

HERITAGE FINANCIAL CORP /WA/  
Form 10-Q  
November 01, 2013  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934  
For the quarterly period ended September 30, 2013  
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 91-1857900  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

201 Fifth Avenue SW, Olympia, WA 98501  
(Address of principal executive offices) (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 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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  x  
Non-accelerated filer  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

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 28, 2013 there were 16,210,802 shares of the registrant's common stock, no par value per share, outstanding.

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Forward Looking Statements

“Safe Harbor” statement under the Private Securities Litigation Reform Act of 1995: This Form 10-Q contains forward-looking statements that are subject to risks and uncertainties, including, but not limited to: our ability to successfully integrate any acquired assets, liabilities, customers, systems, and management personnel through the acquisition of Valley Community Bancshares, Inc., Northwest Commercial Bank, Cowlitz Bank and Pierce Commercial Bank, or may in the future acquire, into our operations, and our ability to realize related revenue synergies and cost savings within expected time frames or at all, and any goodwill charges related thereto and costs or difficulties relating to the integration matters, including but not limited to customer and employee retention, which might be greater than expected; the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets, which may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses no longer being adequate to cover actual losses, and require us to increase our allowance for loan losses; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the the Board of Governors of the Federal Reserve System ("Federal Reserve Board") and of our bank subsidiary by the Federal Deposit Insurance Corporation (the "FDIC"), the Washington State Department of Financial Institutions, Division of Banks (the "Washington DFI") or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our allowance for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, or impose additional requirements and restrictions on us, any of which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, including the interpretation of regulatory capital or other rules, including as a result of Basel III; our ability to control operating costs and expenses; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act and implementing regulations; further increases in premiums for deposit insurance; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our condensed consolidated statement of financial condition; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; failure or security breach of computer systems on which we depend; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our expansion strategy of pursuing acquisitions and de novo branching; increased competitive pressures among financial service companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services; and other risks detailed from time to time in our filings with the Securities and Exchange Commission ("SEC"), including our Annual Report on Form 10-K for the year ended December 31, 2012.

The Company cautions readers not to place undue reliance on any forward-looking statements. Moreover, you should treat these statements as speaking only as of the date they are made and based only on information then actually known to the Company. The Company does not undertake and specifically disclaims any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements. These risks could cause our actual results for the remainder of 2013 and beyond to differ

materially from those expressed in any forward-looking statements by, or on behalf of, us, and could negatively affect the Company's operating and stock price performance.

As used throughout this report, the terms "we", "our", "us", or the "Company" refer to Heritage Financial Corporation and its consolidated subsidiary, unless the context otherwise requires.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## HERITAGE FINANCIAL CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Dollars in thousands)

(Unaudited)

	September 30, 2013	December 31, 2012
<b>A S S E T S</b>		
Cash on hand and in banks	\$55,794	\$37,180
Interest earning deposits	79,329	67,088
Cash and cash equivalents	135,123	104,268
Other interest earning deposits	17,415	2,818
Investment securities available for sale, at fair value	167,226	144,293
Investment securities held to maturity (fair value of \$35,509 and \$11,010)	35,113	10,099
Loans held for sale	—	1,676
Originated loans receivable, net	961,892	874,485
Less: Allowance for loan losses	(17,357)	(19,125)
Originated loans receivable, net of allowance for loan losses	944,535	855,360
Purchased covered loans receivable, net of allowance for loan losses of (\$5,972 and \$4,352)	63,484	83,978
Purchased non-covered loans receivable, net of allowance for loan losses of (\$5,426 and \$5,117)	200,063	59,006
Total loans receivable, net	1,208,082	998,344
Federal Deposit Insurance Corporation (“FDIC”) indemnification asset	4,413	7,100
Other real estate owned (\$317 and \$260 covered by FDIC shared-loss, respectively)	4,129	5,666
Premises and equipment, net	34,074	24,755
Federal Home Loan Bank (“FHLB”) stock, at cost	5,795	5,495
Accrued interest receivable	5,658	4,821
Prepaid expenses and other assets	26,252	22,107
Other intangible assets, net	1,772	1,086
Goodwill	29,365	13,012
Total assets	\$1,674,417	\$1,345,540
<b>LIABILITIES AND STOCKHOLDERS’ EQUITY</b>		
Deposits	\$1,425,985	\$1,117,971
Securities sold under agreement to repurchase	22,655	16,021
Accrued expenses and other liabilities	9,182	12,610
Total liabilities	1,457,822	1,146,602
Stockholders’ equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at September 30, 2013 and December 31, 2012	—	—
Common stock, no par value, 50,000,000 shares authorized; 16,210,872 and 15,117,980 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively	138,426	121,832
Retained earnings	78,851	75,362

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Accumulated other comprehensive (loss) income, net	(682	) 1,744
Total stockholders' equity	216,595	198,938
Total liabilities and stockholders' equity	\$1,674,417	\$1,345,540

