

HERITAGE FINANCIAL CORP /WA/  
Form 10-Q  
October 31, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**  
**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2008

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
Commission File Number 0-29480

**HERITAGE FINANCIAL CORPORATION**

(Exact name of registrant as specified in its charter)

**Washington**  
(State or other jurisdiction of incorporation or organization)

**91-1857900**  
(I.R.S. Employer Identification No.)

**201 Fifth Avenue SW, Olympia, WA**  
(Address of principal executive office)

**98501**  
(ZIP Code)

**(360) 943-1500**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant 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.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date:

As of October 14, 2008 there were 6,695,766 common shares outstanding, with no par value, of the registrant.

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**HERITAGE FINANCIAL CORPORATION**

**FORM 10-Q**

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**Table of Contents****ITEM 1. HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(Dollars in thousands, except for per share data)

(Unaudited)

	Three Months		Nine Months Ended	
	Ended September 30, 2008	2007	September 30, 2008	2007
<b>INTEREST INCOME:</b>				
Interest and fees on loans	\$ 13,692	\$ 15,779	\$ 41,366	\$ 45,329
Taxable interest on investment securities	425	415	1,194	1,240
Nontaxable interest on investment securities	51	44	145	133
Interest on federal funds sold and interest bearing deposits	14	25	134	105
Dividends on Federal Home Loan Bank stock	11	5	31	13
<b>Total interest income</b>	<b>14,193</b>	<b>16,268</b>	<b>42,870</b>	<b>46,820</b>
<b>INTEREST EXPENSE:</b>				
Deposits	4,252	6,344	14,300	17,970
Other borrowings	85	446	261	1,372
<b>Total interest expense</b>	<b>4,337</b>	<b>6,790</b>	<b>14,561</b>	<b>19,342</b>
<b>Net interest income</b>	<b>9,856</b>	<b>9,478</b>	<b>28,309</b>	<b>27,478</b>
Provision for loan losses	1,760	210	2,830	570
<b>Net interest income after provision for loan losses</b>	<b>8,096</b>	<b>9,268</b>	<b>25,479</b>	<b>26,908</b>
<b>NON-INTEREST INCOME:</b>				
Gains on sales of loans, net	112	39	384	52
Brokered mortgage income	41	149	193	551
Service charges on deposits	1,059	977	3,072	2,798
Rental income	77	82	240	242
Merchant visa income	819	759	2,285	2,123
Other income	143	185	597	687
<b>Total non-interest income</b>	<b>2,251</b>	<b>2,191</b>	<b>6,771</b>	<b>6,453</b>
<b>NON-INTEREST EXPENSE:</b>				
Salaries and employee benefits	3,658	3,722	11,044	11,231
Occupancy and equipment	954	998	2,896	3,102
Data processing	400	404	1,170	1,172
Marketing	135	133	434	396
Office supplies and printing	101	95	280	295
Merchant visa	669	612	1,845	1,706
Professional services	167	129	493	510
State and local taxes	233	252	710	711
Impairment loss on investment securities	147		1,259	
Other expense	796	683	2,385	2,267
<b>Total non-interest expense</b>	<b>7,260</b>	<b>7,028</b>	<b>22,516</b>	<b>21,390</b>

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Income before federal income taxes	3,087	4,431	9,734	11,971
Federal income taxes	1,006	1,498	3,189	4,038
Net income	\$ 2,081	\$ 2,933	\$ 6,545	\$ 7,933
Earnings per share:				
Basic	\$ 0.32	\$ 0.45	\$ 0.99	\$ 1.21
Diluted	\$ 0.31	\$ 0.44	\$ 0.99	\$ 1.19
Dividends declared per share:	\$ 0.14	\$ 0.21	\$ 0.56	\$ 0.63

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

(Dollars in thousands)

(Unaudited)

	September 30, 2008	December 31, 2007
<b>Assets</b>		
Cash on hand and in banks	\$ 20,287	\$ 28,401
Interest earning deposits	765	6,062
Investment securities available for sale	25,818	35,660
Investment securities held to maturity (market value of \$11,963 and \$3,929)	12,983	3,890
Loans held for sale	570	447
Loans receivable	811,964	779,319
Less: Allowance for loan losses	(12,628)	(10,374)
Loans receivable, net	799,336	768,945
Other real estate owned	169	169
Premises and equipment, at cost, net	14,604	14,819
Federal Home Loan Bank and Federal Reserve stock, at cost	3,516	3,227
Accrued interest receivable	4,528	4,401
Prepaid expenses and other assets	6,529	4,156
Deferred federal income taxes, net	2,599	2,364
Intangible assets, net	444	502
Goodwill	13,012	13,012
Total assets	\$ 905,160	\$ 886,055
<b>Liabilities and Stockholders Equity</b>		
Deposits	\$ 795,065	\$ 776,280
Advances from Federal Home Loan Bank	13,900	14,990
Other borrowings	1,657	1,951
Accrued expenses and other liabilities	5,731	7,867
Total liabilities	816,353	801,088
Stockholders equity:		
Common stock, no par value per share, 15,000,000 shares authorized; 6,693,903 and 6,642,972 shares outstanding at September 30, 2008 and December 31, 2007, respectively	25,689	24,985
Unearned compensation ESOP	(380)	(447)
Retained earnings	63,578	60,780
Accumulated other comprehensive loss, net	(80)	(351)
Total stockholders equity	88,807	84,967
Total liabilities and stockholders equity	\$ 905,160	\$ 886,055

See Notes to Condensed Consolidated Financial Statements.



