HERITAGE COMMERCE CORP
Form 10-Q
May 06, 2016

Use these links to rapidly review the document

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended Mach 31, 2016

OR

o	**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	**77-0469558**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
150 Almaden Boulevard, San Jose, California	**95113**
(Address of Principal Executive Offices)	(Zip Code)

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

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

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

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 ý NO o

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

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

The Registrant had 32,170,920 shares of Common Stock outstanding on April 28, 2016.

Table of Contents

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

Table of Contents

Cautionary Note Regarding Forward-Looking Statements

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

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

- local, regional, and national economic conditions and events and their impact on us and our customers;
- changes in the financial performance or condition of the Company's customers;
- volatility in credit and equity markets and its effect on the global economy;
- competition for loans and deposits and failure to attract or retain deposits and loans;
- our ability to increase market share and control expenses;
- our ability to develop and promote customer acceptance of new products and services in a timely manner;
- risks associated with concentrations in real estate related loans;
- other than temporary impairment charges to our securities portfolio;
- an oversupply of inventory and deterioration in values of California commercial real estate;
- a prolonged slowdown in construction activity;
- changes in the level of nonperforming assets and charge offs and other credit quality measures, and their impact on the adequacy of the Company's allowance for loan losses and the Company's provision for loan losses;
- the effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Federal Open Market Committee of the Federal Reserve Board;

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

our ability to raise capital or incur debt on reasonable terms;

regulatory limits on Heritage Bank of Commerce's ability to pay dividends to the Company;

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

Table of Contents

- operational issues stemming from, and/or capital spending necessitated by, the potential need to adapt to industry changes in information technology systems, on which we are highly dependent;

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

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

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

- the effect and uncertain impact on the Company of the enactment of the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 and the rules and regulations promulgated by supervisory and oversight agencies implementing the new legislation;

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

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

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

- the successful integration of the business, employees and operations of Focus Business Bank with the Company and our ability to achieve the projected synergies of this acquisition within expected time frame; and

- our success in managing the risks involved in the foregoing factors.

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

Table of Contents

Part I FINANCIAL INFORMATION

ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HERITAGE COMMERCE CORP

CONSOLIDATED BALANCE SHEETS (Unaudited)

	March 31, 2016	December 31, 2015
	(Dollars in thousands)	
Assets		
Cash and due from banks	$ 25,573	$ 24,112
Interest-bearing deposits in other financial institutions	117,562	319,980
Total cash and cash equivalents	143,135	344,092
Securities available-for-sale, at fair value	448,540	385,079
Securities held-to-maturity, at amortized cost (fair value of $187,047 at March 31, 2016 and $109,821 at December 31, 2015)	185,165	109,311
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	2,389	7,297
Loans, net of deferred fees	1,395,264	1,358,716
Allowance for loan losses	(19,458)	(18,926)
Loans, net	1,375,806	1,339,790
Federal Home Loan Bank and Federal Reserve Bank stock and other investments, at cost	12,702	12,694
Company owned life insurance	60,470	60,021
Premises and equipment, net	7,625	7,773
Goodwill	45,664	45,664
Other intangible assets	8,126	8,518
Accrued interest receivable and other assets	37,711	41,340
Total assets	$ 2,327,333	$ 2,361,579
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	$ 768,525	$ 821,405
Demand, interest-bearing	506,272	496,278
Savings and money market	493,275	496,843
Time deposits-under $250	61,595	62,026
Time deposits-$250 and over	179,048	160,815
Time deposits-brokered	11,829	17,825
CDARS money market and time deposits	8,192	7,583
Total deposits	2,028,736	2,062,775
Short-term borrowings		3,000
Accrued interest payable and other liabilities	46,938	50,368
Total liabilities	2,075,674	2,116,143

Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at March 31, 2016 and December 31, 2015 (liquidation preference of $21,004 at March 31, 2016 and December 31, 2015)	19,519	19,519
Common stock, no par value; 60,000,000 shares authorized; 32,170,920 shares issued and outstanding at March 31, 2016 and 32,113,479 shares issued and outstanding at December 31, 2015	194,153	193,364
Retained earnings	41,485	38,773
Accumulated other comprehensive loss	(3,498)	(6,220)
Total shareholders' equity	251,659	245,436
Total liabilities and shareholders' equity	$ 2,327,333	$ 2,361,579

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended March 31,	
	2016	**2015**
	(Dollars in thousands, except per share data)	
Interest income:		
Loans, including fees	$ 19,188	$ 15,004
Securities, taxable	2,774	1,604
Securities, exempt from Federal tax	579	506
Other investments and interest-bearing deposits in other financial institutions	521	252
Total interest income	23,062	17,366
Interest expense:		
Deposits	747	508
Short-term borrowings	11	
Total interest expense	758	508
Net interest income before provision for loan losses	22,304	16,858
Provision (credit) for loan losses	401	(60)
Net interest income after provision for loan losses	21,903	16,918
Noninterest income:		
Service charges and fees on deposit accounts	767	623
Increase in cash surrender value of life insurance	449	400
Servicing income	371	306
Gain on sales of SBA loans	305	207
Gain on sales of securities	180	
Other	542	390
Total noninterest income	2,614	1,926
Noninterest expense:		
Salaries and employee benefits	8,947	8,042
Occupancy and equipment	1,085	1,045
Professional fees	825	95
Other	3,828	3,094
Total noninterest expense	14,685	12,276
Income before income taxes	9,832	6,568
Income tax expense	3,726	2,430
Net income	6,106	4,138
Dividends on preferred stock	(504)	(448)
Net income available to common shareholders	$ 5,602	$ 3,690

