b>2010</b>	<b>Percent of Total</b>
	<b>(Dollars in thousands)</b>			
Salaries and employee benefits	\$ 5,393	52%	\$ 5,881	48%
Occupancy and equipment	1,038	10%	959	8%
Professional fees	839	8%	1,278	10%
FDIC deposit insurance premiums	524	5%	1,191	10%
Software subscriptions	255	2%	234	2%
Insurance expense	241	2%	256	2%
Data processing	220	2%	212	2%
Low income housing investment losses	162	2%	225	2%
Other real estate owned expense	21	0%	418	3%
Other	1,738	17%	1,544	13%
<b>Total noninterest expense</b>	<b>\$ 10,431</b>	<b>100%</b>	<b>\$ 12,198</b>	<b>100%</b>

Salaries and employee benefits decreased \$488,000, or 8%, for the first quarter of 2011 from the same period in 2010, primarily due to a reduction in force implemented in the fourth quarter of 2010. Full-time equivalent employees were 185 and 201 at March 31, 2011 and 2010, respectively. Professional fees decreased \$439,000, or 34%, for the first quarter of 2011 from the same period in 2010 primarily due to a decrease in legal fees related to loan workouts and litigation and decreased expenses for bank regulatory compliance. FDIC deposit insurance premiums decreased \$667,000, or 56%, for the first quarter of 2011 compared to the same period in 2010, due to a decrease in the FDIC deposit assessment rate and lower deposit balances. OREO expense decreased \$397,000, or 95%, in the first quarter of 2011, compared to the same period in 2010 due to a decrease in write-downs of OREO properties.

***Income Tax Expense***

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

The Company's Federal and state income tax expense was \$331,000 in the first quarter of 2011, as compared to a income tax benefit of \$120,000 in the first quarter of 2010. The following table shows the Company's effective income tax rates for the periods indicated:

	<b>For the Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Effective income tax rate	17.3%	-2.8%

The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes and tax credits related to investments in low income housing limited partnerships.

Table of Contents

The Company has total investments of \$4.5 million in low-income housing limited partnerships as of March 31, 2011. These investments have generated annual tax credits of approximately \$1.0 million and \$1.1 million in the years ended December 31, 2010 and 2009, respectively.

Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles, leading to timing differences between the Company's actual tax liability and the amount accrued for this liability based on book income. These temporary differences comprise the "deferred" portion of the Company's tax expense or benefit, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as they reverse. At March 31, 2011, the Company had a net deferred tax asset of approximately \$26.9 million, compared to \$27.4 million at December 31, 2010. The deferred tax asset at March 31, 2011 and December 31, 2010 is net of a \$3.7 million valuation allowance.

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

In assessing the realization of deferred tax assets at March 31, 2011, the Company estimates that it has sufficient forecasted future taxable income and various tax planning strategies which could be implemented to generate taxable income in future periods, to support the balance of deferred tax assets net of the \$3.7 million valuation allowance.

**FINANCIAL CONDITION**

As of March 31, 2011, total assets were \$1.26 billion, compared to \$1.34 billion as of March 31, 2010, and \$1.25 billion at December 31, 2010. Total securities available-for-sale (at fair value) were \$250.1 million at March 31, 2011, an increase of 79% from \$139.4 million at March 31, 2010, and an increase of 8% from \$232.2 million at December 31, 2010. The total loan portfolio, excluding loans held-for-sale, was \$803.4 million at March 31, 2011, a decrease of 20% from \$1.01 billion at March 31, 2010, and a decrease of 5% from \$846.0 million at December 31, 2010. Total deposits decreased 7% to \$1.00 billion at March 31, 2011, from \$1.08 billion at March 31, 2010, and increased 1% from \$993.9 million at December 31, 2010. There were no securities sold under agreement to repurchase at March 31, 2011, compared to \$20.0 million at March 31, 2010, and \$5.0 million at December 31, 2010.