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION  
 CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
 (Dollars in thousands, except for per share amounts)  
 (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
<b>INTEREST INCOME:</b>				
Interest and fees on loans	\$17,505	\$16,181	\$50,252	\$49,664
Taxable interest on investment securities	518	525	1,296	1,781
Nontaxable interest on investment securities	428	274	1,108	797
Interest and dividends on other assets	82	51	220	167
Total interest income	18,533	17,031	52,876	52,409
<b>INTEREST EXPENSE:</b>				
Deposits	939	1,061	2,786	3,501
Other borrowings	13	15	32	49
Total interest expense	952	1,076	2,818	3,550
Net interest income	17,581	15,955	50,058	48,859
Provision for loan losses on originated loans	150	215	990	415
Provision for loan losses on purchased loans	928	592	2,254	902
Net interest income after provision for loan losses	16,503	15,148	46,814	47,542
<b>NONINTEREST INCOME:</b>				
Bargain purchase gain on bank acquisition	—	—	399	—
Service charges and other fees	1,609	1,397	4,395	4,117
Merchant Visa income, net	259	182	642	534
Change in FDIC indemnification asset	(350)	(492)	(336)	(687)
Other income	1,064	440	2,122	1,535
Total noninterest income	2,582	1,527	7,222	5,499
<b>NONINTEREST EXPENSE:</b>				
Impairment loss on investment securities	—	14	26	112
Less: Portion recorded as other comprehensive loss	—	(14)	—	(52)
Impairment loss on investment securities, net	—	—	26	60
Compensation and employee benefits	8,014	7,224	23,220	21,709
Occupancy and equipment	2,190	1,880	6,105	5,497
Data processing	953	643	2,809	1,902
Marketing	477	435	1,189	1,207
Professional services	862	742	2,532	1,924
State and local taxes	292	295	876	925
Federal deposit insurance premium	237	245	744	783
Other real estate owned, net	(162)	35	(260)	487
Other expense	1,422	1,004	3,769	3,477
Total noninterest expense	14,285	12,503	41,010	37,971
Income before income taxes	4,800	4,172	13,026	15,070
Income tax expense	1,510	1,309	4,161	4,843
Net income	\$3,290	\$2,863	\$8,865	\$10,227
Basic earnings per common share	\$0.20	\$0.19	\$0.57	\$0.67

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Diluted earnings per common share	\$0.20	\$0.19	\$0.57	\$0.67
Dividends declared per common share	\$0.18	\$0.08	\$0.34	\$0.42

See accompanying Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in thousands)

(Unaudited)

	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
Comprehensive Income	2013	2012	2013	2012	
Net income	\$3,290	\$2,863	\$8,865	\$10,227	
Change in fair value of securities available for sale, net of tax of \$(100), \$51, \$(1,332) and \$69	(185	) 95	(2,474	) 128	
Other-than-temporary impairment on securities held to maturity, net of tax of \$0, \$(5), \$0 and \$(18)	—	(9	) —	(34	)
Accretion of other-than-temporary impairment on securities held to maturity, net of tax of \$7, \$15, \$26 12 and \$43		29	48	81	
Other comprehensive (loss) income	\$(173	) \$115	\$(2,426	) \$175	
Comprehensive income	\$3,117	\$2,978	\$6,439	\$10,402	

See accompanying Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

For the Nine Months Ended September 30, 2013

(Dollars and shares in thousands, except for per share amounts)

(Unaudited)

	Number of common shares	Common stock	Retained earnings	Accumulated other comprehensive income (loss), net	Total stock- holders' equity
Balance at December 31, 2012	15,118	\$121,832	\$75,362	\$1,744	\$198,938
Restricted and unrestricted stock awards issued, net of forfeitures	100	—	—	—	—
Stock option compensation expense	—	55	—	—	55
Exercise of stock options (including tax effect from nonqualified stock options)	17	166	—	—	166
Restricted stock compensation expense	—	926	—	—	926
Excess tax benefits from restricted stock	—	72	—	—	72
Common stock repurchased and retired	(557	) (8,820	) —	—	(8,820 )
Net income	—	—	8,865	—	8,865
Other comprehensive loss, net of tax	—	—	—	(2,426	) (2,426 )
Common stock issued in acquisition	1,533	24,195	—	—	24,195
Cash dividends declared on common stock (\$0.34 per share)	—	—	(5,376	) —	(5,376 )
Balance at September 30, 2013	16,211	\$138,426	\$78,851	\$(682	) \$216,595

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
For the Nine Months Ended September 30, 2013 and 2012  
(Dollars in thousands)  
(Unaudited)

	Nine Months Ended September	
	30,	2012
	2013	2012
Cash flows from operating activities:		
Net income	\$8,865	\$10,227
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,996	3,027
Changes in net deferred loan fees, net of amortization	419	56
Provision for loan losses	3,244	1,317
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities	1,960	1,129
Recognition of compensation expense related to ESOP shares and share based payment	926	895
Stock option compensation expense	55	83
Tax provision realized from stock options exercised, share based payment and dividends on unallocated ESOP shares	(72)	) 34
Amortization of intangible assets	386	320
Bargain purchase gain on bank acquisition	(399)	) —
Impairment loss on investment of securities	26	60
Origination of loans held for sale	(6,784)	) (15,136 )
Gain on sale of loans	(142)	) (208 )
Proceeds from sale of loans	8,602	15,761
Valuation adjustment on other real estate owned	23	483
Gain on other real estate owned, net	(307)	) —
(Gain) loss on sale of premises and equipment, net	(596)	) 2
Net cash provided by operating activities	20,202	18,050
Cash flows from investing activities:		
Loans originated, net of principal payments	(46,311)	) (8,895 )
Maturities of investment securities available for sale	43,272	37,765
Maturities of investment securities held to maturity	1,561	1,424
Purchase of investment securities available for sale	(38,155)	) (42,276 )
Purchase of investment securities held to maturity	(3,625)	) —
Maturities of other interest earning deposits	272	—
Purchase of premises and equipment	(4,300)	) (1,464 )
Proceeds from sale of other real estate owned	5,590	2,695
Proceeds from sale of premises and equipment	700	—
Proceeds from redemption of FHLB stock	154	49
Net cash received from acquisitions	18,260	—
Net cash used in investing activities	(22,582)	) (10,702 )
Cash flows from financing activities:		
Net increase (decrease) in deposits	40,559	(2,344 )
Common stock cash dividends paid	(5,376)	) (6,397 )

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Net increase (decrease) in securities sold under agreement to repurchase	6,634	(202	)
Proceeds from exercise of stock options, net of tax effect	166	53	
Net excess tax benefit (deficiency) realized from stock options exercised, share based payment and dividends on unallocated ESOP shares	72	(34	)
Repurchase of common stock	(8,820	) (5,278	)
Net cash provided by (used in) financing activities	33,235	(14,202	)
Net increase (decrease) in cash and cash equivalents	30,855	(6,854	)
Cash and cash equivalents at beginning of period	104,268	123,173	
Cash and cash equivalents at end of period	\$135,123	\$116,319	

