HERITAGE COMMERCE CORP
Form 10-Q
August 07, 2013

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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 June 30, 2013

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 26,338,521 shares of Common Stock outstanding on July 30, 2013.

HERITAGE COMMERCE CORP
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:

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

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

Risks associated with concentrations in real estate related loans;

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

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

Stability of funding sources and continued availability of borrowings;

Our 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;

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

The impact of reputational risk on such matters as business generation and retention, funding and liquidity;

Oversupply of inventory and continued deterioration in values of California commercial real estate;

A prolonged slowdown in construction activity;

The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities, and executive compensation) which we must comply, including but not limited to, the Dodd-Frank Act of 2010;

The effects of security breaches and computer viruses that may affect our computer systems;

Changes in consumer spending, borrowings and saving habits;

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- 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, as well as 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 ability to increase market share and control expenses; and
- Our success in managing the risks involved in the foregoing items.

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

	June 30, 2013	December 31, 2012
	(Dollars in thousands)	
Assets		
Cash and due from banks	$ 33,890	$ 16,520
Interest-bearing deposits in other financial institutions	51,872	357,045
Total cash and cash equivalents	85,762	373,565
Securities available-for-sale, at fair value	293,778	367,912
Securities held-to-maturity, at amortized cost (fair value of $72,772 at June 30, 2013 and $50,964 at December 31, 2012)	81,731	51,472
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	6,321	3,409
Loans, net of deferred fees	841,950	812,313
Allowance for loan losses	(19,342)	(19,027)
Loans, net	822,608	793,286
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	10,871	10,728
Company owned life insurance	49,184	48,358
Premises and equipment, net	7,541	7,469
Intangible assets	1,763	2,000
Accrued interest receivable and other assets	39,947	35,113
Total assets	$ 1,399,506	$ 1,693,312
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	$ 407,516	$ 727,684
Demand, interest-bearing	171,027	155,951
Savings and money market	295,336	272,047
Time deposits under $100	23,062	25,157
Time deposits $100 and over	197,718	190,502
Time deposits brokered	76,800	97,807
CDARS money market and time deposits	17,580	10,220
Total deposits	1,189,039	1,479,368
Subordinated debt	9,279	9,279
Accrued interest payable and other liabilities	33,568	34,924
Total liabilities	1,231,886	1,523,571
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 June 30, 2013 and December 31, 2012 (liquidation preference of $21,004 at June 30, 2013 and December 31, 2012)	19,519	19,519
Common stock, no par value; 60,000,000 shares authorized; 26,338,521 shares issued and outstanding at June 30, 2013 and 26,322,147 shares issued and outstanding at December 31, 2012	132,097	131,820
Retained earnings	20,694	15,721

Accumulated other comprehensive (loss) income	(4,690)	2,681
Total shareholders' equity	167,620	169,741
Total liabilities and shareholders' equity	$ 1,399,506	$ 1,693,312

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands, except per share data)			
Interest income:				
Loans, including fees	$ 10,051	$ 10,292	$ 20,140	$ 20,608
Securities, taxable	2,399	2,975	4,860	6,072
Securities, non-taxable	358		606	
Interest-bearing deposits in other financial institutions	30	29	99	65
Total interest income	12,838	13,296	25,705	26,745
Interest expense:				
Deposits	595	738	1,220	1,454
Subordinated debt	90	472	178	946
Short-term borrowings		2	1	2
Total interest expense	685	1,212	1,399	2,402
Net interest income before provision for loan losses	12,153	12,084	24,306	24,343
Provision (credit) for loan losses	(270)	815	(270)	915
Net interest income after provision for loan losses	12,423	11,269	24,576	23,428
Noninterest income:				
Service charges and fees on deposit accounts	618	601	1,195	1,191
Increase in cash surrender value of life insurance	410	429	826	858
Servicing income	385	447	750	907
Gain on sales of SBA loans	134	376	270	412
Gain on sales of securities	7	32	38	59
Other	361	205	499	386
Total noninterest income	1,915	2,090	3,578	3,813
Noninterest expense:				
Salaries and employee benefits	5,864	5,377	11,875	11,044
Occupancy and equipment	1,028	967	2,096	1,963
Professional fees	400	470	1,382	1,681
Data processing	327	247	579	492
Low income housing investment losses	300	262	611	531
Software subscriptions	294	313	585	603
Insurance expense	253	224	508	447
FDIC deposit insurance premiums	207	202	466	427
Correspondent bank charges	179	155	343	299
Subordinated debt redemption charges	167		167	
Foreclosed assets, net	(96)	105	(251)	220
Other	1,466	1,132	2,809	2,603
Total noninterest expense	10,389	9,454	21,170	20,310
Income before income taxes	3,949	3,905	6,984	6,931
Income tax expense	1,156	1,226	2,011	2,177

