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)

ý **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

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

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

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

California	**77-0469558**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
150 Almaden Boulevard, San Jose, California	**95113**
(Address of Principal Executive Offices)	(Zip Code)

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

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

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

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

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

Large accelerated filer o	Accelerated filer ý	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

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

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Cautionary Note Regarding Forward-Looking Statements

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

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

- Competition for loans and deposits and failure to attract or retain deposits and loans;
- Local, regional, and national economic conditions and events and the impact they may have on us and our customers, and our assessment of that impact on our estimates including, the allowance for loan losses;
- Risks associated with concentrations in real estate related loans;
- Changes in the level of nonperforming assets and charge-offs and other credit quality measures, and their impact on the adequacy of the Company's allowance for loan losses and the Company's provision for loan losses;
- The effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Federal Open Market Committee of the Federal Reserve Board;
- Stability of funding sources and continued availability of borrowings;
- Our ability to raise capital or incur debt on reasonable terms;
- Regulatory limits on Heritage Bank of Commerce's ability to pay dividends to the Company;
- Continued volatility in credit and equity markets and its effect on the global economy;
- The impact of reputational risk on such matters as business generation and retention, funding and liquidity;
- Oversupply of inventory and continued deterioration in values of California commercial real estate;

A prolonged slowdown in construction activity;

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

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

Changes in consumer spending, borrowings and saving habits;

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- Changes in the competitive environment among financial or bank holding companies and other financial service providers;

- The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the 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.

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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

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

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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)

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

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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

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

	Six Months Ended June 30, 2012 and 2011							
	Preferred Stock			**Common Stock**			**Accumulated Other Comprehensive**	**Total**
	Shares	**Amount**	**Discount**	**Shares**	**Amount**	**Retained Earnings**	**Income / (Loss)**	**Shareholders' Equity**
	(Dollars in thousands, except share data)							
Balance, January 1, 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 fortfeitures 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 fortfeitures and taxes					223			223
Stock options exercised				2,276	9			9
Balance, June 30, 2012	21,004	$ 19,519	$	26,293,277	$ 131,443	$ 10,566	$ 3,163	$ 164,691

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Six Months Ended June 30, 2012	Six Months Ended June 30, 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

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

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

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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, 2012	For the Three Months Ended June 30, 2011	For the Six Months Ended June 30, 2012	For the Six Months Ended June 30, 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 oustanding, 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

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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

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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

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

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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

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

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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	$	$	$	$	$	$

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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

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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, 2012	June 30, 2011	December 31, 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		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	$ 9,040	$ 1,665	$ 10,705	$ 8,876	$ 1,803	$ 10,679
Real estate:						
Commercial and residential	1,104		1,104	2,137		2,137
Land and construction	2,365		2,365	3,514	456	3,970
Home equity	398		398		32	32
Consumer	160		160	12		12
Total	$ 13,067	$ 1,665	$ 14,732	$ 14,539	$ 2,291	$ 16,830

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

4) Loans (Continued)

The following table presents the aging of past due loans as of June 30, 2012 by class of loans:

	June 30, 2012					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 1,718	$ 2,794	$ 2,189	$ 6,701	$ 377,559	$ 384,260
Real estate:						
Commercial and residential	1,164	1,369	101	2,634	330,414	333,048
Land and construction	2,472			2,472	17,350	19,822
Home equity					47,813	47,813
Consumer					13,024	13,024
Total	$ 5,354	$ 4,163	$ 2,290	$ 11,807	$ 786,160	$ 797,967

The following table presents the aging of past due loans as of December 31, 2011 by class of loans:

	December 31, 2011					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 1,999	$ 508	$ 3,394	$ 5,901	$ 360,689	$ 366,590
Real estate:						
Commercial and residential	2,293			2,293	309,186	311,479
Land and construction			1,532	1,532	21,484	23,016
Home equity	753		32	785	51,232	52,017
Consumer					11,166	11,166
Total	$ 5,045	$ 508	$ 4,958	$ 10,511	$ 753,757	$ 764,268

Past due loans 30 days or greater totaled $11,807,000 and $10,511,000 at June 30, 2012 and December 31, 2011, respectively, of which $5,353,000 and $6,312,000 were on nonaccrual. At June 30, 2012, there were also $7,537,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2011, there were also $8,041,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

4) Loans (Continued)

Credit Quality Indicators

Concentrations of credit risk arise when a number of clients are engaged in similar business activities, or activities in the same geographic region, or have similar features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions. The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and service) and real estate lending, with the balance in consumer loans. While no specific industry concentration is considered significant, the Company's lending operations are located in the Company's market areas that are dependent on the technology and real estate industries and their supporting companies. Thus, the Company's borrowers could be adversely impacted by a continued downturn in these sectors of the economy which could reduce the demand for loans and adversely impact the borrowers' ability to repay their loans.

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

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

Substandard-Nonaccrual. Loans classified as substandard-nonaccrual are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. In addition, the Company no longer accrues interest on the loan because of the underlying weaknesses.

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

4) Loans (Continued)

The following table provides a summary of the loan portfolio by loan type and credit quality classification at June 30, 2012 and December 31, 2011:

	June 30, 2012			December 31, 2011		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)					
Commercial	$ 353,651	$ 30,609	$ 384,260	$ 333,506	$ 33,084	$ 366,590
Real estate:						
Commercial and residential	317,845	15,203	333,048	294,653	16,826	311,479
Land and construction	13,832	5,990	19,822	15,343	7,673	23,016
Home equity	47,168	645	47,813	51,368	649	52,017
Consumer	12,635	389	13,024	10,853	313	11,166
Total	$ 745,131	$ 52,836	$ 797,967	$ 705,723	$ 58,545	$ 764,268

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company's underwriting policy.

During the three months and six months ended June 30, 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or more combination of the following: a reduction of the stated interest rate of the loan; or an extension of maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk.

The recorded investment of troubled debt restructurings at June 30, 2012 was $5,240,000, which included $3,163,000 of nonaccrual loans and $2,077,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2011 was $7,396,000, which included $4,323,000 of nonaccrual loans and $3,073,000 of accruing loans. Approximately $849,000 and $574,000 in specific reserves were established with respect to these loans as of June 30, 2012 and December 31, 2011, respectively. As of June 30, 2012 and December 31, 2011, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

The following table presents loans by class modified as troubled debt restructurings during the three month period ended June 30, 2012:

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

4) Loans (Continued)

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

The following table presents loans by class modified as troubled debt restructurings during the six month period ended June 30, 2012:

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

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

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the three month and six month periods ended June 30, 2012.

5) Income Taxes

Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles, leading to timing differences between the Company's actual tax liability and the amount accrued for this liability based on book income. These temporary differences comprise the "deferred" portion of the Company's tax expense or benefit, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as they reverse.

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

5) Income Taxes (Continued)

The Company had net deferred tax assets of $19,522,000, and $21,870,000, at June 30, 2012, and December 31, 2011, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at June 30, 2012 and December 31, 2011 will be fully realized in future years.