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## Supplemental disclosures of cash flow information:

Cash paid for interest	\$2,770	\$3,608
Cash paid for income taxes	3,074	7,848
Seller-financed sale of other real estate owned	250	—
Loans transferred to other real estate owned	1,740	5,979
Common stock issued in Valley Acquisition	24,195	—
Assets acquired (liabilities assumed) in acquisitions:		
Other interest earning deposits	14,869	—
Investment securities available for sale	34,197	—
Investment securities held to maturity	22,908	—
Purchased non-covered loans receivable	168,580	—
Other real estate owned	2,279	—
Premises and equipment	6,772	—
FHLB stock	454	—
Accrued interest receivable	697	—
Prepaid expenses and other assets	4,347	—
Deferred income taxes, net	2,788	—
Core deposit intangible	1,072	—
Deposits	(267,445	) —
Accrued expenses and other liabilities	(1,528	) —

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
For the Three and Nine Months Ended September 30, 2013 and 2012  
(Unaudited)

(1) Description of Business and Basis of Presentation

(a) Description of Business

Heritage Financial Corporation (the “Company”) is a bank holding company incorporated in the State of Washington in August 1997. The Company is primarily engaged in the business of planning, directing and coordinating the business activities of its wholly-owned subsidiary Heritage Bank (the “Bank”). The Bank is a Washington-chartered commercial bank and its deposits are insured by the FDIC under the Deposit Insurance Fund (“DIF”). The Bank is headquartered in Olympia, Washington and conducts business from its forty-two branch offices located throughout Washington state and the greater Portland, Oregon area. The Bank’s business consists primarily of lending and deposit relationships with small businesses and their owners in its market areas and attracting deposits from the general public. The Bank also makes real estate construction and land development loans and consumer loans and originates first mortgage loans on residential properties located in western and central Washington State and the greater Portland, Oregon area. The Company has expanded its footprint during the past three years through acquisitions beginning with the FDIC-assisted acquisition of Cowlitz Bank, a Washington chartered commercial bank headquartered in Longview, Washington effective on July 30, 2010. Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Cowlitz Bank (the “Cowlitz Acquisition”). The Cowlitz Acquisition included nine branches of Cowlitz Bank, including its division Bay Bank, which opened as branches of Heritage Bank on August 2, 2010. It also included the Trust Services Division of Cowlitz Bank.

Effective November 5, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Pierce Commercial Bank, a Washington chartered commercial bank headquartered in Tacoma, Washington (the “Pierce Commercial Acquisition”). The Pierce Commercial Acquisition included one branch, which opened as a branch of Heritage Bank as of November 8, 2010. On September 14, 2012, the Company and the Bank entered into a definitive agreement to acquire Northwest Commercial Bank (“NCB”), a Washington chartered commercial bank headquartered in Lakewood, Washington (the “NCB Acquisition”). The NCB Acquisition was completed on January 9, 2013, with the merger of NCB into Heritage Bank. See Note 2, “Business Combinations” for additional information.

On March 11, 2013, the Company entered into a definitive agreement to acquire Valley Community Bancshares, Inc. (“Valley” or “Valley Community Bancshares”) and its wholly-owned subsidiary, Valley Bank, both headquartered in Puyallup, Washington (the “Valley Acquisition”). The Valley Acquisition was completed on July 15, 2013. See Note 2, “Business Combinations” for additional information.

On April 8, 2013, the Company announced the proposed merger of its two wholly-owned bank subsidiaries Central Valley Bank and Heritage Bank, with Central Valley Bank merging into Heritage Bank. The common control merger was completed on June 19, 2013 and on a consolidated basis had no accounting impact on the Company. Central Valley Bank now operates as a division of Heritage Bank.



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(b) Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with Generally Accepted Accounting Principles (“GAAP”), for interim financial information, pursuant to the rules and regulations of the SEC. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These Condensed Consolidated Financial Statements and accompanying Notes should be read with our December 31, 2012 audited Consolidated Financial Statements and the accompanying Notes included in our Annual Report on Form 10-K (“2012 Annual 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, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. In preparing the Condensed 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. Estimates related to the allowance for loan losses, other than temporary impairments in the fair value of investment securities, expected cash flows of purchased loans and related indemnification asset, fair value measurements, stock-based compensation, impairment of goodwill and other intangible assets and income taxes are particularly subject to change.

Certain prior period amounts have been reclassified to conform to the current period’s presentation. Reclassifications had no effect on prior periods’ net income or stockholders’ equity.

(c) Significant Accounting Policies

The significant accounting policies used in preparation of our Condensed Consolidated Financial Statements are disclosed in our 2012 Annual Form 10-K. There have not been any material changes in our significant accounting policies from those contained in our 2012 Annual Form 10-K disclosure for the year ended December 31, 2012.

(d) Recently Issued Accounting Pronouncements

Financial Accounting Standards Board (“FASB”) Accounting Standards Updated (“ASU”) 2011-11, Disclosures about Offsetting Assets and Liabilities, was issued in December 2011 to require an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The adoption of the Update did not have a material effect on the Company’s Condensed Consolidated Financial Statements at the date of adoption.

FASB ASU 2012-6, Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution, was issued in October 2012. The objective of the Update is to address the diversity in practice about how to interpret the terms “on the same basis” and “contractual limitations” when subsequently measuring an indemnification asset. This Update is effective for fiscal years and interim periods beginning on or after December 15, 2012. Early adoption was permitted, and adoption was to be applied prospectively to indemnification assets existing as of the date of adoption. The adoption of this Update did not have a material effect on the Company’s Condensed Consolidated Financial Statements at the date of adoption as the Company previously accounted for its indemnification asset in a manner consistent with the Update.

FASB ASU 2013-2, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, was issued in February 2013. The Update requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income (loss) by component and to present either on the face of the statement where net income is presented, or in the notes, significant amounts reclassified out of accumulated other comprehensive income (loss) by the respective line items of net income, but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2012. The adoption of this Update did not have a material effect on the Company’s Condensed Consolidated Financial Statements. The additional disclosures are included in Note 7, “Accumulated Other Comprehensive (Loss) Income.”