Earnings per common share:				
Basic	$	0.16	$	0.13
Diluted	$	0.16	$	0.13

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	For the Three Months Ended March 31,	
	2016	2015
	(Dollars in thousands)	
Net income	$ 6,106	$ 4,138
Other comprehensive income:		
Change in net unrealized holding gains on available-for-sale securities and I/O strips	4,839	888
Deferred income taxes	(2,032)	(374)
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(14)	(14)
Deferred income taxes	6	6
Reclassification adjustment for gains on sales of securities realized in income	(180)	
Deferred income taxes	75	
Change in unrealized gains on securities and I/O strips, net of deferred income taxes	2,694	506
Change in net pension and other benefit plan liabilities adjustment	48	48
Deferred income taxes	(20)	(20)
Change in pension and other benefit plan liabilities net of deferred income taxes	28	28
Other comprehensive income	2,722	534
Total comprehensive income	$ 8,828	$ 4,672

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

Three Months Ended March 31, 2016 and 2015

	Preferred Stock		Common Stock			Accumulated Other Comprehensive	Total
	Shares	Amount	Shares	Amount	Retained Earnings	Income / (Loss)	Shareholders' Equity
	(Dollars in thousands, except share data)						
Balance, January 1, 2015	21,004	$ 19,519	26,503,505	$ 133,676	$ 33,014	$ (1,851)	$ 184,358
Net income					4,138		4,138
Other comprehensive income						534	534
Amortization of restricted stock awards, net of forfeitures and taxes				(14)			(14)
Cash dividend declared $0.08 per share					(2,569)		(2,569)
Stock option expense, net of forfeitures and taxes				224			224
Stock options exercised			19,234	106			106
Balance, March 31, 2015	21,004	$ 19,519	26,522,739	$ 133,992	$ 34,583	$ (1,317)	$ 186,777
Balance, January 1, 2016	21,004	$ 19,519	32,113,479	$ 193,364	$ 38,773	$ (6,220)	$ 245,436
Net income					6,106		6,106
Other comprehensive income						2,722	2,722
Amortization of restricted stock awards, net of forfeitures and taxes				186			186
Cash dividend declared $0.09 per share					(3,394)		(3,394)
Stock option expense, net of forfeitures and taxes				245			245
Stock options exercised			57,441	358			358
Balance, March 31, 2016	21,004	$ 19,519	32,170,920	$ 194,153	$ 41,485	$ (3,498)	$ 251,659

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Three Months Ended March 31,	
	2016	2015
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 6,106	$ 4,138
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	667	293
Gain on sale of securities available-for-sale	(180)	
Gain on sale of SBA loans	(305)	(207)
Proceeds from SBA loans originated for sale	4,927	2,345
SBA loans originated for sale	(2,505)	(2,356)
Provision (credit) for loan losses	401	(60)
Increase in cash surrender value of life insurance	(449)	(400)
Depreciation and amortization	169	186
Amortization of intangible assets	392	189
Gain on sale of foreclosed assets, net		(124)
Stock option expense, net	245	224
Amortization of restricted stock awards, net	186	(14)
Effect of changes in:		
Accrued interest receivable and other assets	1,700	(1,074)
Accrued interest payable and other liabilities	(3,387)	(1,841)
Net cash provided by operating activities	7,967	1,299
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(75,803)	
Purchase of securities held-to-maturity	(78,680)	
Maturities/paydowns/calls of securities available-for-sale	11,075	6,204
Maturities/paydowns/calls of securities held-to-maturity	2,665	720
Proceeds from sale of securities available-for-sale	5,598	
Net change in loans	(33,675)	(11,877)
Change in Federal Home Loan Bank and Federal Reserve Bank stock and other investments	(8)	(20)
Purchase of premises and equipment	(21)	(75)
Proceeds from sale of foreclosed assets		322
Net cash used in investing activities	(168,849)	(4,726)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	(34,039)	35,263
Exercise of stock options	358	106
Repayment of short-term borrowings	(3,000)	
Payment of cash dividends	(3,394)	(2,569)
Net cash (used in) provided by financing activities	(40,075)	32,800
Net (decrease) increase in cash and cash equivalents	(200,957)	29,373
Cash and cash equivalents, beginning of period	344,092	122,403
Cash and cash equivalents, end of period	$ 143,135	$ 151,776

Supplemental disclosures of cash flow information:		
Interest paid	$ 741	$ 487
Income taxes paid	1,375	1,000
Supplemental schedule of non-cash investing activity:		
Transfer of loans held for sale to loan portfolio	2,791	
Loans transferred to foreclosed assets	49	1,236

See notes to unaudited consolidated financial statements

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2016

(Unaudited)

1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company" or "HCC") and its wholly owned subsidiary, Heritage Bank of Commerce ("HBC"), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes that were included in the Company's Form 10-K for the year ended December 31, 2015.

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

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

HBC is a commercial bank serving customers located in Santa Clara, Alameda, Contra Costa, and San Benito counties of California. Bay View Funding provides business-essential working capital factoring financing to various industries throughout the United States. No customer accounts for more than 10 percent of revenue for HBC or the Company. With the acquisition of Bay View Funding, the Company now has two reportable segments consisting of Banking and Factoring. The Company's management uses segment results in its operating and strategic planning.

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

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

The results for the three months ended March 31, 2016 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2016.

