

HERITAGE COMMERCE CORP
Form 10-Q
August 08, 2012

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2012

OR

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

For the transition period from _____ to _____
Commission file number 000-23877

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

California
(State or Other Jurisdiction of
Incorporation or Organization)

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

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

95113
(Zip Code)

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

N/A

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a
smaller reporting company)

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

The Registrant had 26,293,277 shares of Common Stock outstanding on July 30, 2012.

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

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

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

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;

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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 Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;

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

The 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.

Table of Contents**Part I FINANCIAL INFORMATION****ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

HERITAGE COMMERCE CORP
CONSOLIDATED BALANCE SHEETS (Unaudited)

	June 30, 2012	December 31, 2011
	(Dollars in thousands, except per share data)	
Assets		
Cash and due from banks	\$ 21,885	\$ 20,861
Interest-bearing deposits in other financial institutions	24,476	52,011
Total cash and cash equivalents	46,361	72,872
Securities available-for-sale, at fair value	389,820	380,455
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	2,714	753
Loans held-for-sale other, at lower of cost or fair value, including deferred costs	177	413
Loans, including deferred costs	798,106	764,591
Allowance for loan losses	(20,023)	(20,700)
Loans, net	778,083	743,891
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	10,897	9,925
Company owned life insurance	47,496	46,388
Premises and equipment, net	7,740	7,980
Intangible assets	2,246	2,491
Accrued interest receivable and other assets	39,168	41,026
Total assets	\$ 1,324,702	\$ 1,306,194
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 367,937	\$ 344,303
Demand, interest-bearing	148,777	134,119
Savings and money market	290,867	282,478
Time deposits under \$100	28,009	28,557
Time deposits \$100 and over	164,056	168,874
Time deposits CDARS	5,427	6,371
Time deposits brokered	97,680	84,726
Total deposits	1,102,753	1,049,428
Subordinated debt	23,702	23,702
Accrued interest payable and other liabilities	33,556	35,233
Total liabilities	1,160,011	1,108,363
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		
Series A fixed rate cumulative preferred stock, 40,000 shares issued and outstanding (liquidation preference of \$40,250) at December 31, 2011		39,846
Discount on Series A preferred stock		(833)
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at June 30, 2012 and December 31, 2011 (liquidation preference of \$21,004 at June 30, 2012 and December 31, 2011)	19,519	19,519

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Common stock, no par value; 60,000,000 shares authorized; 26,293,277 shares issued and outstanding at June 30, 2012 and 26,295,001 shares issued and outstanding at December 31, 2011

	131,443	131,172
Retained earnings	10,566	7,172
Accumulated other comprehensive income	3,163	955
Total shareholders' equity	164,691	197,831
Total liabilities and shareholders' equity	\$ 1,324,702	\$ 1,306,194

See notes to consolidated financial statements

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
(Dollars in thousands, except per share data)				
Interest income:				
Loans, including fees	\$ 10,292	\$ 10,685	\$ 20,608	\$ 21,675
Securities	2,975	2,278	6,072	4,240
Interest-bearing deposits in other financial institutions	29	52	65	86
Total interest income	13,296	13,015	26,745	26,001
Interest expense:				
Deposits	738	1,068	1,454	2,339
Subordinated debt	472	467	946	932
Other	2	8	2	62
Total interest expense	1,212	1,543	2,402	3,333
Net interest income before provision for loan losses	12,084	11,472	24,343	22,668
Provision for loan losses	815	955	915	1,725
Net interest income after provision for loan losses	11,269	10,517	23,428	20,943
Noninterest income:				
Service charges and fees on deposit accounts	601	587	1,191	1,154
Servicing income	447	435	907	846
Increase in cash surrender value of life insurance	429	419	858	845
Gain on sale of SBA loans	376	476	412	855
Gain on sale of securities	32		59	
Other	205	253	386	387
Total noninterest income	2,090	2,170	3,813	4,087
Noninterest expense:				
Salaries and employee benefits	5,377	5,111	11,044	10,504
Occupancy and equipment	967	1,031	1,963	2,069
Professional fees	470	456	1,681	1,295
Software subscriptions	313	274	603	529
Low income housing investment losses	262	40	531	202
Data processing	247	198	492	419
Insurance expense	224	244	447	486
FDIC deposit insurance premiums	202	383	427	907
Other real estate owned expense	105	127	220	147
Other	1,287	1,608	2,902	3,345
Total noninterest expense	9,454	9,472	20,310	19,903
Income before income taxes	3,905	3,215	6,931	5,127
Income tax expense	1,226	1,129	2,177	1,460
Net income	2,679	2,086	4,754	3,667
Dividends and discount accretion on preferred stock		(604)	(1,206)	(1,200)