Net income	2,793	2,679	4,973	4,754
Dividends and discount accretion on preferred stock				(1,206)
Net income available to common shareholders	$ 2,793	$ 2,679	$ 4,973	$ 3,548
Earnings per common share:				
Basic	$ 0.09	$ 0.08	$ 0.16	$ 0.11
Diluted	$ 0.09	$ 0.08	$ 0.16	$ 0.11

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (Unaudited)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Net income	$ 2,793	$ 2,679	$ 4,973	$ 4,754
Other comprehensive income (loss):				
Change in net unrealized holding gains (loss) on available-for-sale securities and I/O strips	(10,544)	3,398	(12,708)	3,769
Deferred income taxes	4,428	(1,427)	5,337	(1,583)
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(14)		(28)	
Deferred income taxes	6		12	
Reclassification adjustment for (gains) realized in income	(7)	(32)	(38)	(59)
Deferred income taxes	3	13	16	25
Change in unrealized gains (loss) on securities and I/O strips, net of deferred income taxes	(6,128)	1,952	(7,409)	2,152
Change in net pension and other benefit plan liability adjustment	36	41	65	97
Deferred income taxes	(15)	(17)	(27)	(41)
Change in pension and other benefit plan liability, net of deferred income taxes	21	24	38	56
Other comprehensive income (loss)	(6,107)	1,976	(7,371)	2,208
Total comprehensive income (loss)	$ (3,314)	$ 4,655	$ (2,398)	$ 6,962

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

Six Months Ended June 30, 2013 and 2012

	Preferred Stock			Common Stock			Accumulated Other Comprehensive	Total
	Shares	Amount	Discount	Shares	Amount	Retained Earnings	Income / (Loss)	Shareholders' Equity
	(Dollars in thousands, except share data)							
Balance, January 1, 2012	61,004	$ 59,365	$ (833)	26,295,001	$ 131,172	$ 7,172	$ 955	$ 197,831
Net income						4,754		4,754
Other comprehensive income							2,208	2,208
Repurchase of Series A preferred stock	(40,000)	(40,000)						(40,000)
Series A preferred stock capitalized offering costs		154				(154)		
Issuance (forfeitures) of restricted stock awards, net				(4,000)				
Reversal of restricted stock awards due to forfeitures					39			39
Cash dividends accrued on Series A preferred stock						(373)		(373)
Accretion of discount on Series A preferred stock			833			(833)		
Stock option expense, net of fortfeitures and taxes					223			223
Stock options exercised				2,276	9			9
Balance, June 30, 2012	21,004	$ 19,519	$	26,293,277	$ 131,443	$ 10,566	$ 3,163	$ 164,691
Balance, January 1, 2013	21,004	$ 19,519	$	26,322,147	$ 131,820	$ 15,721	$ 2,681	$ 169,741
Net income						4,973		4,973
Other comprehensive loss							(7,371)	(7,371)
Issuance of restricted stock awards				10,000				
Repurchase of warrant					(140)			(140)
Amortization of restricted stock awards, net of forfeitures and taxes					116			116
Stock option expense, net of forfeitures and taxes					275			275
Stock options exercised				6,374	26			26
Balance, June 30, 2013	21,004	$ 19,519	$	26,338,521	$ 132,097	$ 20,694	$ (4,690)	$ 167,620