**Table of Contents****HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY FOR THE NINE MONTHS ENDED  
SEPTEMBER 30, 2008 AND COMPREHENSIVE INCOME FOR THE THREE AND NINE MONTHS ENDED****SEPTEMBER 30, 2008 AND 2007**

(In Thousands)

(Unaudited)

	Number of common shares	Common stock	Unearned Compensation- ESOP	Retained earnings	Accumulated other comprehensive loss, net	Total stockholders equity
Balance at December 31, 2007	6,643	\$ 24,985	\$ (447)	\$ 60,780	\$ (351)	\$ 84,967
Stock option compensation expense		136				136
Earned ESOP shares	6	62	67			129
Earned restricted stock shares		252				252
Tax liability on vesting of restricted stock shares		(2)				(2)
Restricted stock awards granted	25					
Tax benefit on dividends paid on unallocated ESOP shares and restricted stock shares		26				26
Exercise of stock options (including tax benefits from nonqualified stock options)	20	230				230
Net income				6,545		6,545
Change in fair value of securities available for sale, net of tax					271	271
Cash dividends declared				(3,747)		(3,747)
Balance at September 30, 2008	6,694	\$ 25,689	\$ (380)	\$ 63,578	\$ (80)	\$ 88,807

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
<b>Comprehensive Income</b>				
Net income	\$ 2,081	\$ 2,933	\$ 6,545	\$ 7,933
Change in fair value of securities available for sale, net of tax of \$98, \$67, \$146, \$39	182	125	271	72
Comprehensive income	\$ 2,263	\$ 3,058	\$ 6,816	\$ 8,005

See Notes to Condensed Consolidated Financial Statements.



**Table of Contents****HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****For the nine months ended September 30, 2008 and 2007**

(Dollars in thousands)

(Unaudited)

	2008	2007
Cash flows from operating activities:		
Net income	\$ 6,545	\$ 7,933
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	898	1,179
Deferred loan fees, net of amortization	(348)	(118)
Provision for loan losses	2,830	570
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities	(4,606)	1,114
Recognition of compensation related to ESOP shares and restricted stock awards	381	287
Stock option compensation expense	136	217
Tax benefit realized from stock options exercised, restricted stock awards vested, and dividends on unallocated ESOP shares and restricted stock awards	(36)	(179)
Amortization of intangible assets	58	58
Deferred federal income tax	(381)	128
Impairment loss on investment securities	1,259	
Origination of loans held for sale	(15,636)	(3,961)
Gain on sale of loans	(384)	(52)
Proceeds from sale of loans	15,897	4,013
Loss on sale of other real estate owned	5	20
(Gain) loss on sale of premises and equipment	(2)	4
<b>Net cash provided by operating activities</b>	<b>6,616</b>	<b>11,213</b>
Cash flows from investing activities:		
Loans originated, net of principal payments	(33,369)	(53,002)
Maturities of investment securities available for sale	11,816	4,349
Maturities of investment securities held to maturity	1,141	150
Purchase of investment securities available for sale	(13,367)	(1,260)
Purchase of investment securities held to maturity	(2,335)	
Purchase of premises and equipment	(734)	(620)
Purchase of Federal Home Loan Bank stock	(289)	
Proceeds from sale of other real estate owned	491	285
Proceeds from sale of premises and equipment	8	13
Proceeds from sales of securities available for sale	2,698	
<b>Net cash used in investing activities</b>	<b>(33,940)</b>	<b>(50,085)</b>
Cash flows from financing activities:		
Net increase in deposits	18,785	59,746
Net decrease in borrowed funds	(433)	(11,708)
Repayments of long-term debt	(951)	(888)
Cash dividends paid	(3,742)	(4,169)
Proceeds from exercise of stock options	218	1,438
	36	179

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Tax benefit realized from stock options exercised, restricted stock awards vested, and dividends on unallocated ESOP shares and restricted stock awards

Repurchase of common stock		(1,324)
Net cash provided by financing activities	13,913	43,274
Net increase (decrease) in cash and cash equivalents	(13,411)	4,402
Cash and cash equivalents at beginning of period	34,463	26,431
Cash and cash equivalents at end of period	\$ 21,052	\$ 30,833

Supplemental disclosures of cash flow information:

Cash payments for:

Interest expense	\$ 15,187	\$ 19,510
Federal income taxes	3,165	3,427

Supplemental disclosures of noncash investing and financing activities:

Loans transferred to other real estate owned	496	80
Securities exchanged in redemption-in-kind transaction	7,857	

See Notes to Condensed Consolidated Financial Statements.

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**HERITAGE FINANCIAL CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Three and Nine Months Ended September 30, 2008 and 2007**

(Unaudited)

**NOTE 1. Description of Business and Basis of Presentation**

*(a.) Description of Business*

Heritage Financial Corporation (Company) is a bank holding company that was incorporated in the State of Washington in August 1997. We were organized for the purpose of acquiring all of the capital stock of Heritage Savings Bank upon our reorganization from a mutual holding company form of organization to a stock holding company form of organization. Effective September 1, 2004, Heritage Savings Bank switched its charter from a State Chartered Savings Bank to a State Chartered Commercial Bank and changed its legal name from Heritage Savings Bank to Heritage Bank. Effective September 1, 2005, Central Valley Bank (acquired by the Company in March 1999) changed its charter from a Nationally Chartered Commercial Bank to a State Chartered Commercial Bank.