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(2) Business Combinations

During the nine months ended September 30, 2013, the Company completed the acquisitions of Northwest Commercial Bank and Valley Community Bancshares, referred to jointly as the "NCB and Valley Acquisitions." There were no acquisitions completed during the year ended December 31, 2012.

Northwest Commercial Bank

On September 14, 2012, the Company and Heritage Bank entered into a definitive agreement to acquire NCB headquartered in Lakewood, Washington. NCB was a full service commercial bank that operated two branch locations in Lakewood and Auburn, Washington. Prior to the closing of the transaction, NCB redeemed its outstanding preferred stock of approximately \$2.0 million issued to the U.S. Department of Treasury in connection with its participation in the Troubled Asset Relief Program Capital Purchase Plan. The NCB Acquisition was completed on January 9, 2013 with the merger of NCB with and into Heritage Bank. After the NCB Acquisition, the NCB Lakewood branch was consolidated into one of Heritage Bank's full service banking offices in Lakewood, Washington.

In connection with the NCB Acquisition, the Company paid cash consideration of \$3.0 million, or \$5.50 per NCB share, to NCB shareholders on January 9, 2013. In addition, pursuant to the merger agreement, the NCB shareholders had the ability to potentially receive an additional cash payment based on an earn-out structure from the sale of a NCB asset included in "other real estate owned." This contingent payment was factored into the NCB liabilities assumed by Heritage Bank as of the January 9, 2013 acquisition date. This asset was sold by Heritage Bank in June 2013, and the \$491,000 of proceeds from the sale were paid to the NCB shareholders in July 2013. The payment of these proceeds did not impact the recorded bargain purchase gain on bank acquisition.

During the three and nine months ended September 30, 2013, the Company incurred NCB Acquisition-related costs (including conversion costs) of approximately \$5,000 and \$746,000, respectively.

Valley Community Bancshares

On March 11, 2013, the Company entered into a definitive agreement to acquire Valley Community Bancshares and its wholly-owned subsidiary, Valley Bank, both headquartered in Puyallup, Washington. The Valley Acquisition was completed on July 15, 2013. Valley operated eight branches prior to acquisition, of which only four are anticipated to be maintained by the Company. Of the four other branches, three leases will be terminated during the fourth quarter of 2013 and one owned branch building was considered held for sale at the time of acquisition.

Pursuant to the terms of the merger agreement, the shareholders of Valley common stock received \$19.50 per share in cash and 1.3611 shares of Heritage common stock per Valley share. The merger consideration for Valley consisted of cash and stock, with \$22.0 million paid in cash by the Company and 1,533,267 shares of the Company's common stock being issued with fair value of \$24.2 million. The Company also recognized \$157,000 in capitalized acquisition costs related to the issuance of its securities.

The Valley Acquisition resulted in \$16.4 million of goodwill. This goodwill is not deductible for tax purposes.

During the three and nine months ended September 30, 2013, the Company incurred Valley Acquisition-related costs (including conversion costs) of approximately \$161,000 and \$515,000, respectively.

Business Combination Accounting

The NCB and Valley Acquisitions constitute business acquisitions as defined by FASB Accounting Standards Codification ("ASC") 805, Business Combinations. The Business Combinations topic establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired and the liabilities assumed. Accordingly, the estimated fair values of the acquired assets, including the identifiable intangible assets, and the assumed liabilities in the acquisition were measured and recorded as of the acquisition dates.

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The fair value of the assets acquired and liabilities assumed in the NCB and Valley Acquisitions were as follows:

	Valley July 15, 2013 (In thousands)	NCB January 9, 2013
<b>Assets</b>		
Cash and cash equivalents	\$40,643	\$2,712
Other interest earning deposits	13,866	1,003
Investment securities available for sale	31,444	2,753
Investment securities held to maturity	22,908	—
Purchased non-covered loans receivable	117,071	51,509
Other real estate owned	—	2,279
Premises and equipment	6,558	214
FHLB stock	366	88
Accrued interest receivable	465	232
Core deposit intangible	916	156
Prepaid expenses and other assets	3,172	1,175
Deferred income taxes, net	(85	) 2,873
Total assets acquired	\$237,324	\$64,994
<b>Liabilities</b>		
Deposits	\$207,013	\$60,442
Accrued expenses and other liabilities	342	1,186
Total liabilities assumed	207,355	61,628
Net assets acquired	\$29,969	\$3,366

Summaries of the net assets purchased and the estimated fair value adjustments and resulting bargain purchase gain or goodwill recognized from the NCB and Valley Acquisitions were as follows:

	Valley July 15, 2013 (In thousands)	NCB January 9, 2013
Cost basis of net assets on acquisition date	\$29,720	\$6,113
Consideration transferred	(46,323	) (2,967
Fair value adjustments:		
Other interest earning deposits	162	7
Investment securities	—	(2
Purchased non-covered loans, net	(3,003	) (3,299
Other real estate owned	—	(1,301
Premises and equipment	1,837	(69
Core deposit intangible	916	156
Prepaid expenses and other assets	323	(479
Deferred income tax, net	(125	) 2,873
Certificates of deposit	(9	) (11
Accrued expenses and other liabilities	149	(622
(Goodwill) bargain purchase gain recognized from the acquisition	\$(16,353	) \$399

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Goodwill on bank acquisition represents the excess of the consideration transferred over the estimated fair value of the net assets acquired and liabilities assumed. A bargain purchase gain on bank acquisition represents the excess of the estimated fair value of the net assets acquired and liabilities assumed over the value of the consideration paid. The bargain purchase gain in the NCB Acquisition was influenced significantly by the net deferred tax asset acquired. NCB had significant net operating losses and as a result of its estimate of whether or not it was more likely than not that the net deferred tax asset would be realized, had recorded a full valuation allowance on the net deferred tax asset. The Company, however, has reviewed the net deferred tax asset and determined it is more likely than not that the net deferred tax asset would be realized by the Company.