6) Benefit Plans

Supplemental Retirement Plan

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(Dollars in thousands)			
Components of net periodic benefit cost:				
Service cost	$ 294	$ 236	$ 588	$ 472
Interest cost	193	206	386	412
Amortization of prior service cost	7	9	14	18
Amortization of net actuarial loss	63	31	126	62
Net periodic benefit cost	$ 557	$ 482	$ 1,114	$ 964

Split-Dollar Life Insurance Benefit Plan

The Company maintains life insurance policies for current and former directors and officers that are subject to split-dollar life insurance agreements. The following table sets forth the funded status of the split-dollar life insurance benefits for the six months ended June 30, 2012 and the year ended December 31, 2011:

	June 30, 2012	December 31, 2011
	(Dollars in thousands)	
Change in projected benefit obligation		
Projected benefit obligation at beginning of year	$ 4,525	$ 6,361
Interest cost	93	306
Actuarial gain (loss)	(11)	831
Amendments to split dollar agreements		(2,973)
Projected benefit obligation at end of period	$ 4,607	$ 4,525

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

6) Benefit Plans (Continued)

Amounts recognized in accumulated other comprehensive income at June 30, 2012 and December 31, 2011 consist of the following:

	June 30, 2012	December 31, 2011
	(Dollars in thousands)	
Net actuarial gain	$ 525	$ 454
Prior transition obligation	1,730	1,776
Accumulated other comprehensive loss	$ 2,255	$ 2,230

7) Preferred Stock

Series A Preferred Stock

On November 21, 2008, the Company issued 40,000 shares of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") to the U.S. Treasury under the terms of the U.S. Treasury Capital Purchase Program for $40,000,000 with a liquidation preference of $1,000 per share. On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve Board, the Company repurchased all of the Series A Preferred Stock and paid all of the related accrued and unpaid dividends. HCC used available cash and proceeds from a $30,000,000 distribution approved by the California Department of Financial Institutions from HBC to HCC. The repurchase of the Series A Preferred Stock accelerated the accretion of the remaining issuance discount on the Series A Preferred Stock. Total dividends and discount accretion on Preferred Stock, including accelerated accretion of approximately $765,000, reduced net income available to common shareholders by $1,206,000 in the first quarter of 2012. The Company did not repurchase the related warrant that was issued to the U.S Treasury, and the warrant remains outstanding as of the date of this report.

Series C Preferred Stock

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of $3.75 per share upon a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. The Series C Preferred Stock remains outstanding until it has been converted into common stock in accordance with its terms. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of $1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

8) Fair Value

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

8) Fair Value (Continued)

transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

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

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

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Financial Assets and Liabilities Measured on a Recurring Basis

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

The fair value of interest-only ("I/O") strip receivable assets is based on a valuation model used by a third party. The Company is able to compare the valuation model inputs and results to widely available published industry data for reasonableness (Level 2 inputs).

		Fair Value Measurements Using		
	Balance	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
		(Dollars in thousands)		
Assets at June 30, 2012:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 325,926		$ 325,926	
Corporate bonds	23,221		23,221	
Trust preferred securities	40,673		40,673	
I/O strip receivables	2,140		2,140	
Assets at December 31, 2011:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 350,348	$	$ 350,348	
Trust preferred securities	30,107		30,107	
I/O strip receivables	2,094		2,094	

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

8) Fair Value (Continued)

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

Assets and Liabilities Measured on a Non-Recurring Basis

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

At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Impaired loans carried at fair value generally receive specific allocations of the allowance for loan losses. For collateral dependent loans, fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

8) Fair Value (Continued)

	Balance	Fair Value Measurements Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Dollars in thousands)			
Assets at June 30, 2012:				
Impaired loans held-for-sale other:				
Real estate:				
Land and construction	$ 177		$ 177	
Impaired loans held-for-investment:				
Commercial	$ 4,873			$ 4,873
Real estate:				
Commercial and residential	906			906
Land and construction	1,697			1,697
Home equity	317			317
Consumer	142			142
	$ 7,935			$ 7,935
Foreclosed assets:				
Commercial and residential	$ 183			$ 183
Land and construction	2,915			2,915
	$ 3,098			$ 3,098
Assets at December 31, 2011:				
Impaired loans held-for-sale other:				
Real estate:				
Land and construction	$ 186		$ 186	
Impaired loans held-for-investment:				
Commercial	$ 6,526			$ 6,526
Real estate:				
Commercial and residential	1,794			1,794
Land and construction	1,590			1,590
Home equity	32			32
Consumer	10			10
	$ 9,952			$ 9,952
Foreclosed assets:				
Commercial and residential	$ 156			$ 156
Land and construction	2,156			2,156

$ 2,312	$ 2,312

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

8) Fair Value (Continued)

The following table shows the detail of the impaired loans held-for-investment and the impaired loans held-for-investment carried at fair value for the periods indicated:

	June 30, 2012	December 31, 2011
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	$ 9,786	$ 12,279
Book value of impaired loans held-for-investment carried at cost	4,796	5,635
Total impaired loans held-for-investment	$ 14,582	$ 17,914
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	$ 9,786	$ 12,279
Specific valuation allowance	(1,851)	(2,327)
Impaired loans held-for-investment carried at fair value, net	$ 7,935	$ 9,952

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were $14,582,000 at June 30, 2012, after partial charge-offs of $951,000 in the first six months of 2012. In addition, these loans had a specific valuation allowance of $1,851,000 at June 30, 2012. Impaired loans held-for-investment totaling $9,786,000 at June 30, 2012 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining $4,796,000 of impaired loans were carried at cost at June 30, 2012, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during the first six months of 2012 on impaired loans held-for-investment carried at fair value at June 30, 2012 resulted in an additional provision for loan losses of $1,024,000.

Foreclosed assets measured at fair value less costs to sell, had a net carrying amount of $3,098,000, which is made up of the outstanding balance of $3,098,000, with no valuation allowance at June 30, 2012.

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were $17,914,000 at December 31, 2011, after partial charge-offs of $3,604,000 in 2011. In addition, these loans had a specific valuation allowance of $2,327,000 at December 31, 2011. Impaired loans held-for-investment totaling $12,279,000 at December 31, 2011 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining $5,635,000 of impaired loans were carried at cost at December 31, 2011, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during 2011 on impaired loans held-for-investment carried at fair value at December 31, 2011 resulted in an additional provision for loan losses of $2,916,000.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

8) Fair Value (Continued)

At December 31, 2011, foreclosed assets had a carrying amount of $2,312,000, with no valuation allowance at December 31, 2011.

The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at June 30, 2012:

	Fair Value	Valuation Techniques	Unobservable Inputs	Range (Weighted Average)
			(Dollars in thousands)	
Impaired loans held-for-investment:				
Commercial	$ 4,873	Market Approach	Discount adjustment for differences between comparable sales	2% to 34% (17%)
Real estate:				
Commercial and residential	906	Market Approach	Discount adjustment for differences between comparable sales	2% to 7% (5%)
Land and construction	1,697	Market Approach	Discount adjustment for differences between comparable sales	1% to 36% (12%)
Foreclosed assets:				
Land and construction	2,915	Market Approach	Discount adjustment for differences between comparable sales	0% to 23% (6%)

The Company obtains third party appraisals on its impaired loans held-for-investment and foreclosed assets to determine fair value. Generally, the third party appraisals apply the "market approach," which is a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business. Adjustments are then made based on the type of property, age of appraisal, current status of property and other related factors to estimate the current value of collateral.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

8) Fair Value (Continued)

The carrying amounts and estimated fair values of financial instruments at June 30, 2012 are as follows:

	Carrying Amounts	Estimated Fair Value Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	(Dollars in thousands)				
Assets:					
Cash and cash equivalents	$ 46,361	$ 46,361	$	$	$ 46,361
Securities available-for-sale	389,820		389,820		389,820
Loans (including loans held-for-sale), net	780,974		2,891	777,736	780,627
FHLB and FRB stock	10,897				N/A
Accrued interest receivable	3,877		3,877		3,877
Loan servicing rights and I/O strips receivables	2,920		5,228		5,228
Liabilities:					
Time deposits	$ 295,172	$	$ 296,090	$	$ 296,090
Other deposits	807,581		807,581		807,581
Subordinated debt	23,702			19,310	19,310
Accrued interest payable	768		768		768

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2011:

	Carrying Amounts	Estimated Fair Value
	(Dollars in thousands)	
Assets:		
Cash and cash equivalents	$ 72,872	$ 72,872
Securities available-for-sale	380,455	380,455
Loans (including loans held-for-sale), net	745,057	745,421
FHLB and FRB stock	9,925	N/A
Accrued interest receivable	3,719	3,719
Loan servicing rights and I/O strips receivables	2,886	5,261
Liabilities:		
Time deposits	$ 288,528	$ 289,512
Other deposits	760,900	760,900
Subordinated debt	23,702	15,950
Accrued interest payable	784	784

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

8) Fair Value (Continued)

The methods and assumptions, not previously discussed, used to estimate the fair value are described as follows:

Cash and Cash Equivalents

The carrying amounts of cash on hand, noninterest and interest bearing due from bank accounts, and fed funds sold approximate fair values and are classified as Level 1.