We are primarily engaged in the business of planning, directing, and coordinating the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. The deposits of Heritage Bank and Central Valley Bank are insured by the Federal Deposit Insurance Corporation (FDIC) under the Deposit Insurance Fund (DIF). Heritage Bank conducts business from its main office in Olympia, Washington and its thirteen branch offices located in Thurston, Pierce, Mason and south King Counties of Washington State. Central Valley Bank conducts business from its main office in Toppenish, Washington and its five branch offices located in Yakima and Kittitas Counties of Washington State.

Our business consists primarily of lending and deposit relationships with small businesses including agribusiness and their owners in our market area, attracting deposits from the general public and originating for sale or investment purposes first mortgage loans on residential properties located in western and central Washington. We also make residential construction loans, income property loans, and consumer loans.

*(b.) Basis of Presentation*

The accompanying condensed consolidated financial statements have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. These condensed consolidated financial statements should be read with our December 31, 2007 audited consolidated financial statements and its accompanying notes included in our Annual Report on Form 10-K. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ended December 31, 2008. In preparing the consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates.

*(c.) Significant Accounting Policies*

The significant accounting policies used in preparation of our consolidated financial statements are disclosed in our 2007 Annual Report on Form 10-K. There have not been any other material changes in our significant accounting policies compared to those contained in our 2007 10-K disclosure for the year ended December 31, 2007.

**NOTE 2. Stockholders Equity**

*(a.) Earnings per Share*

The following table illustrates the reconciliation of weighted average shares used for earnings per share for the noted periods.

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	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
<b>Basic:</b>				
Weighted average shares outstanding	6,691,308	6,641,923	6,680,720	6,610,982
Less: Weighted average unvested restricted stock awards	(89,876)	(65,524)	(84,743)	(58,153)
Basic weighted average shares outstanding	6,601,432	6,576,399	6,595,977	6,552,829
<b>Diluted:</b>				
Basic weighted average shares outstanding	6,601,432	6,576,399	6,595,977	6,552,829
Incremental shares from unexercised stock options and unvested restricted stock awards	41,827	98,221	46,611	124,885
Weighted average shares outstanding	6,643,259	6,674,620	6,642,588	6,677,714

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Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the nine months ended September 30, 2008 and 2007, anti-dilutive shares outstanding related to options to acquire common stock totaled 457,621 and 108,006, respectively, as the exercise price was in excess of the market value.

*(b.) Cash Dividend Declared*

On September 18, 2008, we announced a quarterly cash dividend of 14.0 cents per share payable on October 31, 2008 to stockholders of record on October 15, 2008.

**NOTE 3. Share Based Payment**

The Company maintains a number of stock-based incentive programs, which are discussed in more detail in Note 4.

Total stock-based compensation expense (excluding ESOP expense) for the nine months ended September 30, 2008 and 2007 were as follows:

	2008	2007
	(Dollars in thousands)	
Compensation expense recognized	\$ 389	\$ 337
Related tax benefit recognized	104	53

As of September 30, 2008, the total unrecognized compensation expense related to non-vested stock awards was \$859,695 and the related weighted average period over which it is expected to be recognized is approximately 2.6 years.

The fair value of options granted during the nine months ended September 30, 2008 and 2007 is estimated on the date of grant using the Black-Scholes option pricing model based on the assumptions noted in the following table. The expected term of share options is derived from historical data and represents the period of time that share options granted are expected to be outstanding. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on historical volatility of Company shares. Expected dividend yield is based on dividends expected to be paid during the expected term of the share options.

Grant period ended	Weighted Average Risk Free Interest Rate	Expected Term in years	Expected Volatility	Expected Dividend Yield	Weighted Average Fair Value
September 30, 2008	2.38%	4.50	21%	4.30%	\$ 2.38
September 30, 2007	5.04%	4.50	21%	3.59%	\$ 4.04

**NOTE 4. Stock Option and Award Plans**

On September 24, 1996, Heritage Bank's stockholders approved the adoption of the 1997 stock option plan. On October 15, 1998, the Company's stockholders approved the adoption of the 1998 stock option plan, which is similar to the 1997 plan. The 1998 plan does not affect any options granted under the 1997 plan. On April 25, 2002, the Company's stockholders approved the adoption of the 2002 Incentive Stock Option Plan, the 2002 Director Nonqualified Stock Option Plan and the 2002 Restricted Stock Plan, which are generally similar to the 1997 and 1998 stock plans. On April 27, 2006, the Company's stockholders approved the adoption of the 2006 Incentive Stock Option Plan, the 2006 Director Nonqualified Stock Option Plan and the 2006 Restricted Stock Plan, which are generally similar to the 1997, 1998 and 2002 stock plans.

Under these stock option plans, on the date of grant, the exercise price of the option must at least equal the market value per share of the Company's common stock. The 1997 plan provides for the granting of options and stock awards up to 270,333 common shares. The 1998 plan provides for the grant of stock options for up to 414,750 shares and stock awards for up to 69,431 shares. The 2002 and 2006 Incentive Stock Option plans provide for the grant of stock options for up to 451,500 and 400,000 shares, respectively. The 2002 and 2006 Director Nonqualified Stock Option Plans provide for the grant of stock options for up to 73,500 and 75,000 shares, respectively. The 2002 and 2006 Restricted Stock Plans provide for the grant of stock awards for up to 52,500 and 25,000 shares, respectively.