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Net income available to common shareholders \$ 2,679 \$ 1,482 \$ 3,548 \$ 2,467

Earnings per common share:

Basic	\$ 0.08	\$ 0.05	\$ 0.11	\$ 0.08
Diluted	\$ 0.08	\$ 0.05	\$ 0.11	\$ 0.08

See notes to consolidated financial statements

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
	(Dollars in thousands)			
Net income	\$ 2,679	\$ 2,086	\$ 4,754	\$ 3,667
Net unrealized holding gains on available-for-sale securities and I/O strips	3,398	4,243	3,769	3,876
Reclassification adjustment for (gains) realized in income	(32)		(59)	
Deferred income taxes	(1,414)	(1,782)	(1,558)	(1,628)
Change in unrealized gains on available-for-sale securities and I/O strips, net of deferred income taxes	1,952	2,461	2,152	2,248
Net pension and other benefit plan liability adjustment	41	89	97	195
Deferred income taxes	(17)	(37)	(41)	(82)
Change in pension and other benefit plan liability, net of deferred income taxes	24	52	56	113
Other comprehensive income	1,976	2,513	2,208	2,361
Total comprehensive income	\$ 4,655	\$ 4,599	\$ 6,962	\$ 6,028

See notes to consolidated financial statements

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

Six Months Ended June 30, 2012 and 2011

	Preferred Stock			Common Stock		Retained Earnings	Accumulated Other Comprehensive Income / (Loss)	Total Shareholders' Equity
	Shares	Amount	Discount	Shares	Amount			
(Dollars in thousands, except share data)								
Balance, January 1, 2011	61,004	\$ 59,365	\$ (1,227)	26,233,001	\$ 130,531	\$ (1,866)	\$ (4,651)	\$ 182,152
Net income						3,667		3,667
Net change in unrealized gain/(loss) on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes							2,248	2,248
Net change in pension and other benefit plan liability, net of deferred income taxes							113	113
Issuance of restricted stock awards				62,000	320			320
Amortization of restricted stock award, net of forfeitures and taxes					(346)			(346)
Cash dividends accrued on Series A preferred stock						(1,006)		(1,006)
Accretion of discount on Series A preferred stock			194			(194)		
Stock option expense, net of forfeitures and taxes					331			331
Balance, June 30, 2011	61,004	\$ 59,365	\$ (1,033)	26,295,001	\$ 130,836	\$ 601	\$ (2,290)	\$ 187,479
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
Net change in unrealized gain/(loss) on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes							2,152	2,152
Net change in pension and other benefit plan liability, net of deferred income taxes							56	56
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 forfeitures 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

