HERITAGE COMMERCE CORP
Form 10-Q
November 06, 2014

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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 September 30, 2014

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 26,421,153 shares of Common Stock outstanding on October 17, 2014.

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QUARTERLY REPORT ON FORM 10-Q
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Cautionary Note Regarding Forward-Looking Statements

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

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

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

Delay in the pace of economic recovery and stagnant or decreasing employment levels;

Changes in the financial performance or condition of the Company's customers, or changes in the performance or creditworthiness of our customers' suppliers or other counterparties, which could lead to decreased loan utilization rates, delinquencies, or defaults, which could negatively affect our customers' ability to meet certain credit obligations;

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

Changes in consumer spending, borrowing or saving habits;

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

The ability to increase market share and control expenses;

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, charge-offs, or 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;

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- Regulatory limits on Heritage Bank of Commerce's ability to pay dividends to the Company;
- The impact of reputational risk on such matters as business generation and retention, funding and liquidity;
- 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;
- The effect of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the rules and regulations to be promulgated by supervisory and oversight agencies implementing the legislation taking into account that the precise timing, extent and nature of such rules and regulations and the impact on the Company are uncertain;
- The impact of revised capital requirements under Basel III;
- Significant changes in applicable laws and regulations, including those concerning taxes, banking and securities;
- Changes in the competitive environment among financial or bank holding companies and other financial service providers;
- The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, 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; and
- Successful integration of the business, employees and operations of Bay View Funding with the Company; 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.

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Part I FINANCIAL INFORMATION

ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HERITAGE COMMERCE CORP

CONSOLIDATED BALANCE SHEETS (Unaudited)

	September 30, 2014	December 31, 2013
	(Dollars in thousands)	
Assets		
Cash and due from banks	$ 23,905	$ 20,158
Interest-bearing deposits in other financial institutions	130,170	92,447
Total cash and cash equivalents	154,075	112,605
Securities available-for-sale, at fair value	191,680	280,100
Securities held-to-maturity, at amortized cost (fair value of $93,161 at September 30, 2014 and $86,032 at December 31, 2013)	94,759	95,921
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	673	3,148
Loans, net of deferred fees	1,029,596	914,913
Allowance for loan losses	(18,541)	(19,164)
Loans, net	1,011,055	895,749
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	10,501	10,435
Company owned life insurance	50,853	50,012
Premises and equipment, net	7,377	7,240
Intangible assets	1,182	1,527
Accrued interest receivable and other assets	36,159	34,895
Total assets	$ 1,558,314	$ 1,491,632
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	$ 488,987	$ 431,085
Demand, interest-bearing	223,121	195,451
Savings and money market	369,378	347,052
Time deposits under $100	20,067	21,646
Time deposits $100 and over	197,562	195,005
Time deposits brokered	28,099	55,524
CDARS money market and time deposits	14,608	40,458
Total deposits	1,341,822	1,286,221
Accrued interest payable and other liabilities	33,576	32,015

Total liabilities		1,375,398		1,318,236
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 September 30, 2014 and December 31, 2013 (liquidation preference of $21,004 at September 30, 2014 and December 31, 2013)		19,519		19,519
Common stock, no par value; 60,000,000 shares authorized; 26,374,980 shares issued and outstanding at September 30, 2014 and 26,350,938 shares issued and outstanding at December 31, 2013		133,195		132,561
Retained earnings		31,014		25,345
Accumulated other comprehensive loss		(812)		(4,029)
Total shareholders' equity		182,916		173,396
Total liabilities and shareholders' equity	$	1,558,314	$	1,491,632

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	**2013**	**2014**	**2013**
	(Dollars in thousands, except per share data)			
Interest income:				
Loans, including fees	$ 12,077	$ 10,733	$ 34,832	$ 30,874
Securities, taxable	1,851	2,247	6,069	7,107
Securities, non-taxable	506	436	1,518	1,042
Interest-bearing deposits in other financial institutions	58	42	120	140
Total interest income	14,492	13,458	42,539	39,163
Interest expense:				
Deposits	500	575	1,527	1,796
Subordinated debt		51		229
Short-term borrowings		1	1	1
Total interest expense	500	627	1,528	2,026
Net interest income before provision for loan losses	13,992	12,831	41,011	37,137
Provision (credit) for loan losses	(24)	(534)	(232)	(804)
Net interest income after provision for loan losses	14,016	13,365	41,243	37,941
Noninterest income:				
Service charges and fees on deposit accounts	631	645	1,897	1,840
Increase in cash surrender value of life insurance	401	414	1,196	1,240
Servicing income	316	331	977	1,081
Gain on sales of SBA loans	259	103	858	373
Gain on sales of securities	47		97	38
Other	216	245	909	744
Total noninterest income	1,870	1,738	5,934	5,316
Noninterest expense:				
Salaries and employee benefits	6,228	5,772	19,290	17,647
Occupancy and equipment	1,055	986	2,987	3,082
Professional fees	617	602	1,329	1,984
Insurance expense	292	255	830	763
Software subscriptions	264	381	702	966