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Stock options generally vest ratably over three years and expire five years after they become exercisable which amounts to an average term of seven years. Restricted Stock awards issued have a five-year cliff vesting. The Company issues new shares to satisfy share option exercises and restricted stock awards.

The following table summarizes stock option activity for the nine months ended September 30, 2008.

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2007	518,658	\$ 20.15		
Granted	17,550	19.99		
Exercised	(20,126)	10.82		
Forfeited or expired	(1,020)	19.65		
Outstanding at September 30, 2008	515,062	\$ 20.51	2.9	\$ 58
Exercisable at September 30, 2008	453,461	\$ 20.07	2.5	\$ 58

The total intrinsic value of options exercised during the nine months ended September 30, 2008 and 2007, was \$164,000 and \$1,262,000, respectively. The total fair value of options vested during the nine months ended September 30, 2008 and 2007 was \$117,000 and \$1,132,000, respectively.

The following table summarizes restricted stock award activity for the nine months ended September 30, 2008.

	Shares	Weighted-Average Grant Date Fair Value
Outstanding at December 31, 2007	65,945	\$ 22.62
Granted	24,495	19.85
Vested	(1,050)	21.40
Forfeited	(635)	22.76
Outstanding at September 30, 2008	88,755	\$ 21.87

**NOTE 5. Fair Value Accounting**

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157 ( SFAS No. 157 ) Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under Generally Accepted Accounting Principles ( GAAP ) and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements.

In accordance with SFAS No. 157, we group our financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

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Level 1 Valuations for assets and liabilities traded in active exchange markets, or interest in open-end mutual funds that allow the Company to sell its ownership interest back to the fund at net asset value (NAV) on a daily basis. Valuations are obtained from readily available pricing sources for market transactions involving identical assets, liabilities, or funds.

Level 2 Valuations for assets and liabilities traded in less active dealer, or broker markets, such as quoted prices for similar assets or liabilities or quoted prices in markets that are not active. Level 2 includes U.S. Treasury, U.S. government and agency debt securities, and mortgage-backed securities. Valuations are usually obtained from third party pricing services for identical or comparable assets or liabilities.

Level 3 Valuations for assets and liabilities that are derived from other valuation methodologies, such as option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.



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The following table summarizes the balances of assets and liabilities measured at fair value on a recurring basis at September 30, 2008.

	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
	<b>(Dollars in thousands)</b>			
Investment securities available for sale	\$ 25,818	\$	\$ 25,818	\$

The following table summarizes the balances of assets and liabilities measured at fair value on a nonrecurring basis at September 30, 2008, and the total losses resulting from these fair value adjustments for the nine months ended September 30, 2008

	<b>Fair Value at September 30, 2008</b>				<b>Nine Months Ended September 30, 2008 (1)</b>
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total Losses</b>
	<b>(Dollars in thousands)</b>				
Impaired loans	\$ 6,628	\$	\$	\$ 6,628	\$ 1,724
Other real estate owned	\$ 169	\$	\$	\$ 169	\$
<b>Total</b>	<b>\$ 6,797</b>	<b>\$</b>	<b>\$</b>	<b>\$ 6,797</b>	<b>\$ 1,724</b>

(1) The loss represents specific allocations to the allowance for loan losses or impairments on nonaccrual loans measured at fair value.

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The following discussion is intended to assist in understanding the financial condition and results of the Company. The information contained in this section should be read with the unaudited condensed consolidated financial statements and its accompanying notes, and the December 31, 2007 audited consolidated financial statements and its accompanying notes included in our recent Annual Report on Form 10-K.

Statements concerning future performance, developments or events, expectations for growth and market forecasts, and any other guidance on future periods, constitute forward-looking statements and are subject to a number of risks and uncertainties, which might cause actual results to differ materially from stated expectations. Specific factors include, but are not limited to, the effect of interest rate changes, risks associated with acquisition of other banks and opening new branches, the ability to control costs and expenses, and general economic conditions. Additional information on these and other factors, which could affect our financial results, are included in our filings with the Securities and Exchange Commission.

**Overview**

Heritage Financial Corporation is a bank holding company, which primarily engages in the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. We provide financial services to our local communities with an ongoing strategic focus in expanding our commercial lending relationships, market expansion and a continual focus on asset quality. Effective January 8, 1998, our common stock began to trade on the NASDAQ National Market under the symbol HFWA.

The following table provides relevant net interest income information for selected time periods. The average loan balances presented in the table are net of allowances for loan losses. Nonaccrual loans have been included in the tables as loans carrying a zero yield. Yields on tax-exempt securities and loans have not been stated on a tax-equivalent basis.