See notes to consolidated financial statements

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

	Six Months Ended June 30,	
	2012	2011
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 4,754	\$ 3,667
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization (accretion) of discounts and premiums on securities	1,071	533
Gain on sale of securities available-for-sale	(59)	
Gain on sale of SBA loans	(412)	(855)
Proceeds from sale of SBA loans originated for sale	5,785	8,967
Net change in SBA loans originated for sale	(7,334)	(3,019)
Write-downs on other loans held-for-sale		29
Provision for loan losses	915	1,725
Increase in cash surrender value of life insurance	(858)	(845)
Depreciation and amortization	385	390
Amortization of intangible assets	245	261
Gains on sale of foreclosed assets, net	(84)	(42)
Stock option expense, net	223	331
Reversal (amortization) of restricted stock awards, net	39	(26)
Effect of changes in:		
Accrued interest receivable and other assets	2,381	891
Accrued interest payable and other liabilities	283	(7,385)
Net cash provided by operating activities	7,334	4,622
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(49,688)	(62,605)
Maturities/paydowns/calls of securities available-for-sale	38,472	14,775
Proceeds from sale of securities available-for-sale	2,280	
Net change in other loans transferred to held-for-sale		27
Net change in loans	(37,064)	59,136
Change in Federal Home Loan Bank and Federal Reserve Bank stock	(972)	(743)
Purchase of premises and equipment	(145)	(79)
Proceeds from sale of foreclosed assets	341	2,240
Proceeds from sale of other loans transferred to held-for-sale	220	1,769
Purchases of company owned life insurance	(250)	(249)
Net cash (used in) provided by investing activities	(46,806)	14,271
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	53,325	4,637
Repayment of preferred stock	(40,000)	
Payment of cash dividends preferred stock	(373)	
Exercise of stock options	9	
Net change in securities sold under agreement to repurchase		(5,000)
Net change in short-term borrowings		(2,445)
Net cash provided by financing activities	12,961	(2,808)
Net increase (decrease) in cash and cash equivalents	(26,511)	16,085
Cash and cash equivalents, beginning of period	72,872	72,177
Cash and cash equivalents, end of period	\$ 46,361	\$ 88,262
Supplemental disclosures of cash flow information:		
Interest paid	\$ 2,418	\$ 5,887

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Income taxes paid	1,230	320
Supplemental schedule of non-cash investing activity:		
Due from broker for securities sold	\$ (378)	\$
Due to broker for securities purchased	3,330	19,755
Loans transferred to foreclosed assets	1,973	1,071
Cash dividend accrued on Series A preferred stock		1,006

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2012

(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 (sometimes referred to as 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, 2011. The Company has also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III which are Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities.

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

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

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

The results for the three months and six months ended June 30, 2012 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2012.

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 May 2011, the FASB issued an accounting standards update to improve the comparability between U.S. GAAP fair value accounting and reporting requirements and International Financial Reporting Standards ("IFRS") fair value accounting and reporting requirements. Additional disclosures required by the update include: (i) disclosure of quantitative information regarding the unobservable inputs used in any fair value measurement classified as Level 3 in the fair value hierarchy in addition to an explanation of the valuation techniques used in valuing Level 3 items and information regarding the

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

1) Basis of Presentation (Continued)

sensitivity in the valuation of Level 3 items to changes in the values assigned to unobservable inputs; (ii) categorization by level within the fair value hierarchy of items not recognized on the Statement of Financial Position at fair value but for which fair values are required to be disclosed; and (iii) instances where the fair values disclosed for non-financial assets were based on a highest and best use assumption when in fact the assets are not being utilized in that capacity. The amendments in the update are effective for interim and annual periods beginning on or after December 15, 2011. 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 8.

In June 2011, the FASB issued an accounting standards update to increase the prominence of items included in Other Comprehensive Income and facilitate the convergence of U.S. GAAP with IFRS. The update prohibits continued presentation of Other Comprehensive Income in the statement of stockholders' equity. The update requires that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but continuous statements. The amendments in the update are effective for interim and annual periods beginning on or after December 15, 2011. The adoption of this amendment changed the presentation of the statement of comprehensive income for the Company to two consecutive statements, instead of presented as part of the consolidated statements of shareholders' equity.

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 21,004 shares of Series C Preferred Stock remain outstanding as of June 30, 2012, and are convertible into 5,601,000 shares of common stock. 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 warrants, using the treasury stock method. The common stock warrant was antidilutive at June 30, 2012 and 2011. A

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2012****(Unaudited)****2) Earnings Per Share (Continued)**

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Net income available to common shareholders	\$ 2,679	\$ 1,482	\$ 3,548	\$ 2,467
Less: net income allocated to Series C Preferred Stock	470	260	623	434
Net income allocated to common shareholders	\$ 2,209	\$ 1,222	\$ 2,925	\$ 2,033
Weighted average common shares outstanding for basic earnings per common share	26,290,480	26,243,334	26,289,907	26,238,168
Dilutive effect of stock options outstanding, using the the treasury stock method	27,011	3,675	28,058	5,566
Shares used in computing diluted earnings per common share	26,317,491	26,247,009	26,317,965	26,243,734
Basic earnings per share	\$ 0.08	\$ 0.05	\$ 0.11	\$ 0.08
Diluted earnings per share	\$ 0.08	\$ 0.05	\$ 0.11	\$ 0.08

3) Securities

The amortized cost and estimated fair value of securities at June 30, 2012 and December 31, 2011 were as follows:

June 30, 2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(Dollars in thousands)				
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 314,020	\$ 11,906	\$	\$ 325,926
Corporate bonds	22,771	508	(58)	23,221
Trust preferred securities	40,758	65	(150)	40,673
Total	\$ 377,549	\$ 12,479	\$ (208)	\$ 389,820

December 31, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(Dollars in thousands)				
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 341,901	\$ 8,484	\$ (37)	\$ 350,348
Trust preferred securities	29,947	194	(34)	30,107
Total	\$ 371,848	\$ 8,678	\$ (71)	\$ 380,455

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2012****(Unaudited)****3) Securities (Continued)**

Mortgage-backed securities decreased \$24,422,000 to \$325,926,000 at June 30, 2012, from \$350,348,000 at December 31, 2011. At June 30, 2012 and December 31, 2011, all agency mortgage-backed securities were issued by the Federal National Mortgage Association ("Fannie Mae") the Federal Home Loan Mortgage Corporation ("Freddie Mac"), or the Government National Mortgage Association ("Ginnie Mae"). At June 30, 2012, the investment portfolio included \$23,221,000 of corporate bonds, compared to no corporate bonds in the investment portfolio at December 31, 2011. At June 30, 2012, the Company's investment portfolio included single entity issue trust preferred securities by four issuers with a carrying value of \$40,758,000 and market value of \$40,673,000, compared to a carrying value of \$29,947,000 and a market value of \$30,107,000 of single entity issue trust preferred securities at December 31, 2011. 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, 2012, the Company held 181 securities, of which ten had fair values below amortized cost. No securities had been carried with an unrealized loss for over 12 months. Unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not intend to sell any securities with an unrealized loss and does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company does not consider these securities to be other-than-temporarily impaired at June 30, 2012.

At December 31, 2011, the Company held 165 securities, of which five had fair values below amortized cost. No securities had been carried with an unrealized loss for over 12 months. The Company did not consider these securities to be other-than-temporarily impaired at December 31, 2011.

The amortized cost and estimated fair values of securities as June 30, 2012, 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 within one year	\$	\$
Due after one through five years	909	921
Due after five through ten years	21,862	22,300
Due after ten years	40,758	40,673
Agency mortgage-backed securities	314,020	325,926
Total	\$ 377,549	\$ 389,820

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2012****(Unaudited)****4) Loans**

Loans were as follows:

	June 30, 2012	December 31, 2011
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	\$ 384,260	\$ 366,590
Real estate:		
Commercial and residential	333,048	311,479
Land and construction	19,822	23,016
Home equity	47,813	52,017
Consumer	13,024	11,166
Loans	797,967	764,268
Deferred loan origination costs and fees, net	139	323
Loans, including deferred costs	798,106	764,591
Allowance for loan losses	(20,023)	(20,700)
Loans, net	\$ 778,083	\$ 743,891

Changes in the allowance for loan losses were as follows:

	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

	Three Months Ended June 30, 2011			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 13,594	\$ 9,539	\$ 876	\$ 24,009
Charge-offs	(1,681)	(601)	(8)	(2,290)
Recoveries	91	401	1	493

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Net (charge-offs)/recoveries	(1,590)	(200)	(7)	(1,797)
Provision/(credit) for loan losses	1,988	(1,177)	144	955
Balance, end of period	\$ 13,992	\$ 8,162	\$ 1,013	\$ 23,167

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2012****(Unaudited)****4) Loans (Continued)****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

Six Months Ended June 30, 2011

	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 13,952	\$ 10,363	\$ 889	\$ 25,204
Charge-offs	(2,800)	(1,596)	(8)	(4,404)
Recoveries	230	411	1	642
Net (charge-offs)/recoveries	(2,570)	(1,185)	(7)	(3,762)
Provision/(credit) for loan losses	2,610	(1,016)	131	1,725
Balance, end of period	\$ 13,992	\$ 8,162	\$ 1,013	\$ 23,167

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2012****(Unaudited)****4) Loans (Continued)**