Reclassifications

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

1) Basis of Presentation (Continued)

Adoption of New Accounting Standards

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

Newly Issued, but not yet Effective Accounting Standards

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments Recognition and Measurement of Financial Assets and Liabilities*. The new guidance is intended to improve the recognition and measurement of financial instruments by requiring: equity investments (other than equity method or consolidation) to be measured at fair value with changes in fair value recognized in net income; public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; separate presentation of financial assets and financial liabilities by measurement category and form of financial assets (i.e. securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement to disclose the fair value of financial instruments measured at amortized cost for organizations that are not public business entities; eliminating the requirement for non-public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is to be required to be disclosed for financial instruments measured at amortized cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from the change in the instrument-specific credit risk (also referred to as "own credit") when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. The new guidance is effective for public business entities for fiscal years beginning after December 15, 2017. We are currently evaluating the impact of adopting the new guidance on the consolidated financial statements, but it is not expected to have a material impact.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*. The standard requires a lessee to recognize assets and liabilities on the balance sheet for leases with lease terms greater than 12 months.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

1) Basis of Presentation (Continued)

A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. When measuring assets and liabilities arising from a lease, a lessee (and a lessor) should include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. Similarly, optional payments to purchase the underlying asset should be included in the measurement of lease assets and lease liabilities only if the lessee is reasonably certain to exercise that purchase option. *Reasonably certain* is a high threshold that is consistent with and intended to be applied in the same way as the *reasonably assured* threshold in the previous leases guidance. In addition, also consistent with the previous leases guidance, a lessee (and a lessor) should exclude most variable lease payments in measuring lease assets and lease liabilities, other than those that depend on an index or a rate or are in substance fixed payments. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term. The new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, and early adoption is permitted. We are currently evaluating the impact of adopting the new guidance on our consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation Stock Compensation*: *Improvements to Employee Share-Based Payment Accounting*. The standard is intended to simplify several areas of accounting for share-based compensation arrangements, including the income tax impact, classification on the statement of cash flows and forfeitures. All excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) should be recognized as income tax expense or benefit in the income statement. The tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. An entity also should recognize excess tax benefits regardless of whether the benefit reduces taxes payable in the current period. Excess tax benefits should be classified along with other income tax cash flows as an operating activity. An entity can make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest (current GAAP) or account for forfeitures when they occur. The threshold to qualify for equity classification permits withholding up to the maximum statutory tax rates in the applicable jurisdictions. Cash paid by an employer when directly withholding shares for tax withholding purposes should be classified as a financing activity. A nonpublic entity can make an accounting policy election to apply a practical expedient to estimate the expected term for all awards with performance or service conditions that meet certain conditions. A nonpublic entity can make a one-time accounting policy election to switch from measuring all liability-classified awards at fair value to intrinsic value. The new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, and early adoption is permitted. We are currently evaluating the impact of adopting the new guidance on our consolidated financial statements.

2) Earnings Per Share

Basic earnings per common share is computed by dividing net income, less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. The Series C

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

2) Earnings Per Share (Continued)

Preferred Stock participates in the earnings of the Company and, therefore, the shares issued on the conversion of the Series C Preferred Stock are considered outstanding under the two class method of computing basic earnings per common share during periods of earnings. Diluted earnings per share reflect potential dilution from outstanding stock options using the treasury stock method. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	For the Three Months Ended March 31,	
	2016	2015
	(Dollars in thousands, except per share amounts)	
Net income available to common shareholders	$ 5,602	$ 3,690
Less: undistributed earnings allocated to Series C Preferred Stock	(403)	(274)
Distributed and undistributed earnings allocated to common shareholders	$ 5,199	$ 3,416
Weighted average common shares outstanding for basic earnings per common share	32,125,716	26,509,723
Dilutive effect of stock options oustanding, using the the treasury stock method	251,777	170,530
Shares used in computing diluted earnings per common share	32,377,493	26,680,253
Basic earnings per share	$ 0.16	$ 0.13
Diluted earnings per share	$ 0.16	$ 0.13

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

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

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

	For the Three Months Ended March 31, 2016 and 2015			
	Unrealized Gains on Available-for-Sale Securities and I/O Strips(1)	Unamortized Unrealized Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity(1)	Defined Benefit Pension Plan Items(1)	Total(1)
	(Dollars in thousands)			
Beginning balance January 1, 2016, net of taxes	$ 1,090	$ 403	$ (7,713)	$ (6,220)
Other comprehensive income before reclassification, net of taxes	2,807			2,807
Amounts reclassified from other comprehensive income (loss), net of taxes	(105)	(8)	28	(85)
Net current period other comprensive income, net of taxes	2,702	(8)	28	2,722
Ending balance March 31, 2016, net of taxes	$ 3,792	$ 395	$ (7,685)	$ (3,498)
Beginning balance January 1, 2015, net of taxes	$ 3,666	$ 435	$ (5,952)	$ (1,851)
Other comprehensive income (loss) before reclassification, net of taxes	514		(21)	493
Amounts reclassified from other comprehensive income (loss), net of taxes		(8)	49	41
Net current period other comprehensive income (loss), net of taxes	514	(8)	28	534
Ending balance March 31, 2015, net of taxes	$ 4,180	$ 427	$ (5,924)	$ (1,317)

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

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

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Three Months Ended March 31, 2016	2015	Affected Line Item Where Net Income is Presented
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	$ 180	$	Realized gains on sale of securities
	(75)		Income tax expense
	105		Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	14	14	Interest income on taxable securities
	(6)	(6)	Income tax expense
	8	8	Net of tax
Amortization of defined benefit pension plan items			
Prior transition obligation	13	12	
Actuarial losses	(60)	(96)	
	(47)	(84)	Salaries and employee benefits
	19	35	Income tax expense
	(28)	(49)	Net of tax
Total reclassification for the period	$ 85	$ (41)	