	Average Balance	For the Three Months Ended September 30,				Average Rate
		2008 Interest Earned/ Paid	Average Rate	Average Balance	2007 Interest Earned/ Paid	
<b>Interest Earning Assets:</b>						
Loans	\$ 795,093	\$ 13,692	6.85%	\$ 789,752	\$ 15,779	7.93%
Taxable securities	31,550	425	5.36	35,153	415	4.68
Nontaxable securities	5,638	50	3.54	4,761	44	3.68
Interest earning deposits	2,944	15	1.98	1,928	25	5.23
Federal Home Loan Bank stock	3,392	11	1.33	3,227	5	0.60
<b>Total interest earning assets</b>	<b>\$ 838,617</b>	<b>\$ 14,193</b>	<b>6.73%</b>	<b>\$ 834,821</b>	<b>\$ 16,268</b>	<b>7.73%</b>
Non-interest earning assets	59,626			58,344		
<b>Total assets</b>	<b>\$ 898,243</b>			<b>\$ 893,165</b>		
<b>Interest Bearing Liabilities:</b>						
Certificates of deposit	\$ 335,209	\$ 2,762	3.28%	\$ 359,543	\$ 4,423	4.88%
Savings accounts	96,363	428	1.77	79,445	382	1.91
Interest bearing demand and money market accounts	250,682	1,062	1.69	226,007	1,539	2.70
<b>Total interest bearing deposits</b>	<b>682,254</b>	<b>4,252</b>	<b>2.48</b>	<b>644,995</b>	<b>6,344</b>	<b>3.78</b>
FHLB advances and other borrowings	10,768	85	3.15	31,135	446	5.69
<b>Total interest bearing liabilities</b>	<b>\$ 693,022</b>	<b>\$ 4,337</b>	<b>2.49%</b>	<b>\$ 696,130</b>	<b>\$ 6,790</b>	<b>3.87%</b>
Demand and other non-interest bearing deposits	105,598			105,884		
Other non-interest bearing liabilities	5,382			7,324		
Stockholders' equity	89,241			83,827		

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Total liabilities and stockholders' equity	\$ 893,243	\$ 893,165
Net interest income	\$ 9,856	\$ 9,478
Net interest spread	4.24%	3.86%
Net interest margin	4.66%	4.50%
Average interest earning assets to average interest bearing liabilities	121.01%	119.92%

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	For the Nine Months Ended September 30,					
	Average Balance	2008 Interest Earned/ Paid	Average Rate	Average Balance	2007 Interest Earned/ Paid	Average Rate
<b>Interest Earning Assets:</b>						
Loans	\$ 779,546	\$ 41,366	7.09%	\$ 764,240	\$ 45,329	7.93%
Taxable securities	33,555	1,194	4.75	35,703	1,240	4.64
Nontaxable securities	5,404	145	3.58	4,784	133	3.71
Interest earning deposits	7,046	134	2.55	2,649	105	5.31
Federal Home Loan Bank stock	3,284	31	1.25	3,227	13	0.53
<b>Total interest earning assets</b>	<b>\$ 828,835</b>	<b>\$ 42,870</b>	<b>6.91%</b>	<b>\$ 810,603</b>	<b>\$ 46,820</b>	<b>7.72%</b>
Non-interest earning assets	57,773			58,263		
<b>Total assets</b>	<b>\$ 886,608</b>			<b>\$ 868,866</b>		
<b>Interest Bearing Liabilities:</b>						
Certificates of deposit	\$ 346,397	\$ 9,827	3.79%	\$ 349,388	\$ 12,702	4.86%
Savings accounts	89,537	1,155	1.72	83,816	1,217	1.94
Interest bearing demand and money market accounts	239,601	3,318	1.85	211,563	4,051	2.56
<b>Total interest bearing deposits</b>	<b>675,535</b>	<b>14,300</b>	<b>2.83</b>	<b>644,767</b>	<b>17,970</b>	<b>3.73</b>
FHLB advances and other borrowings	8,844	261	3.95	32,094	1,372	5.71
<b>Total interest bearing liabilities</b>	<b>\$ 684,379</b>	<b>\$ 14,561</b>	<b>2.84%</b>	<b>\$ 676,861</b>	<b>\$ 19,342</b>	<b>3.82%</b>
Demand and other non-interest bearing deposits	107,290			102,452		
Other non-interest bearing liabilities	6,526			7,180		
Stockholders equity	88,413			82,373		
<b>Total liabilities and stockholders equity</b>	<b>\$ 886,608</b>			<b>\$ 868,866</b>		
<b>Net interest income</b>		<b>\$ 28,309</b>			<b>\$ 27,478</b>	
Net interest spread			4.07%			3.90%
Net interest margin			4.56%			4.53%
Average interest earning assets to average interest bearing liabilities			121.11%			119.76%

**Financial Condition Data**

Total assets increased \$19.1 million (2.2%) to \$905.2 million as of September 30, 2008 from the December 31, 2007 balance of \$886.1 million. Deposits increased \$18.8 million (2.4%) to \$795.1 million as of September 30, 2008 from the December 31, 2007 balance of \$776.3 million. For the same period, net loans, which exclude loans held for sale but are net of the allowance for loan losses, increased \$30.4 million (4.0%) to \$799.3 million as of September 30, 2008 from the December 31, 2007 balance of \$768.9 million. Commercial loans continue to be the largest segment of loans at 54.9% and 54.0% as a percentage of total loans as of September 30, 2008 and December 31, 2007, respectively.

**Earnings Summary**

Earnings for the nine months ended September 30, 2008 were significantly affected by losses totaling \$1,259,000 (\$818,000 net of tax) relating to the Company's investments in the AMF Ultra Short Mortgage Fund. These losses resulted from an other-than-temporary impairment charge in the second quarter of 2008 totaling \$1,112,000 (\$723,000 net of tax) and a subsequent third quarter redemption-in-kind totaling \$147,000 (\$95,000 net of tax) in which fund shares were exchanged for a pro-rata share of cash and underlying securities in the fund.

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Net income was \$0.31 per diluted share for the three months ended September 30, 2008 compared to \$0.44 per diluted share for the three months ended September 30, 2007, a decrease of 29.5%. Net earnings for the three months ended September 30, 2008 were \$2,081,000 compared to \$2,933,000 for the same period in 2007, a decrease of 29.0%. Net income for the nine months ended September 30, 2008 was \$0.99 per diluted share compared to \$1.19 per diluted share for the same period last year, a decrease of 16.8%. Net earnings for the nine months ended September 30, 2008 were \$6,545,000 compared to \$7,933,000 for the same period in 2007, a decrease of 17.5%.