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment, based on the impairment method as of June 30, 2012 and December 31, 2011:

	June 30, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 1,944	\$ 82	\$ 18	\$ 2,044
Collectively evaluated for impairment	11,434	6,457	88	17,979
Total ending allowance balance	\$ 13,378	\$ 6,539	\$ 106	\$ 20,023
Loans:				
Individually evaluated for impairment	\$ 11,121	\$ 3,690	\$ 160	\$ 14,971
Collectively evaluated for impairment	373,139	396,993	12,864	782,996
Total ending loan balance	\$ 384,260	\$ 400,683	\$ 13,024	\$ 797,967

	December 31, 2011			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 2,249	\$ 76	\$ 2	\$ 2,327
Collectively evaluated for impairment	10,966	7,262	145	18,373
Total ending allowance balance	\$ 13,215	\$ 7,338	\$ 147	\$ 20,700
Loans:				
Individually evaluated for impairment	\$ 11,954	\$ 5,948	\$ 12	\$ 17,914
Collectively evaluated for impairment	354,636	380,564	11,154	746,354
Total ending loan balance	\$ 366,590	\$ 386,512	\$ 11,166	\$ 764,268

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of June 30, 2012 and December 31, 2011. The recorded investment included in the

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2012****(Unaudited)****4) Loans (Continued)**

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, 2012			December 31, 2011		
	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	\$ 7,421	\$ 6,470	\$	\$ 7,644	\$ 5,972	\$
Real estate:						
Commercial and residential	1,092	1,092		2,916	2,057	
Land and construction	2,197	2,197		3,491	3,039	
Consumer						
Total with no related allowance recorded	10,710	9,759		14,051	11,068	
With an allowance recorded:						
Commercial	4,651	4,651	1,944	6,526	5,982	2,249
Real estate:						
Commercial and residential	3	3	1	80	80	44
Land and construction				817	740	32
Home Equity	398	398	81	32	32	
Consumer	160	160	18	12	12	2
Total with an allowance recorded	5,212	5,212	2,044	7,467	6,846	2,327
Total	\$ 15,922	\$ 14,971	\$ 2,044	\$ 21,518	\$ 17,914	\$ 2,327

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

	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	\$	\$	\$	\$	\$	\$

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2012****(Unaudited)****4) Loans (Continued)****Three Months Ended June 30, 2011**

	Real Estate					
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	\$ 13,146	\$ 2,780	\$ 7,306	\$ 141	\$ 938	\$ 24,311
Interest income during impairment	\$	\$	\$	\$	\$	\$
Cash-basis interest earned	\$	\$	\$	\$	\$	\$

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

Six Months Ended June 30, 2011

	Real Estate					
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	\$ 13,555	\$ 4,248	\$ 7,823	\$ 94	\$ 925	\$ 26,645
Interest income during impairment	\$ 1	\$	\$	\$ 1	\$	\$ 2
Cash-basis interest earned	\$	\$	\$	\$ 1	\$	\$ 1

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2012****(Unaudited)****4) Loans (Continued)**

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,		December 31,
	2012	2011	2011
	(Dollars in thousands)		
Nonaccrual loans held-for-sale	\$ 177	\$ 202	\$ 186
Nonaccrual loans held-for-investment	12,890	21,607	14,353
Restructured and loans over 90 days past due and still accruing	1,665	1,073	2,291
Total nonperforming loans	\$ 14,732	\$ 22,882	\$ 16,830
Other restructured loans	\$ 416	\$ 1,375	\$ 1,270
Impaired loans, excluding loans held-for-sale	\$ 14,971	\$ 24,055	\$ 17,914

The following table presents the nonperforming loans by class as of June 30, 2012 and December 31, 2011:

	June 30, 2012			December 31, 2011		
	Restructured and Loans Over 90 Days Past Due and Still Accruing			Restructured and Loans Over 90 Days Past Due and Still Accruing		
	Nonaccrual	Still Accruing	Total	Nonaccrual	Still Accruing	Total
	(Dollars in thousands)					
Commercial	\$ 9,040	\$ 1,665	\$ 10,705	\$ 8,876	\$ 1,803	\$ 10,679
Real estate:						
Commercial and residential	1,104					