Table of Contents**Securities Portfolio**

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

	March 31, 2011		December 31, 2010	
	(Dollars in thousands)			
Securities available-for-sale (at fair value)				
U.S. Government Sponsored Entities	\$		\$	1,997
Agency Mortgage-Backed Securities	250,132		132,457	232,165
Collateralized Mortgage Obligations			4,933	
<b>Total</b>	<b>\$</b>	<b>250,132</b>	<b>\$</b>	<b>139,387</b>
			<b>\$</b>	<b>232,165</b>

The following table summarizes the weighted average life and weighted average yields of securities at March 31, 2011:

	Within One Year		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	\$		\$	105,482	3.20%	\$	103,025	3.06%	\$	41,625	3.51%	\$	250,132	3.19%

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

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

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

Compared to March 31, 2010, the securities portfolio increased by \$110.7 million, or 79%, and increased to 20% of total assets at March 31, 2011, from \$139.4 million, or 10% of total assets, at March 31, 2010. The Company increased its holding of mortgage-back securities by \$17.9 million to





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

### Table of Contents

\$250.1 million at March 31, 2011, from \$232.2 million at December 31, 2010 to offset a portion of the contraction in the loan portfolio. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities to otherwise mitigate interest rate risk.

### **Loans**

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

Gross loans, excluding loans held-for-sale, represented 64% of total assets at March 31, 2011, as compared to 75% of total assets at March 31, 2010, and 68% of total assets at December 31, 2010. The ratio of loans to deposits decreased to 80.07% at March 31, 2011 from 93.04% at March 31, 2010 and 85.12% at December 31, 2010. Demand for loans has weakened within the Company's markets due to the current economic environment, and the Company has been more selective with respect to the types of loans the Company chooses to originate.

### **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:

	March 31, 2011		March 31, 2010		December 31, 2010	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
(Dollars in thousands)						
Commercial	\$ 365,748	46%	\$ 395,399	39%	\$ 378,412	45%
Real estate:						
Commercial and residential	320,950	40%	393,168	39%	337,457	40%
Land and construction	50,496	6%	153,811	15%	62,356	7%
Home equity	52,129	6%	51,369	6%	53,697	6%
Consumer	13,174	2%	11,943	1%	13,244	2%
<b>Total loans</b>	<b>802,497</b>	<b>100%</b>	<b>1,005,690</b>	<b>100%</b>	<b>845,166</b>	<b>100%</b>
Deferred loan costs	853		755		883	
<b>Loans, including deferred costs</b>	<b>803,350</b>	<b>100%</b>	<b>1,006,445</b>	<b>100%</b>	<b>846,049</b>	<b>100%</b>
Allowance for loan losses	(24,009)		(26,527)		(25,204)	
<b>Loans, net</b>	<b>\$ 779,341</b>		<b>\$ 979,918</b>		<b>\$ 820,845</b>	

The Company's loan portfolio is concentrated in commercial loans, primarily manufacturing, wholesale, and services, and commercial real estate, with the balance in land development and construction and home equity and consumer loans. The decrease in the Company's loan portfolio in the first quarter of 2011 compared to the first and fourth quarters of 2010 is due to diminished loan demand, and loan payoffs exceeding draw downs of loan commitments. Outstanding loan balances to total loan commitments were 74% at March 31, 2011, and 75% at March 31, 2010 and December 31, 2010. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 53% of its gross loans were secured by real property at March 31, 2011, compared to 59% at March 31, 2010, and 54% at December 31, 2010. While no specific industry concentration is considered significant, the Company's lending operations are located in areas that are dependent on the technology and real estate industries and their supporting companies.

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

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

Table of Contents

for periodic principal payments, with interest payable monthly. Term loans normally provide for floating interest rates, with monthly payments of both principal and interest.

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such guaranteed loans (collectively referred to as "SBA loans"). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold, the Company retains the servicing rights for the sold portion. During the first quarter of 2011, loans were sold resulting in a gain on sale of SBA loans of \$379,000.

As of March 31, 2011, commercial and residential real estate mortgage loans of \$321.0 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 March 31, 2011 consist of \$170.3 million, or 53%, of commercial owner occupied properties, \$146.7 million, or 46%, of commercial investment properties, and \$4.0 million, or 1% in residential properties. Properties securing the commercial real estate mortgage loans are primarily located in the Company's primary market, which is the Greater San Francisco Bay Area.

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. Land and construction loans decreased \$103.3 million to \$50.5 million, or 6% of total loans at March 31, 2011, from \$153.8 million, or 15% of total loans at March 31, 2010, and decreased \$11.9 million from \$62.4 million, or 7% of total loans at December 31, 2010.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 70% loan to value ratio. Home equity lines are reviewed at least semiannually, with specific emphasis on loans with a loan to value ratio greater than 70% and loans that were underwritten from mid-2005 through 2008, when real estate values were at the peak in the cycle. The Company takes measures to work with customers to reduce line commitments and minimize potential losses. There have been no adverse classifications to date as a result of the review.