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 4,973	$ 4,754
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	1,384	1,071
Gain on sales of securities available-for-sale	(38)	(59)
Gain on sales of SBA loans	(270)	(412)
Proceeds from sale of SBA loans originated for sale	3,576	5,785
Net change in SBA loans originated for sale	(6,238)	(7,334)
Provision (credit) for loan losses	(270)	915
Increase in cash surrender value of life insurance	(826)	(858)
Depreciation and amortization	356	385
Amortization of intangible assets	237	245
Gains on sale of foreclosed assets, net	(231)	(84)
Stock option expense, net	275	223
Amortization of restricted stock awards, net	116	39
Effect of changes in:		
Accrued interest receivable and other assets	(135)	2,381
Accrued interest payable and other liabilities	668	283
Net cash provided by operating activities	3,577	7,334
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(8,334)	(49,688)
Purchase of securities held-to-maturity	(34,681)	
Maturities/paydowns/calls of securities available-for-sale	41,588	38,472
Maturities/paydowns/calls of securities held-to-maturity	2,373	
Proceeds from sale of securities available-for-sale	26,944	2,280
Net change in loans	(29,065)	(37,064)
Change in Federal Home Loan Bank and Federal Reserve Bank stock	(143)	(972)
Purchase of premises and equipment	(428)	(145)
Proceeds from sale of foreclosed assets	809	341
Proceeds from sale of other loans transferred to held-for-sale		220
Purchases of company owned life insurance		(250)
Net cash used in investing activities	(937)	(46,806)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	(290,329)	53,325
Repurchase of warrant	(140)	
Repayment of preferred stock		(40,000)
Payment of cash dividends preferred stock		(373)
Exercise of stock options	26	9
Net cash used in provided by financing activities	(290,443)	12,961
Net decrease in cash and cash equivalents	(287,803)	(26,511)
Cash and cash equivalents, beginning of period	373,565	72,872
Cash and cash equivalents, end of period	$ 85,762	$ 46,361
Supplemental disclosures of cash flow information:		
Interest paid	$ 1,442	$ 2,418
Income taxes paid	2,235	1,230

Supplemental schedule of non-cash investing activity:		
Due to broker for securities purchased	$ 1,538	$ 3,330
Due from broker for securities sold		(378)
Loans transferred to foreclosed assets	33	1,973
Transfer of loans held-for-sale to loan portfolio	20	

See notes to consolidated financial statements

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

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

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

In 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 six months ended June 30, 2013 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2013.

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 February 2013, the FASB issued an accounting standards update with the primary objective of improving the reporting of reclassifications out of accumulated other comprehensive income ("AOCI"). For significant reclassifications that are required to be presented in their entirety in net income in the same reporting period by U.S. GAAP, the update requires an entity to report the effect of these reclassifications out of AOCI on the respective line items of net income either on the face of the

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

1) Basis of Presentation (Continued)

statement that reports net income or in the financial statement notes. For AOCI items that are not reclassified to net income in their entirety, presentation in the financial statement notes is required. This update is effective for public companies for fiscal years and interim periods within those years beginning after December 15, 2012, or the first quarter of 2013 for calendar year-end companies, and is required to be applied prospectively. The effect of adopting this standard did not have a material effect on the Company's operating results or financial condition, but the additional disclosures are included in Note 3.