The operating results of the Company for the three and nine months ended September 30, 2013 include the operating results produced by the net assets acquired from the NCB Acquisition since the January 9, 2013 acquisition date and from the Valley Acquisition since the July 15, 2013 acquisition date. The Company has considered the requirement of FASB ASC 805 related to the contribution of the NCB and Valley Acquisitions to the Company's results of operations. The table below presents only the significant results for the acquired businesses from the acquisition dates.

	NCB		Valley	Total	
	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2013 (3)	Three and Nine Months Ended September 30, 2013 (3)	Three Months Ended September 30, 2013 (3)	Nine Months Ended September 30, 2013 (3)
	(In thousands)				
Interest income: Interest and fees on loans (1)	\$608	\$1,768	\$1,290	\$1,898	\$3,058
Interest income: Interest and fees on loans (2)	250	1,712	399	649	2,111
Interest income: Securities and other interest earning assets	29	87	150	179	237
Interest expense: Deposits	(62)	(219)	(66)	(128)	(285)
Provision for loan losses on purchased loans	(808)	(1,058)	—	(808)	(1,058)
Noninterest income	14	486	267	281	753
Noninterest expense	(117)	(1,341)	(829)	(946)	(2,170)
Net effect, pre-tax	\$(86)	\$1,435	\$1,211	\$1,125	\$2,646

(1) Includes the contractual interest income on the purchased other loans.

(2) Includes the accretion of the accretable yield on the purchased impaired loans and the accretion of the discount on the purchased other loans.

(3) NCB was effective January 9, 2013 and Valley was effective July 15, 2013.

The Company also considered the pro forma requirements of FASB ASC 805 and deemed it not necessary to provide pro forma financial statements as required under the standard as the NCB and Valley Acquisitions were not material to the Company. The Company believes that the historical NCB and Valley operating results are not considered of enough significance to be meaningful to the Company's results of operations.

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(3)Loans Receivable

The Company originates loans in the ordinary course of business. These loans are identified as “originated” loans. Disclosures related to the Company’s recorded investment in originated loans receivable generally exclude accrued interest receivable and net deferred loan origination fees and costs because they are insignificant. The Company has also acquired loans through FDIC-assisted and open bank transactions. Loans acquired in a business acquisition are designated as “purchased” loans. The Company refers to the purchased loans subject to the FDIC shared-loss agreements as “covered” loans, and those loans without shared-loss agreements are referred to as “non-covered” loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that not all contractually required payments will be collected are accounted for under FASB ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality. These loans are identified as “purchased impaired” loans. Loans purchased that are not accounted for under FASB ASC 310-30 are accounted for under FASB ASC 310-20, Receivables—Nonrefundable Fees and Other Costs. These loans are identified as “purchased other” loans.

(a) Loan Origination/Risk Management

The Company originates loans in one of the four segments of the total loan portfolio: commercial business, real estate construction and land development, one-to-four family residential and consumer. Within these segments are classes of loans to which management monitors and assesses credit risk in the loan portfolios. The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, and nonperforming and potential problem loans. The Company also conducts external loan reviews and validates the credit risk assessment on a periodic basis and presents the results of these reviews to management. The loan review process complements and reinforces the risk identification and assessment decisions made by loan officers and credit personnel, as well as the Company’s policies and procedures. A discussion of the risk characteristics of each loan portfolio segment is as follows:

Commercial Business:

There are three significant classes of loans in the commercial portfolio segment, including commercial and industrial loans, owner-occupied commercial real estate and non-owner occupied commercial real estate. The owner and non-owner occupied commercial real estate are both considered commercial real estate loans. As the commercial and industrial loans carry different risk characteristics than the commercial real estate loans, they are discussed separately below.

Commercial and industrial. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may include a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate. The Company originates commercial real estate loans within its primary market areas. These loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate involves more risk than other classes of loans in that the lending typically involves higher loan principal amounts, and payments on loans secured by real estate properties are dependent on successful operation and management of the properties. Repayment of these loans may be more adversely affected by conditions in the real estate market or the economy.

One-to-Four Family Residential:

The majority of the Company’s one-to-four family residential loans are secured by single-family residences located in its primary market areas. The Company’s underwriting standards require that single-family portfolio loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying

collateral. Terms of maturity typically range from 15 to 30 years. Historically, the Company sold most single-family loans in the secondary market and retained a smaller portion in its loan portfolio. The process for originating and selling single-family loans wound down in early 2013.

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## Real Estate Construction and Land Development:

The Company originates construction loans for one-to-four family residential and for five or more family residential and commercial properties. The one-to-four family residential construction loans generally include construction of custom homes whereby the home buyer is the borrower. The Company also provides financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Substantially all construction loans are short-term in nature and priced with variable rates of interest. Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project's completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, the Company's estimates with regards to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If the Company's estimate of the value of a project at completion proves to be overstated, it may have inadequate security for repayment of the loan and may incur a loss if the borrower does not repay the loan. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

## Consumer:

The Company originates consumer loans and lines of credit that are both secured and unsecured. The underwriting process for this segment of loans ensures a qualifying primary and secondary source of repayment. Underwriting standards for home equity loans are significantly influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such loans a borrower can have at one time and documentation requirements. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed. The majority of consumer loans are for relatively small amounts disbursed among many individual borrowers which reduces the credit risk for this type of loan. To further reduce the risk, trend reports are reviewed by management on a regular basis.

Originated loans receivable at September 30, 2013 and December 31, 2012 consisted of the following portfolio segments and classes:

	September 30, 2013	December 31, 2012
	(In thousands)	
Commercial business:		
Commercial and industrial	\$292,906	\$277,240
Owner-occupied commercial real estate	197,421	188,494
Non-owner occupied commercial real estate	347,391	265,835
Total commercial business	837,718	731,569
One-to-four family residential	39,902	38,848
Real estate construction and land development:		
One-to-four family residential	20,054	25,175
Five or more family residential and commercial properties	38,704	52,075
Total real estate construction and land development	58,758	77,250
Consumer	28,029	28,914
Gross originated loans receivable	964,407	876,581
Net deferred loan fees	(2,515	) (2,096
Originated loans receivable, net	961,892	874,485



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Allowance for loan losses	(17,357	) (19,125	)
Originated loans receivable, net of allowance for loan losses	\$944,535	\$855,360	

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The recorded investment of purchased covered loans receivable at September 30, 2013 and December 31, 2012 consisted of the following portfolio segments and classes:

	September 30, 2013	December 31, 2012
	(In thousands)	
Commercial business:		
Commercial and industrial	\$ 18,005	\$ 25,781
Owner-occupied commercial real estate	25,724	34,796
Non-owner occupied commercial real estate	14,901	13,028
Total commercial business	58,630	73,605
One-to-four family residential	4,797	5,027
Real estate construction and land development:		
One-to-four family residential	1,895	4,433
Five or more family residential and commercial properties	—	—
Total real estate construction and land development	1,895	4,433
Consumer	4,134	5,265
Gross purchased covered loans receivable	69,456	88,330
Allowance for loan losses	(5,972	) (4,352
Purchased covered loans receivable, net	\$ 63,484	\$ 83,978

The September 30, 2013 and December 31, 2012 gross recorded investment balance of purchased impaired covered loans accounted for under FASB ASC 310-30 was \$44.0 million and \$59.0 million, respectively. The gross recorded investment balance of purchased other covered loans was \$25.5 million and \$29.3 million at September 30, 2013 and December 31, 2012, respectively. At September 30, 2013 and December 31, 2012, the recorded investment balance of purchased covered loans which are no longer covered under the FDIC shared-loss agreements was \$3.3 million and \$3.5 million, respectively.

Funds advanced on the purchased covered loans subsequent to acquisition, referred to as “subsequent advances,” are included in the purchased covered loan balances as these subsequent advances are covered under the shared-loss agreements. These subsequent advances are not accounted for under FASB ASC 310-30. The total balance of subsequent advances on the purchased covered loans was \$7.5 million and \$6.9 million as of September 30, 2013 and December 31, 2012, respectively.

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The recorded investment of purchased non-covered loans receivable at September 30, 2013 and December 31, 2012 consisted of the following portfolio segments and classes:

	September 30, 2013	December 31, 2012
	(In thousands)	
Commercial business:		
Commercial and industrial	\$57,205	\$24,763
Owner-occupied commercial real estate	68,292	13,211
Non-owner occupied commercial real estate	51,427	11,019
Total commercial business	176,924	48,993
One-to-four family residential	11,798	3,040
Real estate construction and land development:		
One-to-four family residential	339	513
Five or more family residential and commercial properties	3,837	864
Total real estate construction and land development	4,176	1,377
Consumer	12,591	10,713
Gross purchased non-covered loans receivable	205,489	64,123
Allowance for loan losses	(5,426	) (5,117
Purchased non-covered loans receivable, net	\$200,063	\$59,006

The September 30, 2013 and December 31, 2012 gross recorded investment balance of purchased impaired non-covered loans accounted for under FASB ASC 310-30 was \$39.5 million and \$42.0 million, respectively. The recorded investment balance of purchased other non-covered loans was \$166.0 million and \$22.1 million at September 30, 2013 and December 31, 2012, respectively.

The loans purchased in the NCB and Valley Acquisitions on January 9, 2013 and July 15, 2013, respectively, are included in the purchased non-covered loans receivable balances shown above as of September 30, 2013. The estimated fair value of the purchased non-covered loans at the acquisition dates totaled \$51.5 million and \$117.1 million for NCB and Valley, respectively. The gross recorded investment balance of the NCB purchased impaired loans and the NCB purchased other loans was \$4.5 million and \$37.8 million at September 30, 2013, respectively. The gross recorded investment balance of the Valley purchased impaired loans and the Valley purchased other loans was \$3.0 million and \$110.6 million at September 30, 2013, respectively.

**(b) Concentrations of Credit**

Most of the Company's lending activity occurs within Washington State, and to a lesser extent Oregon State. The Company's primary market areas include Thurston, Pierce, King, Mason, Cowlitz and Clark counties in Washington and Multnomah County in Oregon, as well as other contiguous markets. The majority of the Company's loan portfolio consists of (in order of balances at September 30, 2013) non-owner occupied commercial real estate, commercial and industrial and owner occupied commercial real estate. As of September 30, 2013 and December 31, 2012, there were no concentrations of loans related to any single industry in excess of 10% of the Company's total loans.

**(c) Credit Quality Indicators**

As part of the on-going monitoring of the credit quality of the Company's loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grade of the loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) nonperforming loans, and (v) the general economic conditions of the United States of America, and specifically the states of Washington and Oregon. The Company utilizes a risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 0 to 9, and a "W". A description of the general characteristics of the risk grades is as follows:

**Grades 0 to 5:** These grades are considered "pass grade" and includes loans with negligible to above average but acceptable risk. These borrowers generally have strong to acceptable capital levels and consistent earnings and debt

service capacity. Loans with the

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higher grades within the “pass” category may include borrowers who are experiencing unusual operating difficulties, but have acceptable payment performance to date. Increased monitoring of financials and/or collateral may be appropriate. Loans with this grade show no immediate loss exposure.

Grade “W”: This grade is considered “pass grade” and includes loans on management’s “watch list” and is intended to be utilized on a temporary basis for pass grade borrowers where a potentially significant risk-modifying action is anticipated in the near term.

Grade 6: This grade includes “Other Assets Especially Mentioned” (“OAEM”) loans in accordance with regulatory guidelines, and is intended to highlight loans with elevated risks. Loans with this grade show signs of deteriorating profits and capital, and the borrower might not be strong enough to sustain a major setback. The borrower is typically higher than normally leveraged, and outside support might be modest and likely illiquid. The loan is at risk of further decline unless active measures are taken to correct the situation.

Grade 7: This grade includes “Substandard” loans in accordance with regulatory guidelines, for which the Company has determined have a high credit risk. These loans also have well-defined weaknesses which make payment default or principal exposure likely, but not yet certain. The borrower may have shown serious negative trends in financial ratios and performance. Such loans may be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business. Loans with this grade can be placed on accrual or nonaccrual status based on the Company’s accrual policy.

Grade 8: This grade includes “Doubtful” loans in accordance with regulatory guidelines, and the Company has determined these loans to have excessive credit risk. Such loans are placed on nonaccrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Additionally, these loans generally have a specific valuation allowance.

Grade 9: This grade includes “Loss” loans in accordance with regulatory guidelines, and the Company has determined these loans have the highest risk of loss. Such loans are charged-off or charged-down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be determined. “Loss” is not intended to imply that the loan or some portion of it will never be paid, nor does it in any way imply that there has been a forgiveness of debt.

Loan grades for all commercial business loans and real estate construction and land development loans are established at the origination of the loan. One-to-four family residential loans and consumer loans (“non-commercial loans”) are not graded with a 0 to 9 at origination date as these loans are determined to be “pass graded” loans. These non-commercial loans may subsequently require a 0-9 risk grade if the credit department has evaluated the credit and determined it necessary to classify the loan. Loan grades are reviewed on a quarterly basis, or more frequently if necessary, by the credit department. Typically, an individual loan grade will not be changed from the prior period unless there is a specific indication of credit deterioration or improvement. Credit deterioration is evidenced by delinquency, direct communications with the borrower, or other borrower information that becomes known to management. Credit improvements are evidenced by known facts regarding the borrower or the collateral property.

The loan grades relate to the likelihood of losses in that the higher the grade, the greater the loss potential. Loans with a pass grade may have some inherent losses in the portfolios, but to a lesser extent than the other loan grades. These pass graded loans may also have a zero percent loss based on historical experience and current market trends. The OAEM loan grade is transitory in that the Company is waiting on additional information to determine the likelihood and extent of the potential loss. The likelihood of loss for OAEM graded loans, however, is greater than Watch graded loans because there has been measurable credit deterioration. Loans with a Substandard grade are generally loans for which the Company has individually analyzed for potential impairment. For Doubtful and Loss graded loans, the Company is almost certain of the losses, and the unpaid principal balances are generally charged-off to the realizable value.

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The following tables present the balance of the originated loans receivable by credit quality indicator as of September 30, 2013 and December 31, 2012.

	September 30, 2013				Total
	Pass	OAEM	Substandard	Doubtful	
	(In thousands)				
Commercial business:					
Commercial and industrial	\$271,774	\$2,533	\$17,327	\$1,272	\$292,906
Owner-occupied commercial real estate	189,060	2,889	5,472	—	197,421
Non-owner occupied commercial real estate	336,533	4,510	6,348	—	347,391
Total commercial business	797,367	9,932	29,147	1,272	837,718
One-to-four family residential	38,746	270	886	—	39,902
Real estate construction and land development:					
One-to-four family residential	11,420	4,534	4,100	—	20,054
Five or more family residential and commercial properties	36,319	—	2,385	—	38,704
Total real estate construction and land development	47,739	4,534	6,485	—	58,758
Consumer	27,560	—	467	2	28,029
Gross originated loans	\$911,412	\$14,736	\$36,985	\$1,274	\$964,407
	December 31, 2012				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	\$254,593	\$3,908	\$18,157	\$582	\$277,240
Owner-occupied commercial real estate	181,630	2,658	4,206	—	188,494
Non-owner occupied commercial real estate	256,077	4,132	5,257	369	265,835
Total commercial business	692,300	10,698	27,620	951	731,569
One-to-four family residential	37,239	920	689	—	38,848
Real estate construction and land development:					
One-to-four family residential	16,446	1,795	6,934	—	25,175
Five or more family residential and commercial properties	48,718	—	3,357	—	52,075
Total real estate construction and land development	65,164	1,795	10,291	—	77,250
Consumer	28,748	—	156	10	28,914
Gross originated loans	\$823,451	\$13,413	\$38,756	\$961	\$876,581

The tables above include \$29.3 million and \$27.5 million of originated impaired loans as of September 30, 2013 and December 31, 2012, respectively, as detailed in the impaired loans section below. These impaired loans have been individually reviewed for probable incurred losses and have a specific valuation allowance, as necessary. The tables above also include potential problem loans. Potential problem loans are those loans that are currently accruing interest

and are not considered impaired, but which management is monitoring because the financial information of the borrower causes concern as to their ability to meet their loan repayment terms. Potential problem originated loans as of September 30, 2013 and December 31, 2012 were \$26.6 million and \$28.3 million, respectively.

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The balance of potential problem originated loans guaranteed by a governmental agency, which reduces the Company's credit exposure, was \$1.7 million and \$3.2 million as of September 30, 2013 and December 31, 2012, respectively.

The following tables present the recorded invested balance of the purchased covered and purchased noncovered loans receivable by credit quality indicator as of September 30, 2013 and December 31, 2012.

	September 30, 2013				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	\$60,909	\$4,572	\$8,369	\$1,360	\$75,210
Owner-occupied commercial real estate	84,723	3,112	5,544	637	94,016
Non-owner occupied commercial real estate	53,139	1,176	8,632	3,381	66,328
Total commercial business	198,771	8,860	22,545	5,378	235,554
One-to-four family residential	12,735	889	2,971	—	16,595
Real estate construction and land development:					
One-to-four family residential	495	—	1,739	—	2,234
Five or more family residential and commercial properties	2,593	—	1,097	147	3,837
Total real estate construction and land development	3,088	—	2,836	147	6,071
Consumer	14,079	342	1,383	921	16,725
Gross purchased covered and noncovered loans	\$228,673	\$10,091	\$29,735	\$6,446	\$274,945
	December 31, 2012				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	\$40,577	\$1,753	\$6,809	\$1,405	\$50,544
Owner-occupied commercial real estate	40,676	2,390	4,676	265	48,007
Non-owner occupied commercial real estate	11,419	2,404	4,806	5,418	24,047
Total commercial business	92,672	6,547	16,291	7,088	122,598
One-to-four family residential	6,059	903	1,105	—	8,067
Real estate construction and land development:					
One-to-four family residential	136	—	1,051	3,759	4,946
Five or more family residential and commercial properties	420	—	444	—	864
Total real estate construction and land development	556	—	1,495	3,759	5,810
Consumer	11,785	157	4,004	32	15,978
Gross purchased covered and noncovered loans	\$111,072	\$7,607	\$22,895	\$10,879	\$152,453



The tables above include \$7.7 million and \$2.2 million of purchased other impaired loans as of September 30, 2013 and December 31, 2012, respectively, as detailed in the impaired loans section below. These purchased other impaired loans have been individually reviewed for potential losses and have a specific valuation allowance, as necessary.