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 \$30.2 million and \$50.3 million at March 31, 2011, respectively.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

**Loan Maturities**

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale) as of March 31, 2011. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall Street Journal. As of March 31, 2011, approximately 69% 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	\$ 326,369	\$ 32,918	\$ 6,461	\$ 365,748
Real estate:				
Commercial and residential	96,473	191,079	33,398	320,950
Land and construction	49,168	1,328		50,496
Home equity	50,549	126	1,454	52,129
Consumer	12,275	899		13,174
<b>Loans</b>	<b>\$ 534,834</b>	<b>\$ 226,350</b>	<b>\$ 41,313</b>	<b>\$ 802,497</b>

Loans with variable interest rates	\$ 485,208	\$ 62,114	\$ 3,375	\$ 550,697
Loans with fixed interest rates	49,626	164,236	37,938	251,800
<b>Loans</b>	<b>\$ 534,834</b>	<b>\$ 226,350</b>	<b>\$ 41,313</b>	<b>\$ 802,497</b>

**Loan Servicing**

As of March 31, 2011 and 2010, \$169.5 million and \$164.0 million, respectively, in SBA loans were serviced by the Company for others. Activity for loan servicing rights was as follows:

	For the Three Months Ended March 31,	
	2011	2010
(Dollars in thousands)		
Beginning of period balance	\$ 915	\$ 1,067
Additions	85	93
Amortization	(131)	(123)
End of period balance	\$ 869	\$ 1,037

Loan servicing rights are included in Accrued Interest Receivable and Other Assets on the consolidated balance sheets and reported net of amortization. There was no valuation allowance as of March 31, 2011 and 2010, as the fair market value of the assets was greater than the carrying value.

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

	March 31,	
	2011	2010
(Dollars in thousands)		
Beginning of period balance	\$ 2,140	\$ 2,466

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Amortization	(40)	(72)
Unrealized holding gain (loss)	93	(379)
End of period balance	\$ 2,193	\$ 2,015

Table of Contents

*Nonperforming Assets*

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

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

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

Nonperforming assets are comprised of the following: loans and loans held-for-sale for which the Company is no longer accruing interest; restructured loans; loans 90 days or more past due and still accruing interest (although they are generally placed on nonaccrual when they become 90 days past due, unless they are both well-secured and in the process of collection); and OREO from foreclosures. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued. Loans may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. OREO consists of properties acquired by foreclosure or similar means that management is offering or will offer for sale. Total OREO was \$918,000 at March 31, 2011, compared to \$1.8 million at March 31, 2010 and \$1.3 million at December 31, 2010. At March 31, 2011, the \$27.5 million of nonperforming assets included \$1.2 million of SBA guaranteed loans.

Table of Contents

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

	March 31,		December 31,
	2011	2010	2010
	(Dollars in thousands)		
Nonaccrual loans held-for-sale	\$ 1,989	\$	\$ 2,026
Nonaccrual loans held-for-investment	22,896	65,026	28,821
Restructured and loans over 90 days past due and still accruing	1,671	2,176	2,492
Total nonperforming loans	26,556	67,202	33,339
Other real estate owned	918	1,835	1,296
Total nonperforming assets	\$ 27,474	\$ 69,037	\$ 34,635

Nonperforming assets as a percentage of loans plus other real estate owned plus nonaccruals loans held-for-sale	3.41%	6.85%	4.08%
Nonperforming assets as a percentage of total assets	2.19%	5.17%	2.78%

The following table provides nonperforming loans by loan type as of March 31, 2011:

	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)		
Commercial	\$ 11,865	\$ 1,389	\$ 13,254
Real estate:			
Commercial and residential	3,866		3,866
Land and construction	8,261		8,261
Home equity		282	282
Consumer	893		893
Total	\$ 24,885	\$ 1,671	\$ 26,556

**Allowance for Loan Losses**

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

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





Table of Contents

the allowance will be established. Loans that are considered impaired are specifically excluded from the formula portion of the allowance for loan losses analysis.