Return on average equity for the quarter ended September 30, 2008 was 9.3% compared to 13.9% for the same period last year. Average equity increased by \$5.4 million to \$89.2 million for the three months ended September 30, 2008 versus \$83.8 million for the same period last year. For the nine months ended September 30, 2008, the Company's return on average equity was 9.9% compared to 12.9% for the nine months ended September 30, 2007. Average equity for the nine months ended September 30, 2008 increased \$6.0 million to \$88.4 million from \$82.4 million for the nine months ended September 30, 2007. The Company's capital position remains strong at 9.81% of total assets as of September 30, 2008, an increase from 9.19% at September 30, 2007.

**Net Interest Income**

Net interest income before provision for loan losses for the three months ended September 30, 2008 increased 4.0% to \$9,856,000 from \$9,478,000 for the same quarter in 2007. Net interest income before provision for loan losses for the nine months ended September 30, 2008 increased 3.0% to \$28,309,000 from \$27,478,000 for the same period in 2007. The net interest margin (net interest income divided by average interest earning assets) increased to 4.66% for the current quarter from 4.50% for the same quarter last year. The net interest margin increased to 4.56% for the nine months ended September 30, 2008 from 4.53% for the same period in 2007.

Interest income decreased \$2.1 million or 12.8%, for the three months ended September 30, 2008 as compared to the third quarter last year and interest expense decreased \$2.5 million or 36.1%, during this same period. Interest income for the nine months ended September 30, 2008 decreased \$4.0 million, or 8.4%, as compared to the same period last year and interest expense decreased \$4.8 million, or 24.7%, during this same period. Net loans averaged \$795.1 million with an average yield of 6.85% for the three months ended September 30, 2008 compared to average net loans of \$789.8 million with an average yield of 7.93% for the same period in 2007. Net loans averaged \$779.5 million with an average yield of 7.09% for the nine months ended September 30, 2008 compared to average net loans of \$764.2 million with an average yield of 7.93% for the same period in 2007. Certificates of deposit averaged \$335.2 million with an average cost of 3.28% for the three months ended September 30, 2008 compared to \$359.5 million with an average cost of 4.88% for the same period in 2007. Certificates of deposit averaged \$346.4 million with an average cost of 3.79% for the nine months ended September 30, 2008 compared to \$349.4 million with an average cost of 4.86% for the same period in 2007.

**Provision for Loan Losses**

The provision for loan losses was \$1,760,000 for the three months ended September 30, 2008, an increase of \$1,550,000 over the provision for loan losses during the third quarter of 2007 of \$210,000. The provision for loan losses was \$2,830,000 for the nine months ended September 30, 2008 an increase of \$2,260,000 over the provision for loan losses during the same period of 2007 of \$570,000. The increase in the loss loan reserves was mostly related to management's assessment of the increased risk in the construction loan portfolio and its current economic environment as well as increases in nonperforming loans.

**Non-interest Income**

Non-interest income increased 2.7% to \$2,251,000 for the three months ended September 30, 2008 compared with \$2,191,000 for the same quarter in 2007. Non-interest income increased 4.9% to \$6,771,000 for the nine months ended September 30, 2008 from \$6,453,000 for same period in 2007. The increases for both the three and nine month periods are the result of service charges on deposits mostly related to the increase in deposit volumes, merchant visa income and the gain on the sale of loans mostly related to higher volumes of SBA and conventional loan sales.

**Non-interest Expense**

Non-interest expense increased 3.3% to \$7,260,000 during the three months ended September 30, 2008 compared to \$7,028,000 for the same period during 2007. Non-interest expense increased 5.3% to \$22,516,000 for the nine months ended September 30, 2008 from \$21,390,000 for the same period last year. The increases for both the three and nine month periods are mostly related to the result of the loss on impairment of the Fund. The efficiency ratio for the quarter ended September 30, 2008 was 60.0% compared to 60.2% for the comparable quarter in 2007. The efficiency ratio for the nine months ended September 30, 2008 was 64.2% compared to 63.0% for the same period last year. The efficiency ratio consists of non-interest expense divided by the sum of net interest income before provision for loan losses plus non-interest income.



**Table of Contents****Lending Activities**

As indicated in the table below, total loans (including loans held for sale) increased to \$812.5 million at September 30, 2008 from \$779.8 million at December 31, 2007.

	At September 30, 2008	% of Total (Dollars in thousands)	At December 31, 2007	% of Total
Commercial	\$ 445,948	54.9%	\$ 421,405	54.0%
Real estate mortgages				
One-to-four family residential	57,727	7.1	57,579	7.4
Five or more family residential and commercial properties	160,879	19.8	163,715	21.0
Total real estate mortgages	218,606	26.9	221,294	28.4
Real estate construction				
One-to-four family residential	77,790	9.6	82,165	10.6
Five or more family residential and commercial properties	52,009	6.4	40,342	5.2
Total real estate construction	129,799	16.0	122,507	15.8
Consumer	20,106	2.4	16,641	2.1
Gross loans	814,459	100.2	781,847	100.3
Less: deferred loan fees	(1,926)	(0.2)	(2,081)	(0.3)
Total loans	\$ 812,533	100.0%	\$ 779,766	100.0%

**Nonperforming Assets**

The following table describes our nonperforming assets for the dates indicated.