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. 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 convertible into 5,601,000 shares of common stock when transferred in accordance with its terms. The Series C Preferred Stock participate 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 warrant, using the treasury stock method. The common stock warrant was antidilutive for the six months ended June 30, 2013 and for the three months and six months ended June 30, 2012. The Company repurchased the warrant for $140,000 in the second quarter of 2013. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Net income available to common shareholders	$ 2,793	$ 2,679	$ 4,973	$ 3,548
Less: net income allocated to Series C Preferred Stock	489	470	871	623
Net income allocated to common shareholders	$ 2,304	$ 2,209	$ 4,102	$ 2,925
Weighted average common shares outstanding for basic earnings per common share	26,336,244	26,290,480	26,332,793	26,289,907
Dilutive effect of stock options oustanding, using the the treasury stock method	35,648	27,011	46,123	28,058
Shares used in computing diluted earnings per common share	26,371,892	26,317,491	26,378,916	26,317,965
Basic earnings per share	$ 0.09	$ 0.08	$ 0.16	$ 0.11
Diluted earnings per share	$ 0.09	$ 0.08	$ 0.16	$ 0.11

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

3) Accumulated Other Comprehensive Income ("AOCI")

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

	For the Three Months Ended June 30, 2013 and 2012			
	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 April 1, 2013, net of taxes	$ 6,614	$ 489	$ (5,686)	$ 1,417
Other comprehensive (loss) before reclassification, net of taxes	(6,116)		(23)	(6,139)
Amounts reclassified from other comprehensive income (loss), net of taxes	(4)	(8)	44	32
Net current period other comprensive income (loss), net of taxes	(6,120)	(8)	21	(6,107)
Ending balance June 30, 2013, net of taxes	$ 494	$ 481	$ (5,665)	$ (4,690)
Beginning balance April 1, 2012, net of taxes	$ 6,410	$	$ (5,223)	$ 1,187
Other comprehensive income (loss) before reclassification, net of taxes	1,971		(17)	1,954
Amounts reclassified from other comprehensive income (loss), net of taxes	(19)		41	22
Net current period other comprensive income, net of taxes	1,952		24	1,976
Ending balance June 30, 2012, net of taxes	$ 8,362	$	$ (5,199)	$ 3,163

(1) Amounts in parenthesis indicate debits.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

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

	For the Six Months Ended June 30, 2013 and 2012			
	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, 2013, net of taxes	$ 7,887	$ 497	$ (5,703)	$ 2,681
Other comprehensive (loss) before reclassification, net of taxes	(7,371)		(47)	(7,418)
Amounts reclassified from other comprehensive income (loss), net of taxes	(22)	(16)	85	47
Net current period other comprensive income (loss), net of taxes	(7,393)	(16)	38	(7,371)
Ending balance June 30, 2013, net of taxes	$ 494	$ 481	$ (5,665)	$ (4,690)
Beginning balance January 1, 2012, net of taxes	$ 6,210	$	$ (5,255)	$ 955
Other comprehensive income (loss) before reclassification, net of taxes	2,186		(25)	2,161
Amounts reclassified from other comprehensive income (loss), net of taxes	(34)		81	47
Net current period other comprensive income, net of taxes	2,152		56	2,208
Ending balance June 30, 2012, net of taxes	$ 8,362	$	$ (5,199)	$ 3,163

(1) Amounts in parenthesis indicate debits.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

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

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Three Months Ended June 30, 2013	2012	Affected Line Item Where Net Income is Presented
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	$ 7	$ 32	Realized gains on sale of securities
	(3)	(13)	Income tax expense
	4	19	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	14		Interest income on taxable securities
	(6)		Income tax expense
	8		Net of tax
Amortization of defined benefit pension plan items(2)			
Prior service cost		(7)	
Actuarial losses	(75)	(63)	
	(75)	(70)	Income before income tax
	31	29	Income tax expense
	(44)	(41)	Net of tax
Total reclassification for the period	$ (32)	$ (22)	

(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)

June 30, 2013

(Unaudited)

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

Details About AOCI Components	**Amounts Reclassified from AOCI(1) For the Six Months Ended June 30, 2013**	**2012**	**Affected Line Item Where Net Income is Presented**
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	$ 38	$ 59	Realized gains on sale of securities
	(16)	(25)	Income tax expense
	22	34	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	28		Interest income on taxable securities
	(12)		Income tax expense
	16		Net of tax
Amortization of defined benefit pension plan items(2)			
Prior service cost		(14)	
Actuarial losses	(146)	(126)	
	(146)	(140)	Income before income tax
	61	59	Income tax expense
	(85)	(81)	Net of tax
Total reclassification for the period	$ (47)	$ (47)	