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

Loans that demonstrate a weakness, for which there is a possibility of loss if the weakness is not corrected, are categorized as "classified." Classified assets 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), and OREO. The principal balance of classified assets, net of SBA guarantees of \$1.9 million, was \$81.4 million at March 31, 2011, \$171.2 million at March 31, 2010, and \$91.8 million at December 31, 2010. Included in the \$81.4 million of classified assets at March 31, 2011, were \$2.0 million of loans held-for-sale. Loans held-for-sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses. Management of the level of classified assets will continue to be a focus for executive management, the lending staff and the Company's Special Assets Department.

It is the policy of management to maintain the allowance for loan losses at a level adequate for risks inherent in the loan portfolio. On an ongoing basis, we have engaged an outside firm to perform independent credit reviews of our loan portfolio. The Federal Reserve Bank of San Francisco and the California Department of Financial Institutions also review the allowance for loan losses as an integral part of the examination process. Based on information currently available, management believes that the allowance for loan losses is adequate. However, the loan portfolio can be adversely affected if California economic conditions and the real estate market in the Company's market area were to further weaken. Also, any weakness of a prolonged nature in the technology industry would have a negative impact on the local market. The effect of such events, although uncertain at this time, could 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.

Table of Contents

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

	Three Months Ended March 31, 2011				Three Months Ended March 31, 2010
	Commercial	Real Estate	Consumer	Total	Total
	(Dollars in thousands)				
Balance, beginning of period	\$ 13,952	\$ 10,363	\$ 889	\$ 25,204	\$ 28,768
Charge-offs	(1,119)	(995)		(2,114)	(7,702)
Recoveries	139	10		149	366
Net charge-offs	(980)	(985)		(1,965)	(7,336)
Provision for loan losses	622	161	(13)	770	5,095
Balance, end of period	\$ 13,594	\$ 9,539	\$ 876	\$ 24,009	\$ 26,527
<b>RATIOS:</b>					
Net charge-offs to average loans(1)	0.48%	0.48%	0.00%	0.96%	2.83%
Allowance for loan losses to total loans(1)	1.69%	1.19%	0.11%	2.99%	2.64%
Allowance for loan losses to nonperforming loans	51.19%	35.92%	3.30%	90.41%	39.47%

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

The Company's allowance for loan losses decreased \$2.5 million in the first quarter of 2011 from the first quarter of 2010, and decreased \$1.2 million from the fourth quarter of 2010. The decrease in the provision for loan losses in first quarter of 2011 was primarily due to a lower volume of classified and nonperforming loans and a lower loan balance.

Net loans charged-off reflects the realization of losses in the portfolio that were partially recognized previously through provisions for loan losses. Net charge-offs were \$2.0 million in the first quarter of 2011, compared to net charge-offs of \$7.3 million in the first quarter of 2010, and net charge-offs of \$1.1 million in the fourth quarter of 2010. Historical net loan charge-offs are not necessarily indicative of the amount of net charge-offs that the Company will realize in the future.

The following table provides a summary of the allocation of the allowance for loan losses for specific 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 Loan Loss Allowance Table**

	March 31,		December 31,			
	2011	2010	2010	2010		
	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans		
(Dollars in thousands)						
Commercial	\$ 13,594	46%	\$ 10,668	39%	\$ 13,952	45%
Real estate:						
Commercial and residential	5,437	40%	6,118	39%	5,500	40%
Land and construction	3,599	6%	8,263	15%	4,271	7%
Home equity	503	6%	996	6%	592	6%
Consumer	876	2%	482	1%	889	2%
<b>Total</b>	<b>\$ 24,009</b>	<b>100%</b>	<b>\$ 26,527</b>	<b>100%</b>	<b>\$ 25,204</b>	<b>100%</b>

**Deposits**

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

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

	March 31, 2011		March 31, 2010		December 31, 2010	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
(Dollars in thousands)						
Demand deposits, noninterest-bearing	\$ 325,058	32%	\$ 261,047	24%	\$ 280,258	28%
Demand deposits, interest-bearing	135,903	14%	150,923	14%	153,917	16%
Savings and money market	262,763	26%	306,688	28%	272,399	27%
Time deposits under \$100	32,592	3%	38,856	4%	33,499	3%
Time deposits \$100 and over	128,156	13%	131,220	12%	137,514	14%
Time deposits CDARS	21,025	2%	18,490	2%	17,864	2%
Time deposits brokered	97,826	10%	174,471	16%	98,467	10%
<b>Total deposits</b>	<b>\$ 1,003,323</b>	<b>100%</b>	<b>\$ 1,081,695</b>	<b>100%</b>	<b>\$ 993,918</b>	<b>100%</b>