Loans

The fair value of loans held-for-sale is estimated based upon binding contracts and quotes from third party investors resulting in a Level 2 classification.

Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

FHLB and FRB Stock

It was not practical to determine the fair value of FHLB and FRB stock due to restrictions placed on its transferability.

Accrued Interest Receivable/Payable

The carrying amounts of accrued interest approximate fair value resulting in a Level 2 classification.

Deposits

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 2 classification. The carrying amounts of variable rate, fixed-term money market accounts approximate their fair values at the reporting date resulting in a Level 2 classification. The carrying amounts of variable rate, certificates of deposit approximate their fair values at the reporting date resulting in a Level 2 classification. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

8) Fair Value (Continued)

Subordinated Debt

The fair values of the subordinated debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 3 classification.

Off-balance Sheet Instruments

Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material.

9) Equity Plan

The Company granted 18,000 restricted shares of its common stock, at a grant price of $6.39, to three officers pursuant to the terms of the restricted stock agreements, dated May 1, 2012, under the Amended and Restated 2004 Equity Plan. Under the terms of the agreements, the common stock is subject to risk of forfeiture until the common stock has vested. The common stock will vest upon the second anniversary of the grant date. However, upon the occurrence of a change in control, or the death or disability of the participant, the common stock will vest immediately. The fair value of stock awards at the grant date was $115,020, which is being amortized over a two year period on the straight-line method. Amortization expense related to the 18,000 shares was $9,600 for the second quarter of 2012. None of the shares were vested at June 30, 2012. There were 22,000 shares of restricted stock forfeited and the related amortized expense of $48,000 was reversed during the first six months of 2012.

The Company also granted 201,500 shares of unqualified stock options to directors and employees during the first six months of 2012. The exercise price was $6.39 per share, and the options vest over four years. Stock option expense related to the 201,500 shares was $32,000 for the six months ended June 30, 2012. As of June 30, 2012, there was $703,000 of unrecognized compensation expense related to the 201,500 stock options granted during the first six months of 2012.

10) Loss Contingencies

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. The Company's accounting policy for legal costs related to loss contingencies is to accrue for the probable fees that can be reasonably estimated. The Company's accounting policy for uncertain recoveries is to recognize the anticipated recovery when realization is deemed probable. During the first quarter of 2012, the Company accrued $500,000 for probable costs related to an anticipated legal claim that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer. As of the date of this report, this anticipated legal claim has not yet been asserted, and no additional accruals related to this matter were recorded during the second quarter of 2012. This accrual was reduced by payments of $126,000 during the second quarter of 2012, resulting in a balance of $374,000 at June 30, 2012. It is reasonably possible

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

10) Loss Contingencies (Continued)

that the outcome may result in a liability exceeding the amount accrued in the financial statements; however, based on the status of the unasserted claim, a range of the reasonably possible gross loss or gross anticipated recoveries cannot be estimated.

11) Subordinated Debt

The table below summarizes the Company's subordinated debt as of the periods indicated:

	June 30, 2012	December 31, 2011
	(Dollars in thousands)	
Subordinated debentures due to Heritage Capital Trust I with interest payable semi-annually at 10.875%, redeemable with a premium beginning March 8, 2010 and with no premium beginning March 8, 2020, due March 8, 2030	$ 7,217	$ 7,217
Subordinated debentures due to Heritage Statutory Trust I with interest payable semi-annually at 10.60%, redeemable with a premium beginning September 7, 2010 and with no premium beginning September 7, 2020, due September 7, 2030	7,206	7,206
Subordinated debentures due to Heritage Statutory Trust II with interest payable quarterly based on 3-month Libor plus 3.58% (4.04% at June 30, 2012), redeemable with a premium beginning July 31, 2006 and with no premium beginning July 31, 2011, due July 31, 2031	5,155	5,155
Subordinated debentures due to Heritage Statutory Trust III with interest payable quarterly based on 3-month Libor plus 3.40% (3.86% at June 30, 2012), redeemable with no premium beginning September 26, 2007 and due September 26, 2032	4,124	4,124
Total	$ 23,702	$ 23,702

For regulatory reporting purposes, the Company's subordinated debt qualifies for Tier 1 capital treatment.

12) Subsequent Events

Subordinated Debt

In July 2012, the Company provided notice to the holders that it intends to redeem the Company's 10.875% fixed-rate subordinated debentures in the amount of $7,000,000 issued to Heritage Capital Trust I, the related common securities of $217,000 and premium charge of $304,500, and the

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2012

(Unaudited)

12) Subsequent Events (Continued)

Company's 10.60% fixed-rate subordinated debentures in the amount of $7,000,000 issued to Heritage Statutory Trust I, and the related common securities of $206,000 and premium charge of $296,800 (collectively referred to as the "Fixed-Rate Sub Debt"). The redemption of the 10.60% fixed-rate subordinated debentures is expected to be completed on September 7, 2012, and the 10.875% fixed-rate subordinated debentures on September 8, 2012. Additionally, the Company will pay its regularly scheduled interest payments on the Fixed-Rate Sub Debt totaling approximately $752,000 on the respective redemption dates. The Company will use available cash and proceeds from a $15,000,000 distribution from HBC to HCC for the redemptions.

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ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources 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"). This information is intended to facilitate the understanding and assessment of significant changes and trends related to our financial condition and the results of operations. This discussion and analysis should be read in conjunction with our consolidated financial statements and the accompanying notes presented elsewhere in this report. Unless we state otherwise or the context indicates otherwise, references to the "Company," "Heritage," "we," "us," and "our," in this Report on Form 10-Q refer to Heritage Commerce Corp and Heritage Bank of Commerce.

EXECUTIVE SUMMARY

This summary is intended to identify the most important matters on which management focuses when it evaluates the financial condition and performance of the Company. When evaluating financial condition and performance, management looks at certain key metrics and measures. The Company's evaluation includes comparisons with peer group financial institutions and its own performance objectives established in the internal planning process.

The primary activity of the Company is commercial banking. The Company's operations are located entirely in the southern and eastern regions of the general San Francisco Bay Area of California in the counties of Santa Clara, Alameda and Contra Costa. The largest city in this area is San Jose and the Company's market includes the headquarters of a number of technology based companies in the region known commonly as Silicon Valley. The Company's customers are primarily closely held businesses and professionals.

Performance Overview

For the three months ended June 30, 2012, net income was $2.7 million, compared to $2.1 million for the three months ended June 30, 2011. Following the redemption of its $40 million of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") issued to the U.S. Treasury Department under the TARP Capital Purchase Program in the first quarter of 2012, the Company did not have any preferred dividends and discount accretion on preferred stock in the second quarter of 2012. The net income available to common shareholders was $2.7 million, or $0.08 per common share for the three months ended June 30, 2012. After accrued dividends and discount accretion on preferred stock of $604,000, net income available to shareholders was $1.5 million, or $0.05 per average diluted common share, for the second quarter a year ago. The Company's annualized return on average assets was 0.81% and annualized return on average equity was 6.61% for the second quarter of 2012, compared to 0.66% and 4.50%, respectively, a year ago.

For the six months ended June 30, 2012, net income available to common shareholders was $3.6 million, or $0.11 per average diluted common share, up from $2.5 million, or $0.08 per average diluted common share, for the six months ended June 30, 2011. The Company's annualized return on average assets was 0.72% and annualized return on average equity was 5.44% for the first six months of 2012, compared to 0.59% and 4.01%, respectively, a year ago.