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

4) Securities

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

March 31, 2016	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	$ 388,282	$ 4,543	$ (72)	$ 392,753
U.S. Treasury	30,054	278		30,332
Trust preferred securities	15,000	225		15,225
U.S. Government sponsored entities	9,041	140		9,181
Corporate bonds	1,005	44		1,049
Total	$ 443,382	$ 5,230	$ (72)	$ 448,540
Securities held-to-maturity:				
Municipals tax exempt	$ 92,589	$ 2,091	$ (458)	$ 94,222
Agency mortgage-backed securities	92,576	296	(47)	92,825
Total	$ 185,165	$ 2,387	$ (505)	$ 187,047

December 31, 2015	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	$ 324,077	$ 2,457	$ (2,304)	$ 324,230
U.S. Treasury	30,047		(44)	30,003
Trust preferred securities	15,000	132		15,132
U.S. Government sponsored entities	9,042	13	(14)	9,041
Corporate bonds	6,412	261		6,673
Total	$ 384,578	$ 2,863	$ (2,362)	$ 385,079
Securities held-to-maturity:				
Municipals tax exempt	$ 93,518	$ 1,517	$ (863)	$ 94,172

Agency mortgage-backed securities		15,793		24		(168)	15,649
Total	$	109,311	$	1,541	$	(1,031)	$ 109,821

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

4) Securities (Continued)

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

	Less Than 12 Months		12 Months or More		Total	
March 31, 2016	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
			(Dollars in thousands)			
Securities available-for-sale:						
Agency mortgage-backed securities	$ 57,940	$ (58)	$ 4,182	$ (14)	$ 62,122	$ (72)
Total	$ 57,940	$ (58)	$ 4,182	$ (14)	$ 62,122	$ (72)
Securities held-to-maturity:						
Municipals Tax Exempt	$ 2,051	$ (24)	$ 18,643	$ (434)	$ 20,694	$ (458)
Agency mortgage-backed securities	7,297	(14)	3,705	(33)	11,002	(47)
Total	$ 9,348	$ (38)	$ 22,348	$ (467)	$ 31,696	$ (505)

	Less Than 12 Months		12 Months or More		Total	
December 31, 2015	**Fair Value**	**Unrealized (Losses)**	**Fair Value**	**Unrealized (Losses)**	**Fair Value**	**Unrealized (Losses)**
			(Dollars in thousands)			
Securities available-for-sale:						
Agency mortgage-backed securities	$ 241,067	$ (2,258)	$ 2,165	$ (46)	$ 243,232	$ (2,304)
U.S. Treasury	30,003	(44)			30,003	(44)
U.S. Government sponsored entities	4,980	(14)			4,980	(14)
Total	$ 276,050	$ (2,316)	$ 2,165	$ (46)	$ 278,215	$ (2,362)
Securities held-to-maturity:						
Municipals Tax Exempt	$ 9,920	$ (78)	$ 24,412	$ (785)	$ 34,332	$ (863)
	7,152	(89)	4,409	(79)	11,561	(168)

Agency mortgage-backed securities												
Total	$	17,072	$	(167)	$	28,821	$	(864)	$	45,893	$	(1,031)

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, 2016, the Company held 475 securities (199 available-for-sale and 276 held-to-maturity), of which 72 had fair values below amortized cost. At March 31, 2016, there were $4,182,000 of agency mortgage-backed securities available-for-sale, $18,643,000 of municipal bonds held-to-maturity, and $3,705,000 of agency mortgage-backed securities held-to-maturity carried with an unrealized loss for 12 months or more. The total unrealized loss for securities 12 months or more was $481,000 at March 31, 2016. The unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not believe that it is

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

4) Securities (Continued)

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, 2016.

At December 31, 2015, the Company held 460 securities (193 available-for-sale and 267 held-to-maturity), of which 193 had fair values below amortized cost. At December 31, 2015, there were $2,165,000 of agency mortgage-backed securities available-for-sale, $4,409,000 of agency mortgage-backed securities held-to-maturity and $24,412,000 of municipals bonds held-to-maturity carried with an unrealized loss for 12 months or greater. The total unrealized loss for securities 12 months or greater was $910,000 at December 31, 2015. The unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company does not consider these securities to be other-than-temporarily impaired at December 31, 2015.

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

	Three Months Ended March 31,	
	2016	**2015**
	(Dollars in thousands)	
Proceeds	$ 5,598	$
Gross gains	180	
Gross losses		

The amortized cost and estimated fair values of securities as of March 31, 2016, are shown by contractual maturity below. The expected maturities will differ from contractual maturities if borrowers have the right to call or pre-pay obligations with or without call or pre-payment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	**Estimated Fair Value**
	(Dollars in thousands)	
Due after 3 months through one year	$ 6,290	$ 6,297
Due after one through five years	33,810	34,265
Due after ten years	15,000	15,225
Agency mortgage-backed securities	388,282	392,753
Total	$ 443,382	$ 448,540

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

4) Securities (Continued)

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due less than 3 months	$ 612	$ 614
Due after 3 months through one year	1,039	1,045
Due after one through five years	5,239	5,319
Due after five through ten years	14,726	15,533
Due after ten years	70,973	71,711
Agency mortgage-backed securities	92,576	92,825
Total	$ 185,165	$ 187,047

5) Loans

Loans were as follows for the periods indicated:

	March 31, 2016	December 31, 2015
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	$ 592,128	$ 556,522
Real estate:		
Commercial and residential	616,821	625,665
Land and construction	95,547	84,428
Home equity	74,993	76,833
Consumer	16,476	16,010
Loans	1,395,965	1,359,458
Deferred loan origination fees, net	(701)	(742)
Loans, net of deferred fees	1,395,264	1,358,716
Allowance for loan losses	(19,458)	(18,926)
Loans, net	$ 1,375,806	$ 1,339,790

At March 31, 2016 and December 31, 2015, total net loans included in the table above include $130,860,000, and $141,343,000, respectively, of the loans acquired in the Focus transaction that were not purchased credit impaired loans.