	At September 30, 2008	At December 31, 2007
	(Dollars in thousands)	
Nonaccrual loans	\$ 8,283	\$ 1,021
Other real estate owned	169	169
Total nonperforming assets	\$ 8,452	\$ 1,190
Accruing loans past due 90 days or more	\$ 2,834	\$ 2,084
Potential problem loans	25,260	22,023
Allowance for loan losses	12,628	10,374
Nonperforming loans to loans	1.02%	0.13%
Allowance for loan losses to loans	1.56%	1.33%
Allowance for loan losses to nonperforming loans	152.46%	1,016.06%
Nonperforming assets to total assets	0.93%	0.13%

Nonperforming assets increased to \$8,452,000, or 0.93% of total assets at September 30, 2008 from \$1,190,000, or 0.13% of total assets at December 31, 2007 due substantially to increases in nonperforming loans. The increase in nonperforming loans is due primarily to construction loans to two borrowers totaling \$6.3 million. Given the increases in nonperforming loans, growth in our overall loan portfolio and current economic conditions we increased our allowance for loan losses to 1.56% at September 30, 2008 from 1.33% at December 31, 2007. We believe that we are adequately reserved for losses in the portfolio as of September 30, 2008. Potential problem loans are those loans that are currently

accruing interest and are not considered impaired, but which we are monitoring because the financial information of the borrower causes us concerns as to their ability to comply with the present repayment program.

**Analysis of Allowance for Loan Losses**

Management maintains an allowance for loan losses to absorb estimated credit losses associated with the loan portfolio, including all binding commitments to lend. We determine an adequate allowance through our ongoing quarterly loan quality assessments.



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We assess the estimated credit losses inherent in our non-classified and classified loan portfolio by considering a number of elements including:

Historical loss experience in the portfolio;

Levels of and trends in delinquencies and impaired loans;

Levels and trends in charge offs and recoveries;

Effects of changes in risk selection and underwriting standards, and other changes in lending policies, procedures and practices;

Experience, ability, and depth of lending management and other relevant staff;

National and local economic trends and conditions;

External factors such as competition, legal, and regulatory; and

Effects of changes in credit concentrations.

We calculate an adequate allowance for the non-classified and classified portion of our loan portfolio based on an appropriate percentage loss factor that is calculated based on the above-noted elements and trends. We may record specific provisions for each impaired loan after a careful analysis of that loan's credit and collateral factors. Our analysis of an adequate allowance combines the provisions made for our non-classified loans, classified loans, and the specific provisions made for each impaired loan.

While we believe we use the best information available to determine the allowance for loan losses, net income could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance, unforeseen market conditions arise or if we are directed to make adjustments to the allowance for loan losses by our regulators.

The following table summarizes the changes in our allowance for loan losses:

	<b>Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(Dollars in thousands)</b>	
Total loans outstanding at end of period(1)	\$ 811,964	\$ 802,285
Average total loans outstanding during period(1)	790,035	774,222
Allowance balance at beginning of period	10,374	10,105
Provision for loan losses	2,830	570
Charge offs:		
Real estate	(356)	
Commercial	(103)	(380)
Agriculture	(30)	(20)
Consumer	(112)	(75)
Total charge offs	(601)	(475)

Recoveries:		
Real estate	1	1
Commercial	1	2
Agriculture		
Consumer	23	21
Total recoveries	25	24
Net charge offs	(576)	(451)
Allowance balance at end of period	\$ 12,628	\$ 10,224
Allowance for loan losses to loans	1.56%	1.27%
Ratio of net charge offs during period to average loans outstanding	(0.07)%	(0.06)%

(1) Excludes loans held for sale

While pursuing our growth strategy, we continue to employ prudent underwriting and sound monitoring procedures to maintain asset quality. The allowance for loan losses at September 30, 2008 increased by \$2,254,000 to \$12.6 million from \$10.4 million at December 31, 2007. Based on management's assessment of loan quality and current economic conditions, the Company believes that its allowance for loan losses is at an appropriate level at September 30, 2008.

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### **Liquidity and Sources of Funds**

Our primary sources of funds are customer and local government deposits, loan principal and interest payments, loan sales, interest earned on and proceeds from investment securities, and advances from the Federal Home Loan Bank (FHLB) of Seattle. These funds, together with retained earnings, equity, and other borrowed funds, are used to make loans, acquire investment securities and other assets, and fund continuing operations. While maturities and scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by the level of interest rates, economic conditions, and competition.

We must maintain an adequate level of liquidity to ensure the availability of sufficient funds to fund loan originations and deposit withdrawals, satisfy other financial commitments, and fund operations. We generally maintain sufficient cash and short-term investments to meet short-term liquidity needs. At September 30, 2008, cash and cash equivalents totaled \$21.1 million, and investment securities classified as either available for sale or held to maturity with maturities of one year or less amounted to \$1.0 million, or 0.1% of total assets. At September 30, 2008, our banks maintained a credit facility with the FHLB of Seattle for \$171.1 million, with \$13.9 million in FHLB borrowings as of September 30, 2008.

### **Capital**

Stockholders' equity at September 30, 2008 was \$88.8 million compared with \$85.0 million at December 31, 2007. During the nine months ended September 30, 2008, we declared dividends of \$3.7 million, realized income of \$6.5 million, recorded \$271,000 in unrealized gains on securities available for sale, net of tax, and realized the effects of exercising stock options, stock option compensation and earned ESOP and restricted stock shares totaling \$771,000.