The following are major factors that impacted the Company's results of operations:

- The net interest margin remained flat at 3.95% in the second quarter of 2012, compared to the second quarter of 2011, as a decrease in average yields on loans and investment securities was mainly offset by a lower cost of deposits in the second quarter of 2012. The Company's net interest margin increased six basis points to 4.01% for the six months ended June 30, 2012,

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compared to 3.95% for the six months ended June 30, 2011, primarily as a result of a higher yield on loans, a lower level of interest-bearing deposits in other institutions, and a lower cost of deposits.

Net interest income was $12.1 million for the second quarter of 2012, compared to $11.5 million for the second quarter of 2011. The increase in net interest income for the second quarter of 2012 compared to the same period in 2011 was primarily due to an increase in the average balance of investment securities and a lower cost of deposits, partially offset by a decrease in average balance of loans and the yield on loans. Net interest income was $24.3 million for the six months ended June 30, 2012, compared to $22.7 million for the six months ended June 30, 2011. The increase in net interest income for the first six months of 2012 compared to the same period in 2011 was primarily due to an increase in the average balance of investment securities and a lower cost of deposits, partially offset by a decrease in average balance of loans.

The provision for loan losses was $815,000 for the second quarter of 2012, compared to $955,000 for the second quarter of 2011. The provision for loan losses for the six months ended June 30, 2012 was $915,000, compared to $1.7 million for the first six months of 2011. The decrease in provision for loan losses for the three months and six months ended June 30, 2012, compared to the same periods in 2011 reflects a lower volume of classified assets and nonperforming loans, and a decrease in loan charge-offs.

Noninterest income decreased 4% to $2.1 million in the second quarter of 2012, from $2.2 million in the second quarter of 2011, and decreased 7% to $3.8 million in the first six months of 2012 from $4.1 million in the first six months of 2011, primarily due to lower gain on sales of SBA loans.

Noninterest expense remained flat at $9.5 million for the second quarter of 2012, compared to the second quarter of 2011. For the six months ended June 30, 2012, noninterest expense was $20.3 million, compared to $19.9 million for the six months ended June 30, 2011. The increase in noninterest expense in the first six months of 2012 was primarily due to a first quarter $500,000 accrual for probable costs related to an anticipated legal claim that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer.

The efficiency ratio was 66.70% for the second quarter of 2012, compared to 69.43% for the second quarter of 2011. The efficiency ratio for the six months ended June 30, 2012 was 72.13%, compared to 74.39% for the six months ended June 30, 2011.

Income tax expense for the quarter ended June 30, 2012 was $1.2 million, compared to $1.1 million for the second quarter of 2011. For the first six months of 2012, income tax expense was $2.2 million, compared to $1.5 million for the first six months a year ago. The effective tax rate for the second quarter of 2012 was 31%, compared to 35% for the second quarter a year ago. The effective tax rate for the six months ended June 30, 2012 was 31%, compared to 28% for the six months ended June 30, 2011.

The following are important factors in understanding our current financial condition and liquidity position:

Cash, Federal funds sold, interest-bearing deposits in other financial institutions and securities available-for-sale increased 11% to $436.2 million at June 30, 2012, from $391.2 million at June 30, 2011, and decreased 4% from $453.3 million at December 31, 2011.

Total loans, excluding loans held-for-sale, increased $16.0 million, or 2%, to $798.1 million at June 30, 2012, compared to $782.1 million at June 30, 2011, and increased $33.5 million, or 4%, from $764.6 million at December 31, 2011. Land and construction loans decreased $22.2 million,

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or 53%, to $19.8 million at June 30, 2012, compared to $42.0 million at June 30, 2011, and decreased $3.2 million, or 14%, from $23.0 million at December 31, 2011.

Classified assets (net of SBA guarantees) decreased to $54.9 million at June 30, 2012, compared to $76.1 million at June 30, 2011, and decreased from $59.5 million at December 31, 2011.

The allowance for loan losses at June 30, 2012 was $20.0 million, or 2.51% of total loans, representing 137.57% of nonperforming loans excluding nonaccrual loans in loans held-for-sale. The allowance for loan losses at June 30, 2011 was $23.1 million, or 2.96% of total loans, representing 102.15% of nonperforming loans excluding nonaccrual loans in loans held-for-sale. The allowance for loan losses at December 31, 2011, was $20.7 million, or 2.71% of total loans, representing 124.37% of nonperforming loans excluding nonaccrual loans in loans held-for-sale.

Nonperforming assets were $17.8 million, or 1.35% of total assets at June 30, 2012, compared to $23.1 million or 1.83% of total assets at June 30, 2011, and $19.1 million, or 1.47% of total assets at December 31, 2011.

Net loan charge-offs were $1.1 million for the second quarter of 2012, compared to $1.8 million for the second quarter of 2011. Net loan charge-offs were $1.6 million for the fourth quarter of 2011.

Core deposits continued to increase for the second quarter of 2012:

Noninterest-bearing demand deposits increased 10% to $367.9 million at June 30, 2012, from $333.2 million at June 30, 2011, and increased 7% from $344.3 million at December 31, 2011.

Interest-bearing demand deposits increased 16% to $148.8 million at June 30, 2012, from $128.5 million at June 30, 2011, and increased 11% from $134.1 million at December 31, 2011.

Savings and money market deposits increased 5% to $290.9 million at June 30, 2012, from $276.5 million at June 30, 2011, and increased 3% from $282.5 million at December 31, 2011.

The ratio of noncore funding (which consists of time deposits $100,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase and short-term borrowings) to total assets was 20.17% at June 30, 2012, compared to 18.20% at June 30, 2011, and 19.90% at December 31, 2011.

The loan to deposit ratio was 72.37% at June 30, 2012, compared to 78.32% at June 30, 2011, and 72.86% at December 31, 2011.

Capital ratios substantially exceed regulatory requirements for a well-capitalized financial institution, both on a consolidated basis and at the bank level at June 30, 2012. The leverage ratio at the holding company was 12.7%, with a Tier 1 risk-based capital ratio of 16.0%, and a total risk-based capital ratio of 17.3% at June 30, 2012. The leverage ratio for HBC was 11.9%, with a Tier 1 risk-based capital ratio of 14.9%, and a total risk-based capital ratio of 16.2% at June 30, 2012. The regulatory well-capitalized guidelines are a minimum of a 5% leverage ratio, a 6% Tier 1 risk-based capital ratio, and a 10% total risk-based capital ratio.

Recent Events

In July 2012, the Company provided notice to the holders that it intends to redeem the Company's 10.875% fixed-rate subordinated debentures in the amount of $7.0 million issued to Heritage Capital Trust I, and the related common securities of $217,000 and premium cost of $304,500, and the Company's 10.60% fixed-rate subordinated debentures in the amount of $7.0 million issued to Heritage

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Statutory Trust I, and the related common securities of $206,000 and premium cost of $296,800 (collectively referred to as the "Fixed-Rate Sub Debt"). The redemption of the 10.60% fixed-rate subordinated debentures is expected to be completed on September 7, 2012, and the 10.875% fixed-rate subordinated debentures on September 8, 2012. Additionally, the Company will pay its regularly scheduled interest payments on the Fixed-Rate Sub Debt totaling approximately $752,000 on the respective redemption dates. The Company will use available cash and proceeds from a $15 million distribution from HBC to HCC for the redemptions. The redemption of the Fixed-Rate Sub Debt does not significantly reduce capital ratios of HCC or HBC. The Company will incur a charge of $601,300 in the third quarter of 2012, for the early payoff premiums on the redemption of the Fixed-Rate Sub Debt. On an annual basis, the redemption of the Fixed-Rate Sub Debt will eliminate approximately $1.5 million in interest expense.