19

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

5) Loans (Continued)

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

	Three Months Ended March 31, 2016			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 10,748	$ 8,076	$ 102	$ 18,926
Charge-offs	(117)			(117)
Recoveries	32	216		248
Net (charge-offs) recoveries	(85)	216		131
Provision (credit) for loan losses	616	(224)	9	401
Balance, end of period	$ 11,279	$ 8,068	$ 111	$ 19,458

	Three Months Ended March 31, 2015			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 11,187	$ 7,070	$ 122	$ 18,379
Charge-offs	(212)	(2)		(214)
Recoveries	436	13		449
Net recoveries	224	11		235
Provision (credit) for loan losses	(555)	473	22	(60)
Balance, end of period	$ 10,856	$ 7,554	$ 144	$ 18,554

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

	March 31, 2016			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 2	$ 111	$	$ 113
Collectively evaluated for impairment	11,277	7,957	111	19,345
Acquired with deteriorated credit quality				

Total allowance balance	$	11,279	$	8,068	$	111	$	19,458
Loans:								
Individually evaluated for impairment	$	190	$	3,891	$	3	$	4,084
Collectively evaluated for impairment		591,693		783,470		16,473		1,391,636
Acquired with deterioriated credit quality		245						245
Total loan balance	$	592,128	$	787,361	$	16,476	$	1,395,965

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

5) Loans (Continued)

	December 31, 2015			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 174	$ 112	$	$ 286
Collectively evaluated for impairment	10,574	7,964	102	18,640
Acquired with deteriorated credit quality				
Total allowance balance	$ 10,748	$ 8,076	$ 102	$ 18,926
Loans:				
Individually evaluated for impairment	$ 2,014	$ 4,272	$ 4	$ 6,290
Collectively evaluated for impairment	554,271	782,654	16,006	1,352,931
Acquired with deteriorated credit quality	237			237
Total loan balance	$ 556,522	$ 786,926	$ 16,010	$ 1,359,458

Purchased Credit Impaired Loans:

The Company has purchased loans, for which there was, at acquisition, evidence of impaired credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The carrying amount of these loans is as follows:

	March 31, 2016	December 31, 2015
	(Dollars in thousands)	
Commercial	$ 820	$ 876
Outstanding balance	$ 820	$ 876
Carrying amount, net of discount of $575,000 and $639,000 at March 31, 2016 and December 31, 2015, respectively	$ 245	$ 237

The Company did not increase the allowance for loan losses for the purchased credit impaired loans listed above during the first three months of 2016 or during 2015. No allowance for loan losses were reversed during the first three months of 2016 or during 2015.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

5) Loans (Continued)

For these purchased credit impaired loans, the Company cannot reasonably estimate the cash flows expected to be collected on the loans and therefore has continued to account for those loans using the cost recovery method of income recognition. As such, no portion of a purchase discount adjustment has been determined to meet the definition of an accretable yield adjustment on those loans accounted for using the cost recovery method. If, in the future, cash flows from the borrowers can be reasonably estimated, a portion of the purchase discount would be allocated to an accretable yield adjustment based upon the present value of the future estimated cash flows versus the current carrying value of the loan and the accretable yield portion would be recognized as interest income over the remaining life of the loan. Until such accretable yield can be calculated, under the cost recovery method of income recognition, all payments will be used to reduce the carrying value of the loan and no income will be recognized on the loan until the carrying value is reduced to zero. Any loan accounted for under the cost recovery method is also still included as a nonaccrual loan.

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of March 31, 2016 and December 31, 2015. The recorded investment included in the following table represents loan principal net of any partial charge-offs recognized on the loans. The unpaid principal balance represents the recorded balance prior to any partial charge-offs. The recorded investment in consumer loans collateralized by residential real estate property that are in process of foreclosure according to local requirements of the applicable jurisdiction are not material as of March 31, 2016 and December 31, 2015.

	March 31, 2016			December 31, 2015		
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
	(Dollars in thousands)					
With no related allowance recorded:						
Commercial	$ 290	$ 290	$	$ 745	$ 745	$
Real estate:						
Commercial and residential	3,769	2,910		3,851	2,992	
Land and construction	231	213		237	219	
Home Equity	296	296		302	302	
Consumer	3	3		4	4	
Total with no related allowance recorded	4,589	3,712		5,139	4,262	
With an allowance recorded:						
Commercial	145	145	2	1,506	1,506	174
Real estate:						
Home Equity	472	472	111	759	759	112
Total with an allowance recorded	617	617	113	2,265	2,265	286
Total	$ 5,206	$ 4,329	$ 113	$ 7,404	$ 6,527	$ 286

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

5) Loans (Continued)

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

	Three Months Ended March 31, 2016					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 1,343	$ 2,951	$ 216	$ 914	$ 4	$ 5,428
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

	Three Months Ended March 31, 2015					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 1,907	$ 2,901	$ 1,305	$ 341	$ 5	$ 6,459
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

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

	March 31, 2016	March 31, 2015	December 31, 2015
	(Dollars in thousands)		
Nonaccrual loans held-for-investment	$ 4,184	$ 6,733	$ 4,716
Restructured and loans over 90 days past due and still accruing			1,662
Total nonperforming loans	4,184	6,733	6,378
Other restructured loans	145	163	149
Impaired loans, excluding loans held-for-sale	$ 4,329	$ 6,896	$ 6,527

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

5) Loans (Continued)

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

	March 31, 2016			December 31, 2015		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	$ 290	$	$ 290	$ 724	$ 1,378	$ 2,102
Real estate:						
Commercial and residential	2,910		2,910	2,992		2,992
Land and construction	213		213	219		219
Home equity	768		768	777	284	1,061
Consumer	3		3	4		4
Total	$ 4,184	$	$ 4,184	$ 4,716	$ 1,662	$ 6,378

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

	March 31, 2016					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 2,906	$ 796	$	$ 3,702	$ 588,426	$ 592,128
Real estate:						
Commercial and residential		889		889	615,932	616,821
Land and construction			213	213	95,334	95,547
Home equity	1	295		296	74,697	74,993
Consumer					16,476	16,476
Total	$ 2,907	$ 1,980	$ 213	$ 5,100	$ 1,390,865	$ 1,395,965

December 31, 2015

Total

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

5) Loans (Continued)

Past due loans 30 days or greater totaled $5,100,000 and $5,754,000 at March 31, 2016 and December 31, 2015, respectively, of which $509,000 and $591,000 were on nonaccrual. At March 31, 2016, there were also $3,675,000 loans less than 30 days past due included in nonaccrual loans held for investment. At December 31, 2015, there were also $4,125,000 loans less than 30 days past due included in nonaccrual loans held for investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

Credit Quality Indicators

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

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

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

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

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

5) Loans (Continued)

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

Loss. Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for loan losses. Therefore, there is no balance to report at March 31, 2016 and December 31, 2015.

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

	March 31, 2016			December 31, 2015		
	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total
	(Dollars in thousands)					
Commercial	$ 580,826	$ 11,302	$ 592,128	$ 547,536	$ 8,986	$ 556,522
Real estate:						
Commercial and residential	608,771	8,050	616,821	617,865	7,800	625,665
Land and construction	95,334	213	95,547	84,209	219	84,428
Home equity	73,889	1,104	74,993	75,511	1,322	76,833
Consumer	16,183	293	16,476	15,705	305	16,010
Total	$ 1,375,003	$ 20,962	$ 1,395,965	$ 1,340,826	$ 18,632	$ 1,359,458

* Classified loans in the table above include Small Business Administration ("SBA") guarantees.

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

The book balance of troubled debt restructurings at March 31, 2016 was $148,000, which included $3,000 of nonaccrual loans and $145,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2015 was $153,000, which included $4,000 of nonaccrual loans and $149,000 of accruing loans. Approximately $2,000 and $3,000 in specific reserves were established with respect to these loans as of March 31, 2016 and December 31, 2015, respectively. As of March 31, 2016 and December 31, 2015, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

5) Loans (Continued)

There were no new loans modified as troubled debt restructurings during the three month periods ended March 31, 2016 and 2015.

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the three month periods ended March 31, 2016 and 2015.

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

6) Business Combinations

Bay View Funding

On November 1, 2014, HBC acquired all of the outstanding common stock from the stockholders of BVF/CSNK Acquisition Corp., a Delaware corporation for an aggregate purchase price of $22,520,000. CSNK Working Capital Finance Corp. dba Bay View Funding ("Bay View Funding") its wholly-owned subsidiary provides business essential working capital factoring financing to various industries throughout the United States. BVF/CSNK was subsequently merged into Bay View Funding and Bay View Funding became a wholly owned subsidiary of HBC. Bay View Funding's results of operations have been included in the Company's results beginning November 1, 2014.

The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate more accurate or appropriate values for the assets acquired and liabilities assumed, which may be reflective of conditions or events that existed at the acquisition date. As of December 31, 2015, adjustments to the fair value of assets acquired and liabilities assumed in the Bay View Funding transaction were complete.

Focus Business Bank

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

Focus's results of operations have been included in the Company's results of operations beginning August 21, 2015. Pre-tax severance, retention, acquisition and integration costs totaled $119,000 for the first three months of 2015, and $6,398,000 for the year ended December 31, 2015.

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

6) Business Combinations (Continued)

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

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

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

Goodwill of $32,620,000 arising from the acquisition is largely attributable to synergies and cost savings resulting from combining the operations of the companies. As this transaction was structured as a taxfree exchange, the goodwill will not be deductible for tax purposes. The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate a more accurate or appropriate

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

6) Business Combinations (Continued)

value for an asset or liability. The loans with a fair value of $170,353,000 and $1,758,000 of income tax attributes, on the acquisition date, related to the purchase accounting adjustments and Focus' legacy deferred tax assets are subject to change pending receipt of the final valuations and analyses. Loan valuations may be adjusted based on new information obtained by the Company in future periods that may reflect conditions or events that existed on the acquisition date. Deferred tax assets may be adjusted for purchase accounting adjustments on open areas such as loans or upon filing Focus' final August 20, 2015 "stub" period tax returns.

The following table summarizes the consideration paid for Focus:

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

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

UNAUDITED	For the Three Months Ended March 31, 2015 (Dollars in thousands, except per share amounts)
Net interest income	$ 20,092
Provision for loan losses	(10)
Noninterest income	3,102
Noninterest expense	15,418
Income before income taxes	7,786
Income tax expense	2,923
Net income	$ 4,863
Net income per share basic	$ 0.13
Net income per share diluted	$ 0.13

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

(7) Goodwill and Other Intangible Assets

Goodwill

At March 31, 2016, the carrying value of goodwill was $45,664,000, which included $13,044,000 of goodwill related to its acquisition of Bay View Funding and $32,620,000 from its acquisition of Focus. During the fourth quarter of 2015, adjustments were made to the purchase price allocations for the Focus transaction that affected the amounts allocated to goodwill and other assets.

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

The Company completed its annual impairment analysis on the goodwill as of November 30, 2015 with the assistance of an independent valuation firm. Based on the Step Zero qualitative analysis performed, the Company determined that it is more likely than not that the fair value of the reporting unit exceeded its reported book value of equity at November 30, 2015. As such, no impairment was indicated and no further testing was required.

Other Intangible Assets

Core deposit and customer relationship intangible assets acquired in the 2007 acquisition of Diablo Valley Bank were $5,049,000 and $276,000, respectively. These assets are amortized over their estimated useful lives of 10 years. The customer relationship intangible asset was fully amortized at December 31, 2014. Accumulated amortization of these intangible assets was $4,810,000 and $4,703,000 at March 31, 2016 and December 31, 2015, respectively.

The core deposit intangible asset acquired in the acquisition of Focus in August 2015 was $6,285,000. This asset is amortized over its estimated useful lives of 10 years. Accumulated amortization of this intangible asset was $496,000 and $288,000 at March 31, 2016 and December 31, 2015, respectively.

Other intangible assets acquired in the acquisition of Bay View Funding in November 2014 included: a below market value lease intangible asset of $109,000 (amortized over 3 years), customer relationship and brokered relationship intangible assets of $1,900,000, (amortized over the 10 year estimated useful lives), and a non compete agreement intangible asset of $250,000 (amortized over 3 years). Accumulated amortization of these intangible assets was $437,000 and $360,000 at March 31, 2016 and December 31, 2015, respectfully.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

(7) Goodwill and Other Intangible Assets (Continued)

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

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

Impairment testing of the intangible assets is performed at the individual asset level. Impairment exists if the carrying amount of the asset is not recoverable and exceeds its fair value at the date of the impairment test. For intangible assets, estimates of expected future cash flows (cash inflows less cash outflows) that are directly associated with an intangible asset are used to determine the fair value of that asset. Management makes certain estimates and assumptions in determining the expected future cash flows from core deposit and customer relationship intangibles including account attrition, expected lives, discount rates, interest rates, servicing costs and other factors. Significant changes in these estimates and assumptions could adversely impact the valuation of these intangible assets. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset. Based on its assessment, management concluded that there was no impairment of intangible assets at March 31, 2016 and December 31, 2015.

8) Income Taxes

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

Under generally accepted accounting principles, a valuation allowance is required if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions. In accordance with Accounting Standards Codification (ASC) 740-10 Accounting for

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

8) Income Taxes (Continued)

Uncertainty in Income Taxes, the Company estimated the need for a reserve for income taxes of $270,000, net of Federal benefit, for uncertain state income tax positions of Bay View Funding as of March 31, 2016. The Company does not expect this amount to significantly increase or decrease in the next twelve months.

The Company had net deferred tax assets of $18,690,000, and $22,218,000, at March 31, 2016, and December 31, 2015, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at March 31, 2016 and December 31, 2015 will be fully realized in future years.

The Company adopted the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014. The low income housing investment losses, net of the tax benefits received, are included in income tax expense for all periods reflected on the consolidated income statements.

The following table reflects the carry amounts of the low income housing investments included in accrued interest receivable and other assets, and the future commitments as of March 31, 2016 and December 31, 2015:

	March 31, 2016	December 31, 2015
	(Dollars in thousands)	
Low income housing investments	$ 4,235	$ 4,304
Future commitments	$ 845	$ 1,271

The Company expects $123,000 of the future commitments to be paid in 2016, $14,000 in 2017, and $708,000 in 2018 through 2023.

For tax purposes, the Company had low income housing tax credits of $111,000 and $172,000 for the three months ended March 31, 2016 and March 31, 2015, respectively, and low income housing investment losses of $117,000 and $229,000, respectively. The Company recognized low income housing investment expense as a component of income tax expense.

9) Benefit Plans

Supplemental Retirement Plan

The Company has a supplemental retirement plan (the "Plan") covering some current and some former key employees and directors. The Plan is a nonqualified defined benefit plan. Benefits are

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

9) Benefit Plans (Continued)

unsecured as there are no Plan assets. The following table presents the amount of periodic cost recognized for the periods indicated:

	Three Months Ended March 31, 2016	Three Months Ended March 31, 2015
	(Dollars in thousands)	
Components of net periodic benefit cost:		
Service cost	$ 133	$ 216
Interest cost	259	221
Amortization of net actuarial loss	60	96
Net periodic benefit cost	$ 452	$ 533

Split-Dollar Life Insurance Benefit Plan

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

	March 31, 2016	December 31, 2015
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	$ 6,215	$ 4,641
Interest cost	62	169
Amortization of net actuarial loss		1,405
Projected benefit obligation at end of period	$ 6,277	$ 6,215

	March 31, 2016	December 31, 2015
	(Dollars in thousands)	
Net actuarial loss	$ 2,183	$ 2,147
Prior transition obligation	1,395	1,418
Accumulated other comprehensive loss	$ 3,578	$ 3,565

33

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

9) Benefit Plans (Continued)

	For the Three Months Ended March 31,	
	2016	2015
	(Dollars in thousands)	
Amortization of prior transition obligation	$ (13)	$ (12)
Interest cost	62	50
Net periodic benefit cost	$ 49	$ 38

10) Equity

Series C Preferred Stock

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of $3.75 per share upon a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. The 21,004 shares of Series C Preferred Stock are convertible into 5,601,000 shares of common stock. 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. The holders of Series C Preferred Stock receive dividends on an as converted basis when dividends are also declared for 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.

The holders of the Series C Preferred Stock have applied or intend to apply to the Federal Reserve for approval to exchange the 21,004 shares of Series C Preferred Stock for 5,601,000 common stock (the as converted equivalent). The Company has indicated to the holders that if such approval is obtained the Company would agree to enter into an exchange agreement to effect the exchange. One of the holders has obtained approval from the Federal Reserve. There is no assurance the other holder will obtain approval from the Federal Reserve.

11) 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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

11) Fair Value (Continued)

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).

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).

		Fair Value Measurements Using		
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(Dollars in thousands)		
Assets at March 31, 2016:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 392,753		$ 392,753	
U.S. Treasury	$ 30,332	$ 30,332	$	
Trust preferred securities	$ 15,225		$ 15,225	
U.S. Government sponsored entities	$ 9,181		$ 9,181	
Corporate bonds	$ 1,049		$ 1,049	
I/O strip receivables	$ 1,369		$ 1,369	
Assets at December 31, 2015:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 324,230		$ 324,230	
U.S. Treasury	$ 30,003	$ 30,003	$	
Trust preferred securities	$ 15,132		$ 15,132	
U.S. Government sponsored entities	$ 9,041		$ 9,041	
Corporate bonds	$ 6,673		$ 6,673	
I/O strip receivables	$ 1,367		$ 1,367	

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

11) Fair Value (Continued)

Assets and Liabilities Measured on a Non-Recurring Basis

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

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

		Fair Value Measurements Using		
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(Dollars in thousands)		
Assets at March 31, 2016:				
Impaired loans held-for-investment:				
Commercial	$ 143			$ 143
Real estate:				
Commercial and residential	482			482
Land and construction	213			213
Home equity	361			361
	$ 1,199			$ 1,199
Assets at December 31, 2015:				
Impaired loans held-for-investment:				
Commercial	$ 1,333			$ 1,333
Real estate:				
Commercial and residential	503			503
Land and construction	219			219
Home equity	647			647
	$ 2,702			$ 2,702

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

11) 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:

	March 31, 2016	December 31, 2015
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	$ 1,312	$ 2,988
Book value of impaired loans held-for-investment carried at cost	3,017	3,539
Total impaired loans held-for-investment	$ 4,329	$ 6,527
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	$ 1,312	$ 2,988
Specific valuation allowance	(113)	(286)
Impaired loans held-for-investment carried at fair value, net	$ 1,199	$ 2,702

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were $4,329,000 at March 31, 2016. In addition, these loans had a specific valuation allowance of $113,000 at March 31, 2016. Impaired loans held-for-investment totaling $1,312,000 at March 31, 2016, were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining $3,017,000 of impaired loans were carried at cost at March 31, 2016, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during the first three months of 2016 on impaired loans held-for-investment carried at fair value at March 31, 2016 resulted in an additional provision for loan losses of $2,000.

At March 31, 2016, foreclosed assets had a carrying amount of $386,000, with no valuation allowance at March 31, 2016.

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

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

11) Fair Value (Continued)

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

	March 31, 2016			
	Fair Value	Valuation Techniques	Unobservable Inputs	Range (Weighted Average)
	(Dollars in thousands)			
Impaired loans held-for-investment:				
Commercial	$ 143	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%
Real estate:				
Commercial and residential	$ 482	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)
Land and construction	$ 213	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%
Home equity	$ 361	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)

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

Commercial and residential	$ 503	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)
Land and construction	$ 219	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%
Home equity	$ 647	Market Approach	Discount adjustment for differences between comparable sales	0% to 2% (2%)

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

11) Fair Value (Continued)

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

The carrying amounts and estimated fair values of financial instruments at March 31, 2016 are as follows:

		Estimated Fair Value			
	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	(Dollars in thousands)				
Assets:					
Cash and cash equivalents	$ 143,135	$ 143,135	$	$	$ 143,135
Securities available-for-sale	448,540	30,332	418,208		448,540
Securities held-to-maturity	185,165		187,047		187,047
Loans (including loans held-for-sale), net	1,378,195		2,389	1,374,562	1,376,951
FHLB and FRB stock	12,702				N/A
Accrued interest receivable	6,681	83	2,216	4,382	6,681
I/O strips receivables	1,369		1,369		1,369
Liabilities:					
Time deposits	$ 256,538	$	$ 256,842	$	$ 256,842
Other deposits	1,772,198		1,772,198		1,772,198
Accrued interest payable	188		188		188

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

11) Fair Value (Continued)

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

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

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

Cash and Cash Equivalents

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

Loans

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

Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

11) Fair Value (Continued)

cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

FHLB and FRB Stock

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

Accrued Interest Receivable/Payable

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

Deposits

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

Short-term Borrowings

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

Off-balance Sheet Instruments

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

Limitations

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

12) Equity Plan

The Company maintained an Amended and Restated 2004 Equity Plan (the "2004 Plan") for directors, officers, and key employees. The 2004 Plan was terminated on May 23, 2013. On May 23, 2013, the Company's shareholders approved the 2013 Equity Incentive Plan (the "2013 Plan"). The equity plans provide for the grant of incentive and nonqualified stock options and restricted stock. The equity plans provide that the option price for both incentive and nonqualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally options vest over four years. All options expire no later than ten years from the date of grant. Restricted stock is subject to time vesting. For the three months ended March 31, 2016, the Company did not grant shares of nonqualified stock options and restricted stock. There were 940,985 shares available for the issuance of equity awards under the 2013 Plan as of March 31, 2016.

Stock option activity under the equity plans is as follows:

Total Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2016	1,775,027	$ 10.62		
Exercised	(57,441)	$ 6.24		
Forfeited or expired	(12,000)	$ 22.78		
Outstanding at March 31, 2016	1,705,586	$ 10.68	5.6	$ 3,622,227
Vested or expected to vest	1,620,307		5.6	$ 3,441,116