Data processing		238		259		741		838
FDIC deposit insurance premiums		220		200		674		666
Correspondent bank charges		174		170		539		513
Foreclosed assets, net				8		(19)		(242)
Subordinated debt redemption charges								167
Low income housing investment losses		(353)		320				930
Other		1,404		1,427		4,734		4,236
Total noninterest expense		10,139		10,380		31,807		31,550
Income before income taxes		5,747		4,723		15,370		11,707
Income tax expense		2,322		1,510		5,545		3,521
Net income		3,425		3,213		9,825		8,186
Dividends on preferred stock		(280)		(168)		(728)		(168)
Net income available to common shareholders	$	3,145	$	3,045	$	9,097	$	8,018
Earnings per common share:								
Basic	$	0.11	$	0.10	$	0.31	$	0.26
Diluted	$	0.11	$	0.10	$	0.31	$	0.26

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Net income	$ 3,425	$ 3,213	$ 9,825	$ 8,186
Other comprehensive income (loss):				
Change in net unrealized holding gains (losses) on available-for-sale securities and I/O strips	(1,166)	675	5,717	(12,033)
Deferred income taxes	487	(284)	(2,404)	5,053
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(14)	(14)	(41)	(42)
Deferred income taxes	6	6	17	18
Reclassification adjustment for gains realized in income	(47)		(97)	(38)
Deferred income taxes	20		41	16
Change in unrealized gains (losses) on securities and I/O strips, net of deferred income taxes	(714)	383	3,233	(7,026)
Change in net pension and other benefit plan liability adjustment	(9)	44	(27)	109
Deferred income taxes	3	(18)	11	(45)
Change in pension and other benefit plan liability, net of deferred income taxes	(6)	26	(16)	64
Other comprehensive income (loss)	(720)	409	3,217	(6,962)
Total comprehensive income	$ 2,705	$ 3,622	$ 13,042	$ 1,224

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

Nine Months Ended September 30, 2014 and 2013

	Preferred Stock		Common Stock		Retained	Accumulated Other Comprehensive Income /	Total Shareholders'
	Shares	Amount	Shares	Amount	Earnings	(Loss)	Equity
	(Dollars in thousands, except share data)						
Balance, January 1, 2013	21,004	$ 19,519	26,322,147	$ 131,820	$ 15,721	$ 2,681	$ 169,741
Net income					8,186		8,186
Other comprehensive loss						(6,962)	(6,962)
Issuance of restricted stock awards			10,000				
Repurchase of warrant				(140)			(140)
Amortization of restricted stock awards, net of forfeitures and taxes				153			153
Cash dividend declared $0.03 per share					(958)		(958)
Stock option expense, net of forfeitures and taxes				430			430
Stock options exercised			8,874	35			35
Balance, September 30, 2013	21,004	$ 19,519	26,341,021	$ 132,298	$ 22,949	$ (4,281)	$ 170,485
Balance, January 1, 2014	21,004	$ 19,519	26,350,938	$ 132,561	$ 25,345	$ (4,029)	$ 173,396
Net income					9,825		9,825
Other comprehensive income						3,217	3,217
Issuance of restricted stock awards, net			15,000				
Amortization of restricted stock awards, net of forfeitures and taxes				(49)			(49)
Cash dividend declared $0.13 per share					(4,156)		(4,156)
Stock option expense, net of forfeitures and taxes				641			641
Stock options exercised			9,042	42			42
Balance, September 30, 2014	21,004	$ 19,519	26,374,980	$ 133,195	$ 31,014	$ (812)	$ 182,916

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 9,825	$ 8,186
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	859	1,894
Gain on sales of securities available-for-sale	(97)	(38)
Gain on sales of SBA loans	(858)	(373)
Proceeds from sale of SBA loans originated for sale	14,439	5,128
Net change in SBA loans originated for sale	(11,106)	(8,341)
Provision (credit) for loan losses	(232)	(804)
Increase in cash surrender value of life insurance	(1,196)	(1,240)
Depreciation and amortization	539	539
Amortization of intangible assets	345	355
Gains on sale of foreclosed assets, net		(231)
Stock option expense, net	641	430
Amortization of restricted stock awards, net	(49)	153
Gain on redemption of company owned life insurance	(51)	
Effect of changes in:		
Accrued interest receivable and other assets	(3,730)	999
Accrued interest payable and other liabilities	2,511	1,395
Net cash provided by operating activities	11,840	8,052
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(34,775)	(8,334)
Purchase of securities held-to-maturity	(2,347)	(43,324)
Maturities/paydowns/calls of securities available-for-sale	19,696	55,206
Maturities/paydowns/calls of securities held-to-maturity	2,345	3,310
Proceeds from sale of securities available-for-sale	108,603	26,944
Net change in loans	(115,043)	(79,633)
Change in Federal Home Loan Bank and Federal Reserve Bank stock	(66)	(64)
Purchase of premises and equipment	(676)	(460)
Proceeds from sale of foreclosed assets		809
Proceeds from redemption of company owned life insurance	406	
Net cash used in investing activities	(21,857)	(45,546)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	55,601	(283,831)
Repurchase of warrant		(140)
Payment of cash dividends	(4,156)	(958)
Redemption of subordinated debt		(9,279)
Exercise of stock options	42	35
Net cash provided by (used in) financing activities	51,487	(294,173)

Net decrease in cash and cash equivalents		41,470		(331,667)
Cash and cash equivalents, beginning of period		112,605		373,565
Cash and cash equivalents, end of period	$	154,075	$	41,898
Supplemental disclosures of cash flow information:				
Interest paid	$	1,523	$	2,110
Income taxes paid		3,250		3,365
Supplemental schedule of non-cash investing activity:				
Due to broker for securities purchased	$		$	1,901
Loans transferred to foreclosed assets		31		33
Transfer of loans held-for-sale to loan portfolio				20

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(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 (the "Bank" or "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, 2013. The Company also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III, which were Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities. During the third quarter of 2012, the Company dissolved the Heritage Statutory Trust I and the Heritage Capital Trust I. During the third quarter of 2013, the Company dissolved the Heritage Statutory Trust II and the Heritage Commerce Corp Statutory Trust III.

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

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

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

The results for the three and nine months ended September 30, 2014 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2014.

Reclassifications

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

Adoption of New Accounting Standards

In January 2014, the Financial Accounting Standards Board ("FASB") amended existing guidance clarifying that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

1) Basis of Presentation (Continued)

completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. For entities other than public business entities, the amendments in this update are effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. The Company has evaluated the adoption of the new guidance and has determined it will not have a material impact on the consolidated financial statements.

In January 2014, the FASB issued guidance for accounting for investments in qualified affordable housing projects, which represents a consensus of the Emerging Issues Task Force and sets forth new accounting for qualifying investments in flow through limited liability entities that invest in affordable housing projects. The new guidance allows a limited liability investor that meets certain conditions to amortize the cost of its investment in proportion to the tax credits and other tax benefits it receives. The new accounting method, referred to as the proportional amortization method, allows amortization of the tax credit investment to be reflected along with the primary benefits, the tax credits and other tax benefits, on a net basis in the income statement within the income tax expense (benefit) line. For public business entities, the guidance is effective for interim and annual periods beginning after December 15, 2014. For all other entities, the guidance is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. If elected, the proportional amortization method is required to be applied retrospectively. Early adoption is permitted in the annual period for which financial statements have not been issued.

The Company adopted the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014. The Company quantified the impact of adopting the proportional amortization method compared to the equity method to its current year and prior period financial statements. The Company determined that the adoption of the proportional amortization method did not have a material impact to its financial statements; therefore, the Company did not adjust its prior period financial statements. As a result of the change in accounting method, the Company reclassified $353,000 of low income housing investment losses during the third quarter of 2014 that was previously reported as noninterest expense for the first six months of 2014. The low income housing investment losses, net of the tax benefits received, are included in income tax expense on the consolidated statements of income for the three months and nine months ended September 30, 2014. The change in accounting method also resulted in an increase in the effective tax rate to 40.4% and 36.1% for the three months and nine months ended September 30, 2014, respectively, compared to 32.0% and 30.1% for the three months and nine months ended September 30, 2013. Under the equity method of accounting for the low income housing investments for the three months ended September 30, 2014, the low income housing investment losses included in noninterest expense would have been $261,000, income tax expense would have been $1,715,000 and the effective tax rate would

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

1) Basis of Presentation (Continued)

have been 33.4%. Under the equity method of accounting for the low income housing investments for the nine months ended September 30, 2014, the low income housing investment losses included in noninterest expense would have been $614,000, income tax expense would have been $4,938,000 and the effective tax rate would have been 33.5%.

In May 2014, the FASB issued an update to the guidance for accounting for revenue from contracts with customers. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. We are evaluating the impact of adopting the new guidance on the 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 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 and common stock warrants, using the treasury stock method. The common stock warrant was antidilutive for the nine months ended September 30, 2013. The Company repurchased the warrant for $140,000 in the second quarter of 2013. A

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

2) Earnings Per Share (Continued)

reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands, except per share amounts)			
Net income available to common shareholders	$ 3,145	$ 3,045	$ 9,097	$ 8,018
Less: undistributed earnings allocated to Series C Preferred Stock	320	395	993	1,268
Distributed and undistributed earnings allocated to common shareholders	$ 2,825	$ 2,650	$ 8,104	$ 6,750
Weighted average common shares outstanding for basic earnings per common share	26,371,413	26,340,080	26,367,314	26,335,222
Dilutive effect of stock options oustanding, using the the treasury stock method	145,450	46,969	134,646	46,743
Shares used in computing diluted earnings per common share	26,516,863	26,387,049	26,501,960	26,381,965
Basic earnings per share	$ 0.11	$ 0.10	$ 0.31	$ 0.26
Diluted earnings per share	$ 0.11	$ 0.10	$ 0.31	$ 0.26

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(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 September 30, 2014 and 2013			
	Unrealized Gains (Losses) 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 July 1, 2014, net of taxes	$ 3,533	$ 450	$ (4,075)	$ (92)
Other comprehensive income (loss) before reclassification, net of taxes	(679)		(12)	(691)
Amounts reclassified from other comprehensive income (loss), net of taxes	(27)	(8)	6	(29)
Net current period other comprensive income (loss), net of taxes	(706)	(8)	(6)	(720)
Ending balance September 30, 2014, net of taxes	$ 2,827	$ 442	$ (4,081)	$ (812)
Beginning balance July 1, 2013, net of taxes	$ 494	$ 481	$ (5,665)	$ (4,690)
Other comprehensive (loss) before reclassification, net of taxes	391		(6)	385
Amounts reclassified from other comprehensive income (loss), net of taxes		(8)	32	24
Net current period other comprehensive income (loss), net of taxes	391	(8)	26	409
Ending balance September 30, 2013, net of taxes	$ 885	$ 473	$ (5,639)	$ (4,281)

(1) Amounts in parenthesis indicate debits.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

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

	For the Nine Months Ended September 30, 2014 and 2013			
	Unrealized Gains (Losses) 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, 2014, net of taxes	$ (430)	$ 466	$ (4,065)	(4,029)
Other comprehensive (loss) before reclassification, net of taxes	3,313		(32)	3,281
Amounts reclassified from other comprehensive income (loss), net of taxes	(56)	(24)	16	(64)
Net current period other comprensive income (loss), net of taxes	3,257	(24)	(16)	3,217
Ending balance September 30, 2014, net of taxes	$ 2,827	$ 442	$ (4,081)	$ (812)
Beginning balance January 1, 2013, net of taxes	$ 7,887	$ 497	$ (5,703)	$ 2,681
Other comprehensive income (loss) before reclassification, net of taxes	(6,980)		(26)	(7,006)
Amounts reclassified from other comprehensive income (loss), net of taxes	(22)	(24)	90	44
Net current period other comprensive income, net of taxes	(7,002)	(24)	64	(6,962)
Ending balance September 30, 2013, net of taxes	$ 885	$ 473	$ (5,639)	$ (4,281)

(1) Amounts in parenthesis indicate debits.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

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

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Three Months Ended September 30, 2014	2013	Affected Line Item Where Net Income is Presented
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	$ 47	$	Realized gains on sale of securities
	(20)		Income tax expense
	27		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(2)			
Prior transition obligation	25	18	
Actuarial losses	(35)	(73)	
	(10)	(55)	Income before income tax
	4	23	Income tax expense
	(6)	(32)	Net of tax
Total reclassification for the period	$ 29	$ (24)	

(1)

Amounts in parenthesis indicate debits.

(2) This AOCI component is included in the computation of net periodic benefit cost (see Note 7 Benefit Plans).

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

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

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Nine Months Ended September 30, 2014	2013	Affected Line Item Where Net Income is Presented
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	$ 97	$ 38	Realized gains on sale of securities
	(41)	(16)	Income tax expense
	56	22	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	41	42	Interest income on taxable securities
	(17)	(18)	Income tax expense
	24	24	Net of tax
Amortization of defined benefit pension plan items(2)			
Prior transition obligation	77	63	
Actuarial losses	(105)	(219)	
	(28)	(156)	Income before income tax
	12	66	Income tax expense
	(16)	(90)	Net of tax
Total reclassification for the period	$ 64	$ (44)	

(1)

Amounts in parenthesis indicate debits.

(2)
This AOCI component is included in the computation of net periodic benefit cost (see Note 7 Benefit Plans).

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

4) Securities

The amortized cost and estimated fair value of securities at September 30, 2014 and December 31, 2013 were as follows:

September 30, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	$ 137,450	$ 3,125	$ (798)	$ 139,777
Corporate bonds	35,963	636	(183)	36,416
Trust preferred securities	15,000	487		15,487
Total	$ 188,413	$ 4,248	$ (981)	$ 191,680
Securities held-to-maturity:				
Agency mortgage-backed securities	$ 14,851	$ 6	$ (222)	$ 14,635
Municipals tax exempt	79,908	742	(2,124)	78,526
Total	$ 94,759	$ 748	$ (2,346)	$ 93,161

December 31, 2013	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	$ 208,644	$ 2,465	$ (3,465)	$ 207,644
Corporate bonds	53,002	527	(1,483)	52,046
Trust preferred securities	20,849		(439)	20,410
Total	$ 282,495	$ 2,992	$ (5,387)	$ 280,100

Securities held-to-maturity:				
Agency mortgage-backed securities	$ 15,932	$	$ (470)	$ 15,462
Municipals tax exempt	79,989	54	(9,473)	70,570
Total	$ 95,921	$ 54	$ (9,943)	$ 86,032

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

4) Securities (Continued)

Securities with unrealized losses at September 30, 2014 and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

September 30, 2014	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Losses	12 Months or More Fair Value	12 Months or More Unrealized Losses	Total Fair Value	Total Unrealized Losses
			(Dollars in thousands)			
Securities available-for-sale:						
Agency mortgage-backed securities	$	$	$ 38,542	$ (798)	$ 38,542	$ (798)
Corporate bonds	16,071	(106)	5,099	(77)	21,170	(183)
Total	$ 16,071	$ (106)	$ 43,641	$ (875)	$ 59,712	$ (981)
Securities held-to-maturity:						
Agency mortgage-backed securities	$ 4,166	$ (43)	$ 7,124	$ (179)	$ 11,290	$ (222)
Municipals Tax Exempt	1,606	(2)	54,706	(2,122)	56,312	(2,124)
Total	$ 5,772	$ (45)	$ 61,830	$ (2,301)	$ 67,602	$ (2,346)

December 31, 2013	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Losses	12 Months or More Fair Value	12 Months or More Unrealized Losses	Total Fair Value	Total Unrealized Losses
			(Dollars in thousands)			
Securities available-for-sale:						
Agency mortgage-backed securities	$ 87,798	$ (2,869)	$ 8,920	$ (596)	$ 96,718	$ (3,465)
Corporate bonds	38,092	(1,322)	1,860	(161)	39,952	(1,483)
Trust preferred securities	20,410	(439)			20,410	(439)
Total	$ 146,300	$ (4,630)	$ 10,780	$ (757)	$ 157,080	$ (5,387)

Securities held-to-maturity:						
Agency mortgage-backed securities	$ 5,978	$ (101)	$ 9,134	$ (369)	$ 15,112	$ (470)
Municipals Tax Exempt	38,177	(4,421)	25,520	(5,052)	63,697	(9,473)
Total	$ 44,155	$ (4,522)	$ 34,654	$ (5,421)	$ 78,809	$ (9,943)

There were no holdings of securities of any one issuer, other than the U.S. Government and its sponsored entities, in an amount greater than 10% of shareholders' equity. At September 30, 2014, the Company held 351 securities (121 available-for-sale and 230 held-to-maturity), of which 188 had fair values below amortized cost. At September 30, 2014, there were $38,542,000 of agency mortgage-backed securities available-for-sale, $5,099,000 of corporate bonds available-for-sale, $7,124,000 of agency mortgage-backed securities held-to-maturity and $54,706,000 of municipals bonds held-to-maturity carried with an unrealized loss for over 12 months. The total unrealized loss for securities over 12 months was $3,176,000 at September 30, 2014. 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

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

4) Securities (Continued)

maturity date and/or market rates decline. The Company does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company does not consider these securities to be other than temporarily impaired at September 30, 2014.

At December 31, 2013, the Company held 392 securities (163 available-for-sale and 229 held-to-maturity), of which 275 had fair values below amortized cost. At December 31, 2013, there were $8,920,000 of agency mortgage-backed securities available-for-sale, $1,860,000 of corporate bonds available-for-sale, $9,134,000 of agency mortgage-backed securities held-to-maturity, and $25,520,000 of municipal bonds held-to-maturity carried with an unrealized loss for over 12 months. The total unrealized loss for securities over 12 months was $6,178,000 at December 31, 2013. The unrealized losses were due to higher interest rates. The issuers were of high credit quality and all principal amounts were expected to be paid when securities mature. The fair value was expected to recover as the securities approach their maturity date and/or market rates decline. The Company did not believe that it is more likely than not that the Company would be required to sell a security in an unrealized loss position prior to recovery in value. The Company did not consider these securities to be other than temporarily impaired at December 31, 2013.

The proceeds from sales of securities and the resulting gains and losses are listed below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Proceeds	$ 58,592	$	$ 108,603	$ 26,944
Gross gains	288		1,008	310
Gross losses	(241)		(911)	(272)

The amortized cost and estimated fair values of securities as of September 30, 2014, are shown by contractual maturity below. The expected maturities will differ from contractual maturities if borrowers have the right to call or pre-pay obligations with or without call or pre-payment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after one through five years	$ 6,315	$ 6,685
Due after five through ten years	29,648	29,731
Due after ten years	15,000	15,487
Asset-backed securities and agency mortgage-backed securities	137,450	139,777
Total	$ 188,413	$ 191,680

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

4) Securities (Continued)

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after five through ten years	$ 5,721	$ 5,875
Due after ten years	74,187	72,651
Agency mortgage-backed securities	14,851	14,635
Total	$ 94,759	$ 93,161

5) Loans

Loans were as follows:

	September 30, 2014	December 31, 2013
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	$ 436,481	$ 393,074
Real estate:		
Commercial and residential	464,991	423,288
Land and construction	53,064	31,443
Home equity	61,079	51,815
Consumer	14,609	15,677
Loans	1,030,224	915,297
Deferred loan origination fees, net	(628)	(384)
Loans, net of deferred fees	1,029,596	914,913
Allowance for loan losses	(18,541)	(19,164)
Loans, net	$ 1,011,055	$ 895,749

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

	Three Months Ended September 30, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 11,454	$ 7,069	$ 69	$ 18,592
Charge-offs	(132)		(25)	(157)
Recoveries	123	7		130
Net (charge-offs) recoveries	(9)	7	(25)	(27)
Provision (credit) for loan losses	163	(205)	18	(24)
Balance, end of period	$ 11,608	$ 6,871	$ 62	$ 18,541

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

5) Loans (Continued)

	Three Months Ended September 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,811	$ 6,388	$ 143	$ 19,342
Charge-offs	(254)	(40)		(294)
Recoveries	820	7	1	828
Net recoveries	566	(33)	1	534
Provision (credit) for loan losses	(10)	(461)	(63)	(534)
Balance, end of period	$ 13,367	$ 5,894	$ 81	$ 19,342

	Nine Months Ended September 30, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,533	$ 6,548	$ 83	$ 19,164
Charge-offs	(726)		(25)	(751)
Recoveries	309	51		360
Net (charge-offs) recoveries	(417)	51	(25)	(391)
Provision (credit) for loan losses	(508)	272	4	(232)
Balance, end of period	$ 11,608	$ 6,871	$ 62	$ 18,541