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

The Company obtains deposits from a cross-section of the communities it serves. The Company's business is not generally seasonal in nature. The Company is not dependent upon funds from sources outside the United States. At March 31, 2011 and 2010, less than 1% of deposits were from public sources, respectively.

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

### Table of Contents

Noninterest-bearing and low interest-bearing demand deposit accounts increased \$49.0 million, or 12%, at March 31, 2011 from March 31, 2010, and increased \$26.8 million, or 6%, from December 31, 2010. At March 31, 2011, brokered deposits decreased \$76.6 million, or 44%, to \$97.8 million, compared to \$174.5 million at March 31, 2010, decreased \$641,000, or 1%, from \$98.5 million at December 31, 2010.

The following table indicates the contractual maturity schedule of the Company's time deposits of \$100,000 and over, and all CDARS and brokered deposits as of March 31, 2011:

	Balance	% of Total
	(Dollars in thousands)	
Three months or less	\$ 115,990	48%
Over three months through six months	50,570	20%
Over six months through twelve months	40,506	16%
Over twelve months	39,941	16%
<b>Total</b>	<b>\$ 247,007</b>	<b>100%</b>

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

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

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

	Three Months Ended March 31,	
	2011	2010
Annualized return (loss) on average assets	0.51%	-1.23%
Annualized return (loss) on average tangible assets	0.51%	-1.28%
Annualized return (loss) on average equity	3.51%	-9.61%
Annualized return (loss) on average tangible equity	3.57%	-13.15%
Average equity to average assets ratio	14.62%	12.83%

### ***Off-Balance Sheet Arrangements***

In the normal course of business, the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in the contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, yet are not reflected on the Company's consolidated balance sheets. Total unused commitments to extend credit were \$285.6 million at March 31, 2011, as compared to \$327.9 million at March 31, 2010 and \$284.0 million at December 31, 2010. Unused commitments represented 36% and 33% of outstanding gross loans at March 31, 2011 and 2010, respectively.

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

Table of Contents

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

	March 31,				December 31,	
	2011		2010		2010	
	(Dollars in thousands)					
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Unused lines of credit and commitments to make loans	\$ 9,048	\$ 255,701	\$ 9,752	\$ 298,031	\$ 6,740	\$ 256,575
Standby letters of credit	2,291	18,587	457	19,671	2,291	18,419
	\$ 11,339	\$ 274,288	\$ 10,209	\$ 317,702	\$ 9,031	\$ 274,994

**Liquidity and Asset/Liability Management**

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

At March 31, 2011, the Company had loan contraction, including loans held-for-sale, of \$204.9 million from March 31, 2010, and it has experienced an improvement in its liquidity position. One of the measures we analyze for liquidity is our loan to deposit ratio. Our loan to deposit ratio improved to 80.07% at March 31, 2011 compared to 93.04% at March 31, 2010, and 85.12% at December 31, 2010.

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

The Company has off-balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. The Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. The Company had no overnight borrowings from the FHLB at March 31, 2011, March 31, 2010 and December 31, 2010. The Company had \$212.8 million of loans pledged to the FHLB as collateral on an available line of credit of \$114.9 million at March 31, 2011.

The Company can also borrow from FRB's discount window. The Company had \$209.3 million of loans pledged to the FRB as collateral on an available line of credit of \$124.7 million at March 31, 2011, none of which was outstanding.

At March 31, 2011, the Company had Federal funds purchase arrangements available of \$30.0 million. There were no Federal funds purchased outstanding March 31, 2011, March 31, 2010, and December 31, 2010.

Table of Contents

The Company also had a \$2.2 million secured borrowing at March 31, 2011. Secured borrowings represent the guaranteed portions of SBA 7a loans transferred to third parties subject to a SBA warranty for a period of 90 days. This requires the Company to treat these loans as secured borrowings during the warranty period. The warranty period for these loans expires in the following quarter. Provided the loans remain current through the end of the warranty period all elements necessary to record the sale will have been met.