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## (d) Nonaccrual loans

Originated nonaccrual loans, segregated by segments and classes of loans, were as follows as of September 30, 2013 and December 31, 2012:

	September 30, 2013 (1)	December 31, 2012 (1)
	(In thousands)	
Commercial business:		
Commercial and industrial	\$4,441	\$4,560
Owner-occupied commercial real estate	844	563
Non-owner occupied commercial real estate	—	369
Total commercial business	5,285	5,492
One-to-four family residential	583	389
Real estate construction and land development:		
One-to-four family residential	1,467	3,063
Five or more family residential and commercial properties	2,385	3,357
Total real estate construction and land development	3,852	6,420
Consumer	39	157
Gross originated nonaccrual loans	\$9,759	\$12,458

(1) \$1.9 million and \$1.2 million of nonaccrual originated loans were guaranteed by governmental agencies at September 30, 2013 and December 31, 2012, respectively.

The recorded investment balance of purchased other nonaccrual loans, segregated by segments and classes of loans, were as follows as of September 30, 2013 and December 31, 2012:

	September 30, 2013 (1)	December 31, 2012 (1)
	(In thousands)	
Commercial business:		
Commercial and industrial	\$978	\$—
Owner-occupied commercial real estate	130	139
Non-owner occupied commercial real estate	883	437
Total commercial business	1,991	576
One-to-four family residential	—	61
Consumer	10	163
Gross purchased other nonaccrual loans	\$2,001	\$800

(1) \$7,000 and \$39,000 of purchased other nonaccrual loans were covered by the FDIC shared-loss agreements at September 30, 2013 and December 31, 2012, respectively.

## (e) Past due loans

The Company performs an aging analysis of past due loans using the categories of 30-89 days past due and 90 or more days past due. This policy is consistent with regulatory reporting requirements.

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The balances of originated past due loans, segregated by segments and classes of loans, as of September 30, 2013 and December 31, 2012 were as follows:

	September 30, 2013					90 Days or More and Still Accruing
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	
	(In thousands)					
Commercial business:						
Commercial and industrial	\$771	\$3,665	\$4,436	\$288,470	\$292,906	\$ —
Owner-occupied commercial real estate	486	758	1,244	196,177	197,421	—
Non-owner occupied commercial real estate	516	—	516	346,875	347,391	—
Total commercial business	1,773	4,423	6,196	831,522	837,718	—
One-to-four family residential	—	583	583	39,319	39,902	—
Real estate construction and land development:						
One-to-four family residential	—	1,467	1,467	18,587	20,054	—
Five or more family residential and commercial properties	—	—	—	38,704	38,704	—
Total real estate construction and land development	—	1,467	1,467	57,291	58,758	—
Consumer	645	—	645	27,384	28,029	—
Gross originated loans	\$2,418	\$6,473	\$8,891	\$955,516	\$964,407	\$ —
	December 31, 2012					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	\$2,768	\$2,014	\$4,782	\$272,458	\$277,240	\$ 25
Owner-occupied commercial real estate	920	112	1,032	187,462	188,494	—
Non-owner occupied commercial real estate	92	369	461	265,374	265,835	—
Total commercial business	3,780	2,495	6,275	725,294	731,569	25
One-to-four family residential	239	375	614	38,234	38,848	—
Real estate construction and land development:						
One-to-four family residential	847	3,242	4,089	21,086	25,175	179
Five or more family residential and commercial properties	—	3,018	3,018	49,057	52,075	—
Total real estate construction and land development	847	6,260	7,107	70,143	77,250	179
Consumer	68	146	214	28,700	28,914	10
Gross originated loans	\$4,934	\$9,276	\$14,210	\$862,371	\$876,581	\$ 214



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The balances of purchased other past due loans, segregated by segments and classes of loans, as of September 30, 2013 and December 31, 2012 are as follows:

	September 30, 2013					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	\$29	\$223	\$252	\$46,197	\$46,449	\$ —
Owner-occupied commercial real estate	333	—	333	74,888	75,221	—
Non-owner occupied commercial real estate	213	883	1,096	46,854	47,950	—
Total commercial business	575	1,106	1,681	167,939	169,620	—
One-to-four family residential	—	—	—	8,936	8,936	—
Real estate construction and land development:						
One-to-four family residential	—	—	—	—	—	—
Five or more family residential and commercial properties	—	—	—	2,155	2,155	—
Total real estate construction and land development	—	—	—	2,155	2,155	—
Consumer	—	—	—	10,765	10,765	—
Gross purchased other loans	\$575	\$1,106	\$1,681	\$189,795	\$191,476	\$ —
	December 31, 2012					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	\$—	\$—	\$—	\$11,981	\$11,981	\$ —
Owner-occupied commercial real estate	662	—	662	25,748	26,410	—
Non-owner occupied commercial real estate	—	437	437	4,376	4,813	—
Total commercial business	662	437	1,099	42,105	43,204	—
One-to-four family residential	—	61	61	1,323	1,384	—
Real estate construction and land development:						
One-to-four family residential	—	—	—	—	—	—
Five or more family residential and commercial properties	—	—	—	—	—	—
Total real estate construction and land development	—	—	—	—	—	—