Deposits

The composition and cost of the Company's deposit base are important in analyzing the Company's net interest margin and balance sheet liquidity characteristics. Except for brokered time deposits, the Company's depositors are generally located in its primary market area. Depending on loan demand and other funding requirements, the Company also obtains deposits from wholesale sources including deposit brokers. The Company had $97.7 million in brokered deposits at June 30, 2012, compared to $94.6 million at June 30, 2011, and $84.7 million at December 31, 2011. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators increased to $35.7 million at June 30, 2012, compared to $33.3 million at June 30, 2011, and $37.6 million at December 31, 2011. Certificates of deposit from the State of California totaled $50.0 million at June 30, 2012, compared to none at June 30, 2011, and $50 million at December 31, 2011. Deposits at June 30, 2012 were $1.1 billion, compared to $998.6 million at June 30, 2011 and $1.0 billion at December 31, 2011. Core deposits (excluding all time deposits) grew 9% to $807.6 million at June 30, 2012, an increase of $69.4 million from June 30, 2011, and increased $46.7 million, or 6%, from $760.9 million at December 31, 2011. The Company has a policy to monitor all deposits that may be sensitive to interest rate changes to help assure that liquidity risk does not become excessive due to concentrations.

HBC is a member of the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program allows customers with deposits in excess of FDIC insured limits to obtain coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through this program are considered brokered deposits under regulatory guidelines. Deposits in the CDARS program totaled $5.4 million at June 30, 2012, compared to $20.8 million at June 30, 2011, and $6.4 million at December 31, 2011.

Liquidity

Our liquidity position refers to our ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely fashion. At June 30, 2012, we had $46.4 million in cash and cash equivalents and approximately $368.3 million in available borrowing capacity from various sources including the Federal Home Loan Bank ("FHLB"), the Federal Reserve Bank of San Francisco ("FRB"), and Federal funds facilities with several financial institutions. The Company also had $301.2 million in unpledged securities available at June 30, 2012. Our loan to deposit ratio decreased to 72.37% at June 30, 2012, compared to 78.32% at June 30, 2011, and 72.86% at December 31, 2011.

Lending

Our lending business originates principally through our branch offices located in our primary markets. The Company also has an additional SBA loan production office in Santa Rosa, California.

The total loan portfolio remains well diversified with commercial and industrial ("C&I") loans accounting for 48% of the portfolio at June 30, 2012. Commercial and residential real estate loans accounted for 42% of the total loan portfolio at June 30, 2012, of which 51% were owner-occupied by businesses. We have actively lowered our exposure to land and construction loans and our overall credit risk on this portfolio has been reduced. Land and construction loans decreased $22.2 million to $19.8 million at June 30, 2012, compared to $42.0 million at June 30, 2011, and accounted for 2% of our total loan portfolio at June 30, 2012, compared to 5% at June 30, 2011, and 3% at December 31, 2011. Consumer and home equity loans accounted for the remaining 8% of total loans at June 30, 2012. The yield on the loan portfolio was 5.23% for the second quarter of 2012, compared to 5.31% for the same period in 2011, and 5.41% for the first quarter of 2012. The 18 basis points decrease in the second quarter of 2012 from the first quarter of 2012 was due to several positive adjustments in the first quarter of 2012 from loan interest recoveries and lower rates (due to competitive factors) on some new and renewed loans in the second quarter of 2012. The yield on the loan portfolio was 5.32% for the six months ended June 30, 2012, compared to 5.30% for six months ended June 30, 2011. Loans, excluding loans held-for-sale, increased 2% to $798.1 million at June 30, 2012, from $782.1 million a year ago, and increased 4% from $764.6 million at December 31, 2011.

Net Interest Income

The management of interest income and expense is fundamental to the performance of the Company. Net interest income, the difference between interest income and interest expense, is the largest component of the Company's total revenue. Management closely monitors both total net interest income and the net interest margin (net interest income divided by average earning assets).

The Company, through its asset and liability policies and practices, seeks to maximize net interest income without exposing the Company to an excessive level of interest rate risk. Interest rate risk is managed by monitoring the pricing, maturity and repricing options of all classes of interest bearing assets and liabilities. This is discussed in more detail under *"Liquidity and Asset/Liability Management."* In addition, we believe there are measures and initiatives we can take to improve the net interest margin, including increasing loan rates, adding floors on floating rate loans, reducing nonperforming assets, managing deposit interest rates, and reducing higher cost deposits.

The net interest margin is also adversely impacted by the reversal of interest on nonaccrual loans and the reinvestment of loan payoffs into lower yielding investment securities and other short-term investments.

Management of Credit Risk

We continue to proactively identify, quantify, and manage our problem loans. Early identification of problem loans and potential future losses helps enable us to resolve credit issues with potentially less risk and ultimate losses. We maintain an allowance for loan losses in an amount that we believe is adequate to absorb probable incurred losses in the portfolio. While we strive to carefully manage and monitor credit quality and to identify loans that may be deteriorating, circumstances can change at any time for loans included in the portfolio that may result in future losses, that as of the date of the financial statements have not yet been identified as potential problem loans. Through established credit practices, we adjust the allowance for loan losses accordingly. However, because future events are uncertain, there may be loans that deteriorate some of which could occur in an accelerated time frame. As a result, future additions to the allowance for loan losses may be necessary. Because the loan portfolio contains a number of commercial loans, commercial real estate, construction and land development loans with relatively large balances, deterioration in the credit quality of one or more of these loans may require a significant increase to the allowance for loan losses. Future additions to the allowance may also be required based on changes in the financial condition of borrowers, such as have resulted due to the current, and potentially worsening, economic conditions. Additionally, Federal and state banking regulators, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to recognize further loan loss provisions or charge-offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses would have an adverse effect, which may be material, on our financial condition and results of operation.

Further discussion of the management of credit risk appears under *"Provision for Loan Losses"* and *"Allowance for Loan Losses."*

Noninterest Income

While net interest income remains the largest single component of total revenues, noninterest income is an important component.

A portion of the Company's noninterest income is associated with its SBA lending activity, consisting of gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing retained. Other sources of noninterest income include loan servicing fees, service charges and fees, cash surrender value from company owned life insurance policies, and gains on the sale of securities.

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company's performance. The Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. Nevertheless, noninterest expense for the first six months of 2012 increased 2% to $20.3 million, compared to $19.9 million for the first six months of 2011, primarily due to a $500,000 accrual established in the first quarter of 2012 for probable costs related to an anticipated legal claim that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer and higher salaries and employee benefits expense.

Capital Management

As part of its asset and liability management process, the Company continually assesses its capital position to take into consideration growth, expected earnings, risk profile and potential corporate activities that it may choose to pursue.

On November 21, 2008, the Company issued to the U.S. Treasury under its Capital Purchase Program 40,000 shares of Series A Preferred Stock for $40.0 million and issued a warrant to purchase 462,963 shares of common stock at an exercise price of $12.96.

On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve, the Company repurchased all shares of the Series A Preferred Stock and paid the related accrued and unpaid dividends. The repurchase of the Series A Preferred Stock will save $2.0 million in annual dividends. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report.

On June 21, 2010, the Company issued Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") to a limited number of institutional investors. The Series C Preferred Stock remains outstanding until its conversion to common stock upon the transfer of the Series C Preferred Stock in accordance with its terms. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock.

We have supported our growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt that we issued to the trusts is senior to our shares of common stock and Series C Preferred Stock. As a result, we must make payments on the subordinated debt before any dividends can be paid on our common stock and Series C Preferred Stock. Under the terms of the subordinated debt, we may defer interest payments for up to five years. The Company is current with respect to interest accrued on trust preferred subordinated debt securities as of June 30, 2012 and was current as of December 31, 2011.

In July 2012, the Company provided notice to the holders that it intends to redeem the Company's Fixed-Rate Sub Debt. The redemption of the 10.6% fixed-rate subordinated debentures is expected to be completed on September 7, 2012, and the 10.875% fixed-rate subordinated debentures on September 8, 2012.