	Nine Months Ended September 30, 2013			
	Commercial	Real Estate	Consumer	Total

	(Dollars in thousands)			
Balance, beginning of period	$ 12,866	$ 6,034	$ 127	$ 19,027
Charge-offs	(1,213)	(96)		(1,309)
Recoveries	2,158	269	1	2,428
Net recoveries	945	173	1	1,119
Provision (credit) for loan losses	(444)	(313)	(47)	(804)
Balance, end of period	$ 13,367	$ 5,894	$ 81	$ 19,342

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

5) Loans (Continued)

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

	September 30, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 606	$ 124	$	$ 730
Collectively evaluated for impairment	11,002	6,747	62	17,811
Total allowance balance	$ 11,608	$ 6,871	$ 62	$ 18,541
Loans:				
Individually evaluated for impairment	$ 3,398	$ 3,806	$ 6	$ 7,210
Collectively evaluated for impairment	433,083	575,328	14,603	1,023,014
Total loan balance	$ 436,481	$ 579,134	$ 14,609	$ 1,030,224

	December 31, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 1,694	$ 741	$ 21	$ 2,456
Collectively evaluated for impairment	10,839	5,807	62	16,708
Total allowance balance	$ 12,533	$ 6,548	$ 83	$ 19,164

Loans:								
Individually evaluated for impairment	$	4,906	$	6,790	$	122	$	11,818
Collectively evaluated for impairment		388,168		499,756		15,555		903,479
Total loan balance	$	393,074	$	506,546	$	15,677	$	915,297

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

5) Loans (Continued)

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of September 30, 2014 and December 31, 2013. 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.

	September 30, 2014			December 31, 2013		
	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	$ 2,923	$ 2,361	$	$ 1,999	$ 1,915	$
Real estate:						
Commercial and residential	2,531	1,672		2,831	2,831	
Land and construction	2,144	1,655		1,761	1,761	
Home Equity	355	355		377	377	
Consumer	6	6				
Total with no related allowance recorded	7,959	6,049		6,968	6,884	
With an allowance recorded:						
Commercial	1,037	1,037	$ 606	3,225	2,991	1,694
Real estate:						
Commercial and residential				1,531	1,531	451
Home Equity	124	124	124	290	290	290
Consumer				122	122	21
Total with an allowance recorded	1,161	1,161	730	5,168	4,934	2,456
Total	$ 9,120	$ 7,210	$ 730	$ 12,136	$ 11,818	$ 2,456

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

	Three Months Ended September 30, 2014			
		Real Estate		
	Commercial		Consumer	Total

		Commercial and Residential	Land and Construction	Home Equity		
		(Dollars in thousands)				
Average of impaired loans during the period	$ 3,790	$ 2,273	$ 1,672	$ 513	$ 19	$ 8,267
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

5) Loans (Continued)

	Three Months Ended September 30, 2013					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 5,539	$ 5,032	$ 1,989	$ 2,393	$ 133	$ 15,086
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

	Nine Months Ended September 30, 2014					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 4,411	$ 3,034	$ 1,705	$ 575	$ 69	$ 9,794
Interest income during impairment	$ 56	$	$	$	$	$ 56
Cash-basis interest earned	$	$	$	$	$	$

	Nine Months Ended September 30, 2013					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 7,342	$ 5,061	$ 2,095	$ 2,414	$ 138	$ 17,050
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

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

	September 30,		December 31,
	2014	2013	2013

	(Dollars in thousands)		
Nonaccrual loans held-for-investment	$ 7,010	$ 14,615	$ 11,326
Restructured and loans over 90 days past due and still accruing	200	502	492
Total nonperforming loans	$ 7,210	$ 15,117	$ 11,818
Other restructured loans	$	$ 10	$
Impaired loans, excluding loans held-for-sale	$ 7,210	$ 15,127	$ 11,818

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

5) Loans (Continued)

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

	September 30, 2014			December 31, 2013		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	$ 3,198	$ 200	$ 3,398	$ 4,414	$ 492	$ 4,906
Real estate:						
Commercial and residential	1,672		1,672	4,363		4,363
Land and construction	1,655		1,655	1,761		1,761
Home equity	479		479	666		666
Consumer	6		6	122		122
Total	$ 7,010	$ 200	$ 7,210	$ 11,326	$ 492	$ 11,818