Banking regulations require bank holding companies and banks to maintain a minimum leverage ratio of core capital to adjusted quarterly average total assets of at least 3%. Our leverage ratio was 8.5% at September 30, 2008 compared to 8.2% at December 31, 2007. In addition, banking regulators have adopted risk-based capital guidelines, under which risk percentages are assigned to various categories of assets and off-balance sheet items to calculate a risk-adjusted capital ratio. Tier I capital generally consists of common shareholders' equity, while Tier II capital includes the allowance for loan losses, subject to certain limitations. Regulatory minimum risk-based capital guidelines require Tier I capital of 4% of risk-adjusted assets and total capital (combined Tier I and Tier II) of 8%. Our Tier I and total risk based capital ratios were 9.3% and 10.6%, respectively, at September 30, 2008 compared with 9.5% and 10.7%, respectively, at December 31, 2007.

During 1992, the FDIC published the qualifications necessary to be classified as a well-capitalized bank, primarily for assignment of FDIC insurance premium rates beginning in 1993. To qualify as well-capitalized, banks must have a Tier I risk based capital ratio of at least 6%, a total risk based capital ratio of at least 10%, and a leverage ratio of at least 5%. Heritage Bank and Central Valley Bank qualified as well-capitalized at September 30, 2008.

### **ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

Our results of operations are highly dependent upon our ability to manage interest rate risk. We consider interest rate risk to be a significant market risk that could have a material effect on our financial condition and results of operations. Interest rate risk is measured and assessed on a quarterly basis. In our opinion, there has not been a material change in our interest rate risk exposure since our most recent year-end at December 31, 2007.

We do not maintain a trading account for any class of financial instrument nor do we engage in hedging activities or purchase high-risk derivative instruments. Moreover, we have no material risk with foreign currency exchange rate risk or commodity price risk.

### **ITEM 4. Controls and Procedures**

(a) Evaluation of disclosure controls and procedures. We maintain controls and procedures designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 are recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those controls and procedures, the Chief Executive and Chief Financial officers of the Company concluded that the Company's disclosure controls and procedures were adequate as of September 30, 2008.

(b) Changes in internal control over financial reporting. We made no changes in our internal controls over financial reporting that occurred during the Company's quarter ended September 30, 2008, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**  
None

**Table of Contents****Item 1A. Risk Factors**

There have been no material changes from the risk factors as previously disclosed in Item 1A to Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The Company has had various stock repurchase programs since March 1999. In August 2005, the Board of Directors approved a new stock repurchase plan, allowing the Company to repurchase up to 5% of the then outstanding shares, or approximately 295,000 shares over a period of eighteen months. This marked the Company's eighth stock repurchase plan. On January 25, 2006, the Board of Directors authorized an eighteen month extension to this program. On July 25, 2007, the Board of Directors authorized an additional eighteen month extension to this program. During the quarter ended September 30, 2008, the Company did not repurchase additional shares. In total, the Company has repurchased 169,650 shares at an average price of \$22.09 under this plan.

The following table sets forth information about the Company's purchases of its outstanding common stock during the quarter ended September 30, 2008.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1, 2008 – July 31, 2008		\$	6,017,616	140,100
August 1, 2008 – August 31, 2008		\$	6,017,616	140,100
September 1, 2008 – September 30, 2008		\$	6,017,616	140,100
Total		\$	6,017,616	140,100

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None

**Item 6. Exhibits****Exhibit No.**

- 3.1 Articles of Incorporation of the Company (1)
- 3.2 Bylaws of the Company (9)
- 10.1 1998 Stock Option and Restricted Stock Award Plan (2)

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- 10.6 1997 Stock Option and Restricted Stock Award Plan (3)
- 10.10 2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (4)
- 10.12 2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (6)
- 10.13 Employment Agreement between the Company and Brian L. Vance, effective October 1, 2006 as amended and restated in February 2007 (7)
- 10.14 Employment Agreement between Central Valley Bank and D. Michael Broadhead, effective April 1, 2007 (7)
- 10.15 Severance Agreement between Heritage Bank and Edward Cameron, effective April 1, 2007 (7)
- 10.16 Severance Agreement between Heritage Bank and Gregory D. Patjens, effective April 1, 2007 (7)
- 10.17 Severance Agreement between Heritage Bank and Donald J. Hinson, effective August 1, 2007 (8)

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- 14.0 Code of Ethics (5)
- 31.0 Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.0 Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated by reference to the Registration Statement on Form S-1 (Reg. No. 333-35573) declared effective on November 12, 1997.

(2) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-71415).

(3) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-57513).

(4) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-88980; 333-88982; 333-88976).

(5) Incorporated by reference to the Annual Report on Form 10-K dated March 8, 2004.

(6) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-134473; 333-134474; 333-134475).

(7) Incorporated by reference to the Quarterly Report on Form 10-Q dated May 1, 2007.

(8) Incorporated by reference to the Quarterly Report on Form 10-Q dated November 2, 2007.

(9) Incorporated by reference to the Current Report on Form 8-K dated November 29, 2007.

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**SIGNATURES**

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

Date: October 31, 2008

HERITAGE FINANCIAL CORPORATION

/s/ Brian L. Vance  
Brian L. Vance  
President and Chief Executive Officer

(Duly Authorized Officer)

/s/ Donald J. Hinson  
Donald J. Hinson  
Senior Vice President and Chief Financial Officer

(Principal Financial and Accounting Officer)