(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)

June 30, 2013

(Unaudited)

4) Securities

The amortized cost and estimated fair value of securities at June 30, 2013 and December 31, 2012 were as follows:

June 30, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(Dollars in thousands)			
Securities available-for-sale:				
Agency mortgage-backed securities	$ 224,760	$ 3,085	$ (2,448)	$ 225,397
Corporate bonds	49,089	418	(1,861)	47,646
Trust preferred securities	20,809	114	(188)	20,735
Total	$ 294,658	$ 3,617	$ (4,497)	$ 293,778
Securities held-to-maturity:				
Agency mortgage-backed securities	$ 14,211	$	$ (438)	$ 13,773
Municipals tax exempt	67,520		(8,521)	58,999
Total	$ 81,731	$	$ (8,959)	$ 72,772

December 31, 2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(Dollars in thousands)			
Securities available-for-sale:				
Agency mortgage-backed securities	$ 281,598	$ 9,668	$ (22)	$ 291,244
Corporate bonds	53,739	1,849		55,588
Trust preferred securities	20,769	375	(64)	21,080
Total	$ 356,106	$ 11,892	$ (86)	$ 367,912
Securities held-to-maturity:				
Agency mortgage-backed securities	$ 16,659	$ 2	$ (177)	$ 16,484
Municipals tax exempt	34,813	80	(413)	34,480
Total	$ 51,472	$ 82	$ (590)	$ 50,964

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 June 30, 2013, the Company held 353 securities (160 available-for-sale and 193 held-to-maturity), of which 235 had fair values below amortized cost. No securities had been carried with an unrealized loss for over 12 months. Unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The Company does not consider these securities to be other-than-temporarily impaired at June 30, 2013.

At December 31, 2012, the Company held 269 securities (168 available-for-sale and 101 held-to-maturity), of which 70 had fair values below amortized cost. No securities had been carried with

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

4) Securities (Continued)

an unrealized loss for over 12 months. The Company does not consider these securities to be other-than-temporarily impaired at December 31, 2012.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Proceeds	$ 23,414	$ 375	$ 26,944	$ 2,280
Gross gains	279	32	310	59
Gross losses	(272)		(272)	

The amortized cost and estimated fair values of securities as of June 30, 2013, by contractual maturity, are shown 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	$ 2,032	$ 2,115
Due after five through ten years	47,057	45,531
Due after ten years	20,809	20,735
Agency mortgage-backed securities	224,760	225,397
Total	$ 294,658	$ 293,778

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after five through ten years	$ 1,093	$ 1,011
Due after ten years	66,427	57,988
Agency mortgage-backed securities	14,211	13,773
Total	$ 81,731	$ 72,772

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

5) Loans

Loans were as follows:

	June 30, 2013	December 31, 2012
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	$ 383,068	$ 375,469
Real estate:		
Commercial and residential	370,620	354,934
Land and construction	26,705	22,352
Home equity	48,667	43,865
Consumer	13,097	15,714
Loans	842,157	812,334
Deferred loan origination fees, net	(207)	(21)
Loans, net of deferred fees	841,950	812,313
Allowance for loan losses	(19,342)	(19,027)
Loans, net	$ 822,608	$ 793,286

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

	Three Months Ended June 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,455	$ 6,770	$ 117	$ 19,342
Charge-offs	(119)	(56)		(175)
Recoveries	188	257		445
Net recoveries	69	201		270
Provision (credit) for loan losses	287	(583)	26	(270)
Balance, end of period	$ 12,811	$ 6,388	$ 143	$ 19,342

	Three Months Ended June 30, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 13,734	$ 6,409	$ 163	$ 20,306
Charge-offs	(1,280)	(101)		(1,381)
Recoveries	60	223		283