The Company also utilizes securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to at March 31, 2011, compared to \$20.0 million at March 31, 2010, and \$5.0 million at December 31, 2010. Repurchase agreements are accounted for as collateralized financial transactions and were secured by mortgage-backed securities carried at an amortized cost of \$25.4 million at March 31, 2010, and \$6.3 million at December 31, 2010.

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

	March 31,		December 31,	
	2011	2010	2010	
	(Dollars in thousands)			
Average balance year-to-date	\$ 2,889	\$ 43,582	\$ 23,888	
Average interest rate year-to-date	3.41%	1.37%	1.78%	
Maximum month-end balance during the period	\$ 5,000	\$ 73,000	\$ 73,000	
Average rate at period-end	N/A	2.30%	3.09%	

**Capital Resources**

The Company uses a variety of measures to evaluate capital adequacy. Management reviews various capital measurements on a regular basis and takes appropriate action to ensure that such measurements are within established internal and external guidelines. The external guidelines, which are issued by the Federal Reserve Board and the FDIC, establish a risk-adjusted ratio relating capital to different categories of assets and off-balance sheet exposures. There are two categories of capital under the Federal Reserve Board and FDIC guidelines: Tier 1 and Tier 2 Capital. Our Tier 1 Capital currently consists of total shareholders' equity (excluding accumulated other comprehensive income or loss) and the proceeds from the issuance of trust preferred securities (trust preferred securities are counted only up to a maximum of 25% of Tier 1 capital), less goodwill and other intangible assets and disallowed deferred tax assets. Our Tier 2 Capital includes the allowances for loan losses and off-balance sheet credit losses.

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Table of Contents

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

	March 31,		December 31,			
	2011	2010	2010	2010		
(Dollars in thousands)						
<b>Capital components:</b>						
Tier 1 Capital	\$ 188,348	\$ 131,507	\$ 185,775			
Tier 2 Capital	11,969	13,999	11,988			
Total risk-based capital	\$ 200,317	\$ 145,506	\$ 197,763			
Risk-weighted assets	\$ 945,089	\$ 1,107,092	\$ 945,499			
Average assets for capital purposes	\$ 1,228,763	\$ 1,290,135	\$ 1,316,600			
				<b>Well-Capitalized</b>	<b>Minimum</b>	
				<b>Regulatory</b>	<b>Regulatory</b>	
				<b>Requirements</b>	<b>Requirements</b>	
<b>Capital ratios:</b>						
Total risk-based capital	21.2%	13.1%	20.9%	10.0%	8.0%	
Tier 1 risk-based capital	19.9%	11.9%	19.7%	6.0%	4.0%	
Leverage(1)	15.3%	10.2%	14.1%	N/A	4.0%	

(1)

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

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

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

	March 31,		December 31,			
	2011	2010	2010	2010		
(Dollars in thousands)						
<b>Capital components:</b>						
Tier 1 Capital	\$ 163,478	\$ 129,936	\$ 159,192			
Tier 2 Capital	11,992	14,005	11,993			
Total risk-based capital	\$ 175,470	\$ 143,941	\$ 171,185			
Risk-weighted assets	\$ 946,961	\$ 1,107,571	\$ 945,918			
Average assets for capital purposes	\$ 1,230,163	\$ 1,290,438	\$ 1,316,969			
				<b>Well-Capitalized</b>	<b>Minimum</b>	
				<b>Regulatory</b>	<b>Regulatory</b>	
				<b>Requirements</b>	<b>Requirements</b>	
<b>Capital ratios:</b>						
Total risk-based capital	18.5%	13.0%	18.1%	10.0%	8.0%	
Tier 1 risk-based capital	17.3%	11.7%	16.8%	6.0%	4.0%	



Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Leverage(1)

---

13.3%

10.1%

12.1%

5.0%

4.0%

(1)

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

54

---

Table of Contents

The table above presents the capital ratios of HBC computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements under the FDIC's prompt corrective action authority. During 2010, in accordance with the Written Agreement, we submitted a written plan for sufficient capitalization of both HBC and HCC (on a consolidated basis), based on their respective risk profiles to the Federal Reserve and DFI. The plan was approved in the fourth quarter of 2010.

At March 31, 2011 and 2010, and December 31, 2010, HCC's and HBC's capital met all minimum regulatory requirements. As of March 31, 2011, HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under the prompt corrective action provisions.

At March 31, 2011, the Company had total shareholders' equity of \$183.2 million, including \$58.2 million in preferred stock, \$130.7 million in common stock, (\$881,000) in accumulated deficit, and (\$4.8) million of accumulated other comprehensive loss. The components of other comprehensive loss at March 31, 2011 include the following: an unrealized loss on available-for-sale securities of (\$1.9) million, an unrealized loss on split dollar insurance contracts of (\$2.1) million, an unrealized loss on the supplemental executive retirement plan of (\$2.0) million and an unrealized gain on interest-only strip from SBA loans of \$1.2 million.

***Mandatory Redeemable Cumulative Trust Preferred Securities***

To enhance regulatory capital and to provide liquidity, the Company, through unconsolidated subsidiary grantor trusts, issued the following mandatory redeemable cumulative trust preferred securities of subsidiary grantor trusts: In the first quarter of 2000, the Company issued \$7.2 million aggregate principal amount of 10.87% subordinated debt due on March 8, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2000, the Company issued \$7.2 million aggregate principal amount of 10.60% subordinated debt due on September 7, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2001, the Company issued \$5.2 million aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on July 31, 2031 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2002, the Company issued \$4.1 million of aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on September 26, 2032 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. The subordinated debt is recorded as a component of long-term debt and includes the value of the common stock issued by the trusts to the Company. The common stock is recorded as other assets for the amount issued. Under applicable regulatory guidelines, the trust preferred securities currently qualify as Tier I capital. The subsidiary trusts are not consolidated in the Company's consolidated financial statements. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, certain trust preferred securities will no longer be eligible to be included as Tier 1 capital for regulatory purposes. However, an exception to this statutory prohibition applies to securities issued prior to May 19, 2010 by bank holding companies with less than \$15 billion of total assets; therefore, our trust preferred securities will continue to be eligible to be treated as Tier 1 capital, subject to other rules and limitations.

In November 2009, the Company announced that it was exercising its right to defer interest payments on its outstanding trust preferred subordinated debt securities. The Company will continue to accrue the cost and recognize the expense of the interest at the normal rate on a compounded basis until such time as the deferred arrearage has been paid current. As a result the Company has accrued but has not paid approximately \$2.9 million in interest on its subordinated debt as of March 31, 2011.

Table of Contents

***U.S. Treasury Capital Purchase Program***

The Company received \$40 million in November 2008 through the issuance of its Series A Preferred Stock and a warrant to purchase 462,963 shares of its common stock to the Treasury through the U.S. Treasury Capital Purchase Program. The Series A Preferred Stock qualifies as a component of Tier 1 capital. In November 2009, the Company announced that it was exercising its right to suspend payment of dividends on its Series A Preferred Stock. The Company accrues the cumulative unpaid dividends at the compounded dividend rate. As a result of the Company has accrued but has not paid approximately \$3.3 million in dividends on its Series A Preferred Stock as of March 31, 2011.

***Private Placement***

On June 21, 2010, the Company issued to various institutional investors 53,996 shares of Series B Mandatorily Convertible Cumulative Perpetual Preferred Stock ("Series B Preferred Stock") and 21,004 shares of newly issued Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") for an aggregate purchase price of \$75.0 million. The Series B Preferred Stock was mandatorily convertible into common stock, upon approval by the shareholders at a conversion price of \$3.75 per share. The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of \$3.75 per share upon both approval by the shareholders and thereafter, a subsequent transfer of the Series C Preferred stock to third parties not affiliates with the holder in a widely dispersed offering. The Series B Preferred Stock and the Series C Preferred Stock did not include a beneficial conversion feature, as the conversion price at \$3.75 per share was not below the fair market value of the Company's common stock on the commitment date.

At the Company's Special Meeting of shareholders held on September 15, 2010, the Company's shareholders approved the issuance of common stock upon the conversion of the Series B Preferred Stock and upon the conversion of the Series C Preferred Stock. As a result, on September 16, 2010, the Series B Preferred Stock was converted into 14,398,992 shares of common stock of the Company and the shares of Series B Preferred Stock ceased to be outstanding.