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

	September 30, 2014					
	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	$ 344	$ 131	$ 2,197	$ 2,672	$ 433,809	$ 436,481
Real estate:						
Commercial and residential			1,065	1,065	463,926	464,991
Land and construction	308			308	52,756	53,064
Home equity			124	124	60,955	61,079
Consumer					14,609	14,609
Total	$ 652	$ 131	$ 3,386	$ 4,169	$ 1,026,055	$ 1,030,224

	December 31, 2013					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 3,314	$ 428	$ 2,865	$ 6,607	$ 386,467	$ 393,074
Real estate:						
Commercial and residential	1,559		1,065	2,624	420,664	423,288
Land and construction					31,443	31,443
Home equity	28		290	318	51,497	51,815
Consumer			89	89	15,588	15,677
Total	$ 4,901	$ 428	$ 4,309	$ 9,638	$ 905,659	$ 915,297

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

5) Loans (Continued)

Past due loans 30 days or greater totaled $4,169,000 and $9,638,000 at September 30, 2014 and December 31, 2013, respectively, of which $3,809,000 and $5,900,000 were on nonaccrual. At September 30, 2014, there were also $3,201,000 loans less than 30 days past due included in nonaccrual loans held for investment. At December 31, 2013, there were also $5,426,000 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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

5) Loans (Continued)

deficiencies are not corrected. In addition, the Company no longer accrues interest on the loan because of the underlying weaknesses.

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

Loss. Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for loan losses. Therefore, there is no balance to report at September 30, 2014 or December 31, 2013.

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

	September 30, 2014			December 31, 2013		
	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total
	(Dollars in thousands)					
Commercial	$ 428,372	$ 8,109	$ 436,481	$ 380,806	$ 12,268	$ 393,074
Real estate:						
Commercial and residential	458,671	6,320	464,991	416,992	6,296	423,288
Land and construction	51,408	1,656	53,064	29,682	1,761	31,443
Home equity	59,945	1,134	61,079	48,818	2,997	51,815
Consumer	14,252	357	14,609	15,336	341	15,677
Total	$ 1,012,648	$ 17,576	$ 1,030,224	$ 891,634	$ 23,663	$ 915,297

* 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 recorded investment of troubled debt restructurings at September 30, 2014 was $1,638,000, which included $1,438,000 of nonaccrual loans and $200,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2013 was $3,722,000, which included $3,230,000 of nonaccrual loans and $492,000 of accruing loans. Approximately $147,000 and $1,186,000 in specific reserves were established with respect to these loans as of September 30, 2014 and December 31, 2013, respectively. As of September 30, 2014 and December 31, 2013, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

There were no new loans modified as troubled debt restructurings during the three and nine month periods ended September 30, 2014 and 2013.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

5) Loans (Continued)

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the three and nine month periods ended September 30, 2014 and 2013.

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) 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.

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

The Company had net deferred tax assets of $18,741,000, and $23,326,000, at September 30, 2014, and December 31, 2013, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at September 30, 2014 and December 31, 2013 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 adoption did not have a material impact on the Company's financial condition or results of operations during the current year or on the prior period financial statements. As a result of the change in accounting method, the Company reclassified $353,000 of low income housing investment losses during the third quarter of 2014 that was previously reported as noninterest expense for the first six months of 2014. The low income housing investment losses, net of the tax benefits received, are included in income tax expense on the consolidated statements of income for the three months and nine months ended September 30, 2014. The change in accounting method also resulted in an increase in the effective tax rate to 40.4% and 36.1% for the three months and nine months ended September 30, 2014, respectively, compared to 32.0% and 30.1% for the three months and nine months ended September 30, 2013. Under the equity method of accounting for the low income housing investments for the three months ended September 30, 2014,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2014

(Unaudited)

6) Income Taxes (Continued)

the low income housing investment losses included in noninterest expense would have been $261,000, income tax expense would have been $1,715,000 and the effective tax rate would have been 33.4%. Under the equity method of accounting for the low income housing investments for the nine months ended September 30, 2014, the low income housing investment losses included in noninterest expense would have been $614,000, income tax expense would have been $4,938,000 and the effective tax rate would have been 33.5%.

7) Benefit Plans

Supplemental Retirement Plan

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands)		(Dollars in thousands)	
Components of net periodic benefit cost:				
Service cost	$ 179	$ 303	$ 537	$ 909
Interest cost	228	196	684	588
Amortization of net actuarial loss	35	73	105	219
Net periodic benefit cost	$ 442	$ 572	$ 1,326	$ 1,716