Net (charge-offs)/recoveries		(1,220)		122				(1,098)
Provision (credit) for loan losses		864		8		(57)		815
Balance, end of period	$	13,378	$	6,539	$	106	$	20,023

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

5) Loans (Continued)

	Six Months Ended June 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,866	$ 6,034	$ 127	$ 19,027
Charge-offs	(959)	(56)		(1,015)
Recoveries	1,338	262		1,600
Net recoveries	379	206		585
Provision (credit) for loan losses	(434)	148	16	(270)
Balance, end of period	$ 12,811	$ 6,388	$ 143	$ 19,342

	Six Months Ended June 30, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 13,215	$ 7,338	$ 147	$ 20,700
Charge-offs	(2,190)	(146)		(2,336)
Recoveries	521	223		744
Net (charge-offs)/recoveries	(1,669)	77		(1,592)
Provision (credit) for loan losses	1,832	(876)	(41)	915
Balance, end of period	$ 13,378	$ 6,539	$ 106	$ 20,023

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:

	June 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 2,588	$ 786	$ 28	$ 3,402
Collectively evaluated for impairment	10,223	5,602	115	15,940
Total allowance balance	$ 12,811	$ 6,388	$ 143	$ 19,342
Loans:				
Individually evaluated for impairment	$ 5,342	$ 9,569	$ 135	$ 15,046

Collectively evaluated for impairment		377,726		436,423		12,962		827,111
Total loan balance	$	383,068	$	445,992	$	13,097	$	842,157

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

5) Loans (Continued)

	December 31, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 1,963	$ 760	$ 17	$ 2,740
Collectively evaluated for impairment	10,903	5,274	110	16,287
Total allowance balance	$ 12,866	$ 6,034	$ 127	$ 19,027
Loans:				
Individually evaluated for impairment	$ 10,161	$ 9,336	$ 147	$ 19,644
Collectively evaluated for impairment	365,308	411,815	15,567	792,690
Total loan balance	$ 375,469	$ 421,151	$ 15,714	$ 812,334

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of June 30, 2013 and December 31, 2012. 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.

	June 30, 2013			December 31, 2012		
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
	(Dollars in thousands)					
With no related allowance recorded:						
Commercial	$ 1,031	$ 948	$	$ 7,829	$ 6,978	$
Real estate:						
Commercial and residential	3,509	3,509		2,755	2,741	
Land and construction	2,070	2,070		2,310	2,223	
Home Equity	2,077	2,077		2,141	2,141	
Total with no related allowance recorded	8,687	8,604		15,035	14,083	
With an allowance recorded:						
Commercial	4,487	4,394	2,588	3,678	3,182	1,963
Real estate:						
Commercial and residential	1,560	1,560	480	3,183	1,937	465
Land and construction	59	59	12			
Home Equity	294	294	294	295	295	295
Consumer	135	135	28	147	147	17

Total with an allowance recorded	6,535	6,442	3,402	7,303	5,561	2,740
Total	$ 15,222	$ 15,046	$ 3,402	$ 22,338	$ 19,644	$ 2,740

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(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 June 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	$ 6,736	$ 5,286	$ 2,153	$ 2,401	$ 138	$ 16,714
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

	Three Months Ended June 30, 2012					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 11,034	$ 2,252	$ 2,210	$ 199	$ 86	$ 15,781
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

	Six Months Ended June 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	$ 7,877	$ 5,083	$ 2,177	$ 2,413	$ 141	$ 17,691
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

5) Loans (Continued)

	Six Months Ended June 30, 2012					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 11,341	$ 2,214	$ 2,733	$ 143	$ 61	$ 16,492
Interest income during impairment	$	$ 1	$ 14	$	$	$ 15
Cash-basis interest earned	$	$ 1	$ 14	$	$	$ 15

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:

	June 30, 2013	June 30, 2012	December 31, 2012
	(Dollars in thousands)		
Nonaccrual loans held-for-sale	$	$ 177	$
Nonaccrual loans held-for-investment	13,868	12,890	17,335
Restructured and loans over 90 days past due and still accruing	510	1,665	859
Total nonperforming loans	$ 14,378	$ 14,732	$ 18,194
Other restructured loans	$ 668	$ 416	$ 1,450
Impaired loans, excluding loans held-for-sale	$ 15,046	$ 14,971	$ 19,644

The following table presents the nonperforming loans by class as of June 30, 2013 and December 31, 2012:

	June 30, 2013			December 31, 2012		
	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	$ 4,164	$ 510	$ 4,674	$ 7,852	$ 859	$ 8,711
Real estate:						
Commercial and residential	5,069		5,069	4,676		4,676
Land and construction	2,129		2,129	2,223		2,223
Home equity	2,371		2,371	2,437		2,437
Consumer	135		135	147		147

Total	$ 13,868	$ 510	$ 14,378	$ 17,335	$ 859	$ 18,194

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

5) Loans (Continued)

The following table presents the aging of past due loans as of June 30, 2013 by class of loans:

	June 30, 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	$ 2,540	$ 567	$ 1,871	$ 4,978	$ 378,090	$ 383,068
Real estate:						
Commercial and residential	139		1,639	1,778	368,842	370,620
Land and construction			59	59	26,646	26,705
Home equity			294	294	48,373	48,667
Consumer		99		99	12,998	13,097
Total	$ 2,679	$ 666	$ 3,863	$ 7,208	$ 834,949	$ 842,157

The following table presents the aging of past due loans as of December 31, 2012 by class of loans:

	December 31, 2012					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 1,699	$ 355	$ 5,120	$ 7,174	$ 368,295	$ 375,469
Real estate:						
Commercial and residential	1,603		3,290	4,893	350,041	354,934
Land and construction			78	78	22,274	22,352
Home equity	742		2,045	2,787	41,078	43,865
Consumer					15,714	15,714
Total	$ 4,044	$ 355	$ 10,533	$ 14,932	$ 797,402	$ 812,334

Past due loans 30 days or greater totaled $7,208,000 and $14,932,000 at June 30, 2013 and December 31, 2012, respectively, of which $4,446,000 and $12,020,000 were on nonaccrual. At June 30, 2013, there were also $9,422,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2012, there were also $5,315,000 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

5) Loans (Continued)

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 continued downturn in these sectors of the economy which could reduce the demand for loans and adversely impact the borrowers' ability to repay their loans.

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

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

Substandard-Nonaccrual. Loans classified as substandard-nonaccrual are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. 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 June 30, 2013 or December 31, 2012.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

5) Loans (Continued)

The following table provides a summary of the loan portfolio by loan type and credit quality classification at June 30, 2013 and December 31, 2012:

	June 30, 2013			December 31, 2012		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)					
Commercial	$ 372,077	$ 10,991	$ 383,068	$ 355,440	$ 20,029	$ 375,469
Real estate:						
Commercial and residential	363,222	7,398	370,620	345,045	9,889	354,934
Land and construction	24,576	2,129	26,705	18,858	3,494	22,352
Home equity	45,974	2,693	48,667	41,187	2,678	43,865
Consumer	12,729	368	13,097	15,321	393	15,714
Total	$ 818,578	$ 23,579	$ 842,157	$ 775,851	$ 36,483	$ 812,334

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 under the Company's underwriting policy.

The recorded investment of troubled debt restructurings at June 30, 2013 was $2,759,000, which included $1,581,000 of nonaccrual loans and $1,178,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2012 was $4,107,000, which included $1,798,000 of nonaccrual loans and $2,309,000 of accruing loans. Approximately $804,000 and $1,152,000 in specific reserves were established with respect to these loans as of June 30, 2013 and December 31, 2012, respectively. As of June 30, 2013 and December 31, 2012, 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 month period ended June 30, 2013. The following table presents loans by class modified as troubled debt restructurings during the three month period ended June 30, 2012:

	During the Three Months Ended June 30, 2012		
Troubled Debt Restructurings:	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
	(Dollars in thousands)		
Consumer	1	$ 117	$ 117
Total	1	$ 117	$ 117

The troubled debt restructurings described above increased the allowance for loan losses by $13,000 through the allocation of specific reserves, and resulted in no net charge-offs during the three month period ended June 30, 2012.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

5) Loans (Continued)

There were no new loans modified as troubled debt restructurings during the six month period ended June 30, 2013. The following table presents loans by class modified as troubled debt restructurings during the six month period ended June 30, 2012:

	During the Six Months Ended June 30, 2012		
Troubled Debt Restructurings:	**Number of Contracts**	**Pre-modification Outstanding Recorded Investment**	**Post-modification Outstanding Recorded Investment**
		(Dollars in thousands)	
Commercial	1	$ 112	$ 112
Consumer	1	117	117
Total	2	$ 229	$ 229

The troubled debt restructurings described above increased the allowance for loan losses by $44,000 through the allocation of specific reserves, and resulted in no net charge-offs during the six month period ended June 30, 2012.

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 period ended June 30, 2013 and 2012.

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 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.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

6) Income Taxes (Continued)

The Company had net deferred tax assets of $24,600,000, and $19,264,000, at June 30, 2013, and December 31, 2012, 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 June 30, 2013 and December 31, 2012 will be fully realized in future years.

7) Benefit Plans

Supplemental Retirement Plan

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Components of net periodic benefit cost:				
Service cost	$ 302	$ 294	$ 606	$ 588
Interest cost	196	193	392	386
Amortization of prior service cost		7		14
Amortization of net actuarial loss	75	63	146	126
Net periodic benefit cost	$ 573	$ 557	$ 1,144	$ 1,114

Split-Dollar Life Insurance Benefit Plan

The Company maintains life insurance policies for current and 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:

	June 30, 2013	December 31, 2012
	(Dollars in thousands)	
Change in projected benefit obligation		
Projected benefit obligation at beginning of year	$ 4,717	$ 4,525
Interest cost	89	185
Actuarial gain	2	7
Projected benefit obligation at end of period	$ 4,808	$ 4,717

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2013

(Unaudited)

8) Preferred Stock

Series A Preferred Stock

On November 21, 2008, the Company issued 40,000 shares of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") to the U.S. Treasury under the terms of the U.S. Treasury Capital Purchase Program for $40,000,000 with a liquidation preference of $1,000 per share. On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve Board, the Company repurchased all of the Series A Preferred Stock and paid all of the related accrued and unpaid dividends. HCC used available cash and proceeds from a $30,000,000 distribution approved by the California Department of Financial Institutions from HBC to HCC. The repurchase of the Series A Preferred Stock accelerated the accretion of the remaining issuance discount on the Series A Preferred Stock. Total dividends and discount accretion on Preferred Stock, including accelerated accretion of approximately $765,000, reduced net income available to common shareholders by $1,206,000 in the first quarter of 2012. On June 12, 2013, the Company completed the repurchase of the common stock warrant issued to the U.S. Department of the Treasury on November 21, 2008, which was exercisable into 462,963 shares of common stock at an exercise price of $12.96. The Company repurchased the warrant for $140,000.

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 Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of $1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

9) Fair Value

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

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

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

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June 30, 2013

(Unaudited)

9) Fair Value (Continued)

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 June 30, 2013:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 225,397		$ 225,397	
Corporate bonds	47,646		47,646	
Trust preferred securities	20,735		20,735	
I/O strip receivables	1,726		1,726	
Assets at December 31, 2012:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 291,244		$ 291,244	
Corporate bonds	55,588		55,588	
Trust preferred securities	21,080		21,080	
I/O strip receivables	1,786		1,786	

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

Assets and Liabilities Measured on a Non-Recurring Basis

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

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. The appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are

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(Unaudited)

9) Fair Value (Continued)

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

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(Unaudited)

9) Fair Value (Continued)

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 June 30, 2013:				
Impaired loans held-for-investment:				