At June 30, 2012, HBC's total risk-based capital ratio was 16.2%, compared to the 10% regulatory requirement for well-capitalized banks under the regulatory framework for prompt corrective actions. HBC's Tier 1 risk-based capital ratio of 14.9% and leverage ratio of 11.9% at June 30, 2012 also exceeded regulatory guidelines for well-capitalized banks under the prompt corrective actions framework. On a pro forma basis, assuming HBC distributed $15.0 million to HCC for the redemption of the $14 million Fixed-Rate Sub Debt, the total risk-based capital ratio would be 14.7%, the Tier 1 risk-based capital ratio would be 13.5%, and the leverage ratio would be 10.7% for HBC at June 30, 2012. On a consolidated basis, the Company has a total risk-based capital ratio of 17.3%, a Tier 1 risk-based capital ratio of 16.0%, and a leverage ratio of 12.7% at June 30, 2012. On a pro forma basis, assuming the redemption of the $14 million Fixed-Rate Sub Debt plus the related redemption premiums, the total risk-based capital ratio would be 15.9%, the Tier 1 risk-based capital ratio would be 14.6%, and the leverage ratio would be 11.6% for the Company at June 30, 2012.

RESULTS OF OPERATIONS

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on interest-bearing liabilities. The second is noninterest income, which primarily consists of gains on the sale of loans, loan servicing fees, customer service charges and fees, the increase in cash surrender value of life insurance, and gains on the sale of securities. The majority of the Company's noninterest expenses are operating costs that relate to providing a full range of banking services to our customers.

Net Interest Income and Net Interest Margin

The level of net interest income depends on several factors in combination, including yields on earning assets, the cost of interest-bearing liabilities, the relative volumes of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. To maintain its net interest margin, the Company must manage the relationship between interest earned and paid.

The following Distribution, Rate and Yield table presents the average amounts outstanding for the major categories of the Company's balance sheet, the average interest rates earned or paid thereon, and the resulting net interest margin on average interest earning assets for the periods indicated. Average balances are based on daily averages.

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Distribution, Rate and Yield

NET INTEREST INCOME AND NET INTEREST MARGIN	For the Three Months Ended June 30, 2012 Average Balance	Interest Income/ Expense	Average Yield/ Rate	For the Three Months Ended June 30, 2011 Average Balance	Interest Income/ Expense	Average Yield/ Rate
	(Dollars in thousands)					
Assets:						
Loans, gross(1)	$ 791,660	$ 10,292	5.23%	$ 806,839	$ 10,685	5.31%
Securities	398,143	2,975	3.01%	278,908	2,278	3.28%
Federal funds sold and interest-bearing deposits in other financial institutions	41,508	29	0.28%	77,937	52	0.27%
Total interest earning assets	1,231,311	13,296	4.34%	1,163,684	13,015	4.49%
Cash and due from banks	21,191			20,932		
Premises and equipment, net	7,841			8,160		
Intangible assets	2,316			2,829		
Other assets	69,115			70,542		
Total assets	$ 1,331,774			$ 1,266,147		
Liabilities and shareholders' equity:						
Deposits:						
Demand, noninterest-bearing	$ 370,086			$ 332,535		
Demand, interest-bearing	147,767	56	0.15%	132,079	65	0.20%
Savings and money market	298,544	179	0.24%	280,870	259	0.37%
Time deposits under $100	28,011	35	0.50%	32,194	61	0.76%
Time deposits $100 and over	166,486	246	0.59%	121,929	342	1.13%
Time deposits CDARS	5,900	3	0.20%	21,254	24	0.45%
Time deposits brokered	93,259	219	0.94%	92,131	317	1.38%
Total interest-bearing deposits	739,967	738	0.40%	680,457	1,068	0.63%
Total deposits	1,110,053	738	0.27%	1,012,992	1,068	0.42%
Subordinated debt	23,702	472	8.01%	23,702	467	7.90%
Short-term borrowings	3,196	2	0.25%	1,005	8	3.19%
Total interest-bearing liabilities	766,865	1,212	0.64%	705,164	1,543	0.88%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,136,951	1,212	0.43%	1,037,699	1,543	0.60%
Other liabilities	31,905			42,537		
Total liabilities	1,168,856			1,080,236		
Shareholders' equity	162,918			185,911		
Total liabilities and shareholders' equity	$ 1,331,774			$ 1,266,147		
Net interest income / margin		$ 12,084	3.95%		$ 11,472	3.95%

(1) Includes loans held-for-sale. Yield amounts earned on loans include loan fees and costs. Nonaccrual loans are included in average balance.

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NET INTEREST INCOME AND NET INTEREST MARGIN	For the Six Months Ended June 30, 2012 Average Balance	Interest Income/ Expense	Average Yield/ Rate	For the Six Months Ended June 30, 2011 Average Balance	Interest Income/ Expense	Average Yield/ Rate
	(Dollars in thousands)					
Assets:						
Loans, gross(1)	$ 778,640	$ 20,608	5.32%	$ 825,206	$ 21,675	5.30%
Securities	394,031	6,072	3.10%	262,476	4,240	3.26%
Federal funds sold and interest-bearing deposits in other financial institutions	48,750	65	0.27%	69,228	86	0.25%
Total interest earning assets	1,221,421	26,745	4.40%	1,156,910	26,001	4.53%
Cash and due from banks	21,089			20,742		
Premises and equipment, net	7,909			8,244		
Intangible assets	2,378			2,895		
Other assets	69,082			68,499		
Total assets	$ 1,321,879			$ 1,257,290		
Liabilities and shareholders' equity:						
Deposits:						
Demand, noninterest-bearing	$ 358,689			$ 322,345		
Demand, interest-bearing	145,208	109	0.15%	133,907	132	0.20%
Savings and money market	293,374	345	0.24%	274,346	526	0.39%
Time deposits under $100	28,117	73	0.52%	32,698	132	0.81%
Time deposits $100 and over	168,090	501	0.60%	127,856	761	1.20%
Time deposits CDARS	6,083	6	0.20%	21,389	49	0.46%
Time deposits brokered	88,992	420	0.95%	93,589	739	1.59%
Total interest-bearing deposits	729,864	1,454	0.40%	683,785	2,339	0.69%
Total deposits	1,088,553	1,454	0.27%	1,006,130	2,339	0.47%
Subordinated debt	23,702	946	8.03%	23,702	932	7.93%
Securities sold under agreement to repurchase			N/A	1,436	24	3.37%
Short-term borrowings	1,618	2	0.25%	1,865	38	4.11%
Total interest-bearing liabilities	755,184	2,402	0.64%	710,788	3,333	0.95%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,113,873	2,402	0.43%	1,033,133	3,333	0.65%
Other liabilities	32,287			39,966		
Total liabilities	1,146,160			1,073,099		
Shareholders' equity	175,719			184,191		
Total liabilities and shareholders' equity	$ 1,321,879			$ 1,257,290		
Net interest income / margin		$ 24,343	4.01%		$ 22,668	3.95%

(1) Includes loans held-for-sale. Yield amounts earned on loans include loan fees and costs. Nonaccrual loans are included in average balance.

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Volume and Rate Variances

The Volume and Rate Variances table below sets forth the dollar difference in interest earned and paid for each major category of interest-earning assets and interest-bearing liabilities for the noted periods, and the amount of such change attributable to changes in average balances (volume) or changes in average interest rates. Volume variances are equal to the increase or decrease in the average balance times the prior period rate, and rate variances are equal to the increase or decrease in the average rate times the prior period average balance. Variances attributable to both rate and volume changes are equal to the change in rate times the change in average balance and are included below in the average volume column.