The Series C Preferred Stock remains outstanding until it has been converted into common stock in accordance with its terms. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of \$1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock and ranks on parity with the Company's Series A Preferred Stock.

**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

Table of Contents

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

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

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

Interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Varying interest rate environments can create unexpected changes in prepayment levels of assets 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).

Table of Contents

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 March 31, 2011. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

Change in Interest Rates (basis points)	Increase/(Decrease) in Estimated Annual Net Interest Income	
	Amount	Percent
	(Dollars in thousands)	
+400	\$ 10,141	20.8%
+300	\$ 7,493	15.3%
+200	\$ 4,809	9.9%
+100	\$ 2,218	4.5%
0	\$	0.0%
-100	\$ (4,322)	-8.8%
-200	\$ (10,033)	-20.5%

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.

**CRITICAL ACCOUNTING POLICIES**

Critical accounting policies are discussed in our Form 10-K for the year ended December 31, 2010. There are no changes to these policies as of March 31, 2011.

**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

Table of Contents

effectiveness of the design and operation of the Company's disclosure controls and procedures as of March 31, 2011. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded the Company's disclosure controls were effective as of March 31, 2011, the period covered by this report on Form 10-Q.

During the three months ended March 31, 2011, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to affect, our internal controls over financial reporting.

Table of Contents

**Part II OTHER INFORMATION**

**ITEM 1 LEGAL PROCEEDINGS**

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

**ITEM 1A RISK FACTORS**

In addition to the other information set forth in this Report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2010, which could materially affect our business, financial condition and/or operating results. There were no material changes from risk factors previously disclosed in our 2010 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 made or otherwise addressed in connection with a forward-looking statement or contained in any of our subsequent filings with the Securities and Exchange Commission.

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

None

**ITEM 3 DEFAULTS UPON SENIOR SECURITIES**

As of March 31, 2011, the Company has deferred six dividend payments on its Series A Preferred Stock totaling approximately \$3.3 million.

**ITEM 4 RESERVED**

**ITEM 5 OTHER INFORMATION**

None

Table of Contents

**ITEM 6 EXHIBITS**

<b>Exhibit</b>	<b>Description</b>
3.1	Heritage Commerce Corp Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 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 3.1 to the Registrant's Statement on Form S-1 filed July 23, 2010).
3.3	Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Registration Statement Form S-1 filed on July 23, 2010)
4.1	Certificate of Determination for Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference to Exhibit 3.1 to the Registrant's Form 8-K filed November 26, 2008)
4.2	Warrant to Purchase Common Stock dated November 21, 2008 (incorporated by reference to Exhibit 4.2 to the Registrant's Form 8-K filed on November 26, 2008)
4.3	Certificate of Determination for Series C Convertible Perpetual Preferred Stock (incorporated by reference to to the Registrant's Form 8-K filed on June 22, 2010)
12.1	Calculation of Ratio of Earnings to Fixed Charges and Ratio of Earnings to Fixed Charges and Preferred Stock Dividends
31.1	Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350
32.2	Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350



Table of Contents

**SIGNATURES**

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

Heritage Commerce Corp (Registrant)

Date: May 9, 2011

/s/ WALTER T. KACZMAREK

---

Walter T. Kaczmarek  
*Chief Executive Officer*

Date: May 9, 2011

/s/ LAWRENCE D. MCGOVERN

---

Lawrence D. McGovern  
*Chief Financial Officer*

Table of Contents

**EXHIBIT INDEX**

<b>Exhibit</b>	<b>Description</b>
3.1	Heritage Commerce Corp Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 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 3.1 to the Registrant's Statement on Form S-1 filed July 23, 2010)
3.3	Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Registration Statement Form S-1 filed on July 23, 2010)
4.1	Certificate of Determination for Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference to Exhibit 3.1 to the Registrant's Form 8-K filed November 26, 2008)
4.2	Warrant to Purchase Common Stock dated November 21, 2008 (incorporated by reference to Exhibit 4.2 to the Registrant's Form 8-K filed on November 26, 2008)
4.3	Certificate of Determination for Series C Convertible Perpetual Preferred Stock (incorporated by reference to the Registrant's Form 8-K filed on June 22, 2010)
12.1	Calculation of Ratio of Earnings to Fixed Charges and Ratio of Earnings to Fixed Charges and Preferred Stock Dividends
31.1	Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350
32.2	Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350