	Three Months Ended June 30, 2012 vs. 2011 Increase (Decrease) Due to Change In:		
	Average Volume	Average Rate	Net Change
	(Dollars in thousands)		
Income from interest earning assets:			
Loans, gross	$ (200)	$ (193)	$ (393)
Securities	888	(191)	697
Federal funds sold and interest-bearing deposits in other financial institutions	(25)	2	(23)
Total interest income from interest earnings assets	663	(382)	281
Expense on interest-bearing liabilities:			
Demand, interest-bearing	7	(16)	(9)
Savings and money market	11	(91)	(80)
Time deposits under $100	(5)	(21)	(26)
Time deposits $100 and over	67	(163)	(96)
Time deposits CDARS	(8)	(13)	(21)
Time deposits brokered	4	(102)	(98)
Subordinated debt		5	5
Short-term borrowings	1	(7)	(6)
Total interest expense on interest-bearing liabilities	77	(408)	(331)
Net interest income	$ 586	$ 26	$ 612

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	Six Months Ended June 30, 2012 vs. 2011 Increase (Decrease) Due to Change In:		
	Average Volume	Average Rate	Net Change
	(Dollars in thousands)		
Income from interest earning assets:			
Loans, gross	$ (1,223)	$ 156	$ (1,067)
Securities	2,026	(194)	1,832
Federal funds sold and interest-bearing deposits in other financial institutions	(28)	7	(21)
Total interest income from interest earnings assets	775	(31)	744
Expense on interest-bearing liabilities:			
Demand, interest-bearing	9	(32)	(23)
Savings and money market	18	(199)	(181)
Time deposits under $100	(12)	(47)	(59)
Time deposits $100 and over	120	(380)	(260)
Time deposits CDARS	(15)	(28)	(43)
Time deposits brokered	(22)	(297)	(319)
Subordinated debt		14	14
Securities sold under agreement to repurchase	(24)		(24)
Short-term borrowings		(36)	(36)
Total interest expense on interest-bearing liabilities	74	(1,005)	(931)
Net interest income	$ 701	$ 974	$ 1,675

The Company's net interest margin, expressed as a percentage of average earning assets, remained flat at 3.95% for the second quarter of 2012, compared to the second quarter a year ago, as a decrease in average yields on loans and investment securities was mainly offset by a lower cost of deposits in the second quarter of 2012. For the first six months of 2012, the net interest margin increased to 4.01%, compared to 3.95% for the first six months of 2011, primarily as a result of a higher yield on loans, a lower level of interest-bearing deposits in other institutions, and a lower cost of deposits.

Net interest income, before the provision for loan losses, increased 5% to $12.1 million for the second quarter of 2012, compared to $11.5 million for the second quarter a year ago, primarily due to an increase in the average balance of investment securities. Net interest income for the for the first six months of 2012 increased 7% to $24.3 million, from $22.7 million for the first six months of 2011, primarily due to a higher average balances of investment securities, and a lower cost of deposits, partially offset by a decrease in the average balance of loans.

A substantial portion of the Company's earning assets are variable-rate loans that re-price when the Company's prime lending rate is changed, versus a large base of core deposits that are generally slower to re-price. This causes the Company's balance sheet to be asset-sensitive, which means that all else being equal, the Company's net interest margin will be lower during periods when short-term interest rates are falling and higher when rates are rising.

Provision for Loan Losses

Credit risk is inherent in the business of making loans. The Company establishes an allowance for loan losses through charges to earnings, which are shown in the statements of operations as the provision for loan losses. Specifically identifiable and quantifiable known losses are promptly charged off against the allowance. The provision for loan losses is determined by conducting a quarterly

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evaluation of the adequacy of the Company's allowance for loan losses and charging the shortfall, if any, to the current quarter's expense. This has the effect of creating variability in the amount and frequency of charges to the Company's earnings. The provision for loan losses and level of allowance for each period are dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of the quality of the loan portfolio, the valuation of problem loans and the general economic conditions in the Company's market area.

The Company had a provision for loan losses of $815,000 for the quarter ended June 30, 2012 and $915,000 for the six months ended June 30, 2012. The Company had a provision for loan losses of $955,000 for the quarter ended June 30, 2011 and $1.7 million for the six months ended June 30, 2011.

The allowance for loan losses represented 2.51%, 2.96% and 2.71% of total loans at June 30, 2012, June 30, 2011, and December 31, 2011, respectively. Provisions for loan losses are charged to operations to bring the allowance for loan losses to a level deemed appropriate by the Company based on the factors discussed under "Allowance for Loan Losses".

Noninterest Income

The following table sets forth the various components of the Company's noninterest income for the periods indicated:

	For the Three Months Ended June 30,		Increase (decrease) 2012 versus 2011	
	2012	2011	Amount	Percent
	(Dollars in thousands)			
Service charges and fees on deposit accounts	$ 601	$ 587	$ 14	2%
Servicing income	447	435	12	3%
Increase in cash surrender value of life insurance	429	419	10	2%
Gain on sale of SBA loans	376	476	(100)	-21%
Gain on sale of securities	32		32	N/A
Other	205	253	(48)	-19%
Total noninterest income	$ 2,090	$ 2,170	$ (80)	-4%

	For the Six Months Ended June 30,		Increase (decrease) 2012 versus 2011	
	2012	2011	Amount	Percent
	(Dollars in thousands)			
Service charges and fees on deposit accounts	$ 1,191	$ 1,154	$ 37	3%
Servicing income	907	846	61	7%
Increase in cash surrender value of life insurance	858	845	13	2%
Gain on sale of SBA loans	412	855	(443)	-52%
Gain on sale of securities	59		59	N/A
Other	386	387	(1)	0%
Total noninterest income	$ 3,813	$ 4,087	$ (274)	-7%

The decrease in noninterest income in the second quarter and first six months of 2012 compared to the same periods in 2011 was primarily attributable to lower gain on sales of SBA loans.

Historically, a significant percentage of the Company's noninterest income has been associated with its SBA lending activity, as gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. For the six months ended June 30, 2012, SBA

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loan sales resulted in a $412,000 gain, compared to an $855,000 gain on sale of SBA loans for the six months ended June 30, 2011. The servicing assets that result from the sale of SBA loans with servicing retained, are amortized over the expected term of the loans using a method approximating the interest method. Servicing income generally declines as the respective loans are repaid.

Noninterest Expense

The following table sets forth the various components of the Company's noninterest expense for the periods indicated:

	For the Three Months Ended June 30,		Increase (decrease) 2012 versus 2011	
	2012	**2011**	**Amount**	**Percent**
	(Dollars in thousands)			
Salaries and employee benefits	$ 5,377	$ 5,111	$ 266	5%
Occupancy and equipment	967	1,031	(64)	-6%
Professional fees	470	456	14	3%
Software subscriptions	313	274	39	14%
Low income housing investment losses	262	40	222	555%
Data processing	247	198	49	25%
Insurance expense	224	244	(20)	-8%
FDIC deposit insurance premiums	202	383	(181)	-47%
Other real estate owned expense	105	127	(22)	-17%
Other	1,287	1,608	(321)	-20%
Total noninterest expense	$ 9,454	$ 9,472	$ (18)	0%

	For the Six Months Ended June 30,		Increase (decrease) 2012 versus 2011	
	2012	**2011**	**Amount**	**Percent**
	(Dollars in thousands)			
Salaries and employee benefits	$ 11,044	$ 10,504	$ 540	5%
Occupancy and equipment	1,963	2,069	(106)	-5%
Professional fees	1,681	1,295	386	30%
Software subscriptions	603	529	74	14%
Low income housing investment losses	531	202	329	163%
Data processing	492	419	73	17%
Insurance expense	447	486	(39)	-8%
FDIC deposit insurance premiums	427	907	(480)	-53%
Other real estate owned expense	220	147	73	50%
Other	2,902	3,345	(443)	-13%
Total noninterest expense	$ 20,310	$ 19,903	$ 407	2%

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The following table indicates the percentage of noninterest expense in each category for the periods indicated:

Noninterest Expense by Category

	For The Three Months Ended June 30,			
	2012	Percent of Total	2011	Percent of Total
	(Dollars in thousands)			
Salaries and employee benefits	$ 5,377	57%	$ 5,111	54%
Occupancy and equipment	967	10%	1,031	11%
Professional fees	470	5%	456	5%
Software subscriptions	313	3%	274	3%
Low income housing investment losses	262	3%	40	0%
Data processing	247	3%	198	2%
Insurance expense	224	2%	244	3%
FDIC deposit insurance premiums	202	2%	383	4%
Other real estate owned expense	105	1%	127	1%
Other	1,287	14%	1,608	17%
Total noninterest expense	$ 9,454	100%	$ 9,472	100%

	For The Six Months Ended June 30,			
	2012	Percent of Total	2011	Percent of Total
	(Dollars in thousands)			
Salaries and employee benefits	$ 11,044	54%	$ 10,504	53%
Occupancy and equipment	1,963	10%	2,069	10%
Professional fees	1,681	8%	1,295	6%
Software subscriptions	603	3%	529	3%
Low income housing investment losses	531	3%	202	1%
Data processing	492	3%	419	2%
Insurance expense	447	2%	486	2%
FDIC deposit insurance premiums	427	2%	907	5%
Other real estate owned expense	220	1%	147	1%
Other	2,902	14%	3,345	17%
Total noninterest expense	$ 20,310	100%	$ 19,903	100%

Noninterest expense for the second quarter of 2012 remained flat at $9.5 million, compared to the second quarter of 2011. Higher salaries and employee benefits expense, and higher low income housing investment losses in the second quarter of 2012, were partially offset by lower FDIC deposit insurance premiums and other operating expenses. Full-time equivalent employees were 187 at June 30, 2012 and June 30, 2011.

Noninterest expense for the first six months of 2012 increased 2% to $20.3 million, compared to $19.9 million for the first six months of 2011. This increase resulted from higher salaries and employee benefits expense and additional costs related to an anticipated legal claim that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer, and higher low income housing investment losses, partially offset by lower FDIC deposit insurance premiums and other operating expenses.

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Income Tax Expense

The Company computes its provision for income taxes on a monthly basis. The effective tax rate is determined by applying the Company's statutory income tax rates to pre-tax book income as adjusted for permanent differences between pre-tax book income and actual taxable income. These permanent differences include, but are not limited to, increases in the cash surrender value of life insurance policies, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits.

The Company's Federal and state income tax expense for the quarter and six months ended June 30, 2012 was $1.2 million and $2.2 million, respectively. The income tax expense was $1.1 million and $1.5 million for the same periods in 2011. The following table shows the Company's effective income tax rates for the periods indicated:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	**2011**	**2012**	**2011**
Effective income tax rate	31.4%	35.1%	31.4%	28.5%

The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes and tax credits related to investments in low income housing limited partnerships.

The Company has net investments of $3.1 million in low-income housing limited partnerships as of June 30, 2012. These investments have generated annual tax credits of approximately $846,000 and $1.0 million in the years ended December 31, 2011 and 2010, respectively.

Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles, leading to timing differences between the Company's actual tax liability and the amount accrued for this liability based on book income. These temporary differences comprise the "deferred" portion of the Company's tax expense or benefit, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as they reverse.

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

The Company had net deferred tax assets of $19.5 million and $21.9 million at June 30, 2012, and December 31, 2011, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at June 30, 2012 and December 31, 2011 will be fully realized in future years.

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FINANCIAL CONDITION

As of June 30, 2012, total assets increased to $1.32 billion, compared to $1.26 billion at June 30, 2011, and increased from $1.31 billion at December 31, 2011. Total securities available-for-sale (at fair value) were $389.8 million at June 30, 2012, an increase of 29% from $303.0 million at June 30, 2011, and an increase of 2% from $380.5 million at December 31, 2011. The total loan portfolio, excluding loans held-for-sale, was $798.1 million at June 30, 2012, an increase of 2% from $782.1 million at June 30, 2011, and an increase of 4% from $764.6 million at December 31, 2011. Total deposits increased 10% to $1.1 billion at June 30, 2012, from $998.6 million at June 30, 2011 and increased 5% from $1.0 billion at December 31, 2011.

Securities Portfolio

The following table reflects the estimated fair values for each category of securities at the dates indicated:

	June 30, 2012	June 30, 2011	December 31, 2011
	(Dollars in thousands)		
Securities available-for-sale (at fair value)			
Agency mortgage-backed securities	$ 325,926	$ 302,968	$ 350,348
Corporate bonds	23,221		
Trust preferred securities	40,673		30,107
Total	$ 389,820	$ 302,968	$ 380,455

The following table summarizes the weighted average life and weighted average yields of securities at June 30, 2012:

	June 30, 2012 Weighted Average Life							
	After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(Dollars in thousands)							
Securities available-for-sale (at fair value):								
Mortgage-Backed Securities-Residential	$ 241,763	2.93%	$ 62,143	2.82%	$ 22,020	3.14%	$ 325,926	2.92%
Corporate bonds	921	2.67%	22,300	3.38%			23,221	3.35%
Trust preferred securities					40,673	5.85%	40,673	5.85%
	$ 242,684	2.93%	$ 84,443	2.97%	$ 62,693	4.90%	$ 389,820	3.25%

The securities portfolio is the second largest component of the Company's interest-earning assets, and the structure and composition of this portfolio is important to an analysis of the financial condition of the Company. The portfolio serves the following purposes: (i) it provides a source of pledged assets for securing certain deposits and borrowed funds, as may be required by law or by specific agreement with a depositor or lender; (ii) it provides liquidity to even out cash flows from the loan and deposit activities of customers; (iii) it can be used as an interest rate risk management tool, since it provides a large base of assets, the maturity and interest rate characteristics of which can be changed more readily than the loan portfolio to better match changes in the deposit base and other funding sources of the Company; and (iv) it is an alternative interest-earning use of funds when loan demand is weak or when deposits grow more rapidly than loans.

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The Company's securities are all currently classified under existing accounting rules as "available-for-sale" to allow flexibility for the management of the portfolio. Accounting guidance requires available-for-sale securities to be marked to fair value with an offset to accumulated other comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available-for-sale securities.

The Company's portfolio is historically comprised primarily of: (i) U.S. Treasury securities and U.S. Government sponsored entities' debt securities for liquidity and pledging; (ii) mortgage-backed securities, which in many instances can also be used for pledging, and which generally enhance the yield of the portfolio; (iii) municipal obligations, which provide tax free income and limited pledging potential; (iv) collateralized mortgage obligations, which generally enhance the yield of the portfolio; and (v) single entity issue trust preferred securities, which generally enhance the yield on the portfolio.

Compared to June 30, 2011, the securities portfolio increased by $86.9 million, or 29%, and increased to 29% of total assets at June 30, 2012, from 24% at June 30, 2011. The Company increased its holding of mortgage-back securities by $23.0 million to $325.9 million at June 30, 2012, from $303.0 million at June 30, 2011. Mortgage-backed securities decreased $24.4 million at June 30, 2012, from $350.3 million at December 31, 2011. At June 30, 2012, the investment portfolio included $23.2 million of corporate bonds, compared to no corporate bonds in the investment portfolio at June 30, 2011 and December 31, 2011. At June 30, 2012, the Company's investment portfolio included single entity issue trust preferred securities by four issuers with an amortized cost of $40.8 million and market value of $40.7 million, compared to no trust preferred securities in the investment portfolio at June 30, 2011, and an amortized cost of $29.9 million and a market value of $30.1 million of single entity issue trust preferred securities at December 31, 2011. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities to otherwise mitigate interest rate risk.

Loans

The Company's loans represent the largest portion of invested assets, substantially greater than the securities portfolio or any other asset category, and the quality and diversification of the loan portfolio is an important consideration when reviewing the Company's financial condition.

Gross loans, excluding loans held-for-sale, represented 60% of total assets at June 30, 2012, as compared to 62% of total assets at June 30, 2011, and 59% of total assets at December 31, 2011. The ratio of loans to deposits decreased to 72.37% at June 30, 2012 from 78.32% at June 30, 2011 and 72.86% at December 31, 2011.

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Loan Distribution

The Loan Distribution table that follows sets forth the Company's gross loans, excluding loans held-for-sale, outstanding and the percentage distribution in each category at the dates indicated: