

HERITAGE COMMERCE CORP

Form 10-Q

May 08, 2018

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10 Q

(MARK
ONE)

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

For the quarterly period ended March 31, 2018

OR

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

For the transition period from _____ to _____

Commission file number 000 23877

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

California

(State or Other Jurisdiction of
Incorporation or Organization)

150 Almaden Boulevard, San Jose, California

(Address of Principal Executive Offices)

77 0469558

(I.R.S. Employer Identification No.)

95113

(Zip Code)

(408) 947 6900

(Registrant's Telephone Number, Including Area Code)

N/A

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

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

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

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The Registrant had 40,159,752 shares of Common Stock outstanding on April 30, 2018.

Table of Contents

HERITAGE COMMERCE CORP

QUARTERLY REPORT ON FORM 10 Q

TABLE OF CONTENTS

	Page No.
<u>Cautionary Note on Forward Looking Statements</u>	3
 <u>Part I. FINANCIAL INFORMATION</u>	
<u>Item 1. Consolidated Financial Statements (unaudited)</u>	5
<u>Consolidated Balance Sheets</u>	5
<u>Consolidated Statements of Income</u>	6
<u>Consolidated Statements of Comprehensive Income</u>	7
<u>Consolidated Statements of Changes in Shareholders' Equity</u>	8
<u>Consolidated Statements of Cash Flows</u>	9
<u>Notes to Unaudited Consolidated Financial Statements</u>	10
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	37
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	66
<u>Item 4. Controls and Procedures</u>	66
 <u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	67
<u>Item 1A. Risk Factors</u>	67
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	67
<u>Item 3. Defaults Upon Senior Securities</u>	67
<u>Item 4. Mine Safety Disclosures</u>	67
<u>Item 5. Other Information</u>	67
<u>Item 6. Exhibits</u>	67

SIGNATURES

68

2

Table of Contents

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, Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended, Rule 3b 6 promulgated thereunder 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,” “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:

- current and future economic and market conditions in the United States generally or in the communities we serve, including the effects of declines in property values, high unemployment rates and overall slowdowns in economic growth should these events occur;

- 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;

- changes in inflation, interest rates, and market liquidity which may impact interest margins and impact funding sources;

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

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

- changes in consumer and business spending and saving habits and the related effect on our ability to increase assets and to attract deposits;

- our ability to develop and promote customer acceptance of new products and services in a timely manner;

- risks associated with concentrations in real estate related loans;

other than temporary impairment charges to our securities portfolio;

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;

· increased capital requirements for our continual growth or as imposed by banking regulators, which may require us to raise capital at a time when capital is not available or favorable terms or at all;
regulatory limits on Heritage Bank of Commerce's ability to pay dividends to the Company;

changes in our capital management policies, including those regarding business combinations, dividends, and share repurchases, among others;

3

Table of Contents

operational issues stemming from, and/or capital spending necessitated by, the potential need to adapt to industry changes in information technology systems, on which we are highly dependent;

our ability to keep pace with technological changes, including our ability to identify and address cyber-security risks such as data security breaches, “denial of service” attacks, “hacking” and identity theft;

inability of our framework to manage risks associated with our business, including operational risk and credit risk;

risks of loss of funding of Small Business Administration or SBA loan programs, or changes in those programs;

compliance with governmental and regulatory requirements, including the Dodd-Frank Act and others relating to banking, consumer protection, securities, accounting and tax matters;

significant changes in applicable laws and regulations, including those concerning taxes, banking and securities;

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;

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;

availability of and competition for acquisition opportunities;

risks associated with integration of Tri-Valley Bank and United American Bank with the Company, including the possibility that we may not realize the anticipated benefits of the transactions;

risks resulting from domestic terrorism;

risks of natural disasters (including earthquakes) and other events beyond our control; and

our success in managing the risks involved in the foregoing factors.

Forward-looking statements speak only as of the date they are made. The Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events. You should consider any forward looking statements in light of this explanation, and we caution you about relying on forward-looking statements.

Table of Contents

Part I—FINANCIAL INFORMATION

ITEM 1—CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HERITAGE COMMERCE CORP

CONSOLIDATED BALANCE SHEETS (Unaudited)

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Assets		
Cash and due from banks	\$ 30,454	\$ 31,681
Other investments and interest-bearing deposits in other financial institutions	271,535	284,541
Total cash and cash equivalents	301,989	316,222
Securities available-for-sale, at fair value	344,766	391,852
Securities held-to-maturity, at amortized cost (fair value of \$383,637 at March 31, 2018 and \$394,292 at December 31, 2017)	395,274	398,341
Loans held-for-sale - SBA, at lower of cost or fair value, including deferred costs	2,859	3,419
Loans, net of deferred fees	1,591,201	1,582,667
Allowance for loan losses	(20,139)	(19,658)
Loans, net	1,571,062	1,563,009
Federal Home Loan Bank and Federal Reserve Bank stock and other investments, at cost	17,917	17,911
Company-owned life insurance	61,177	60,814
Premises and equipment, net	7,203	7,353
Goodwill	45,664	45,664
Other intangible assets	5,348	5,589
Accrued interest receivable and other assets	32,289	33,278
Total assets	\$ 2,785,548	\$ 2,843,452
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 975,846	\$ 989,753
Demand, interest-bearing	621,402	601,929
Savings and money market	688,217	684,131
Time deposits - under \$250	49,861	51,710
Time deposits - \$250 and over	71,446	138,634

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

CDARS - interest-bearing demand, money market and time deposits	15,420	16,832
Total deposits	2,422,192	2,482,989
Subordinated debt, net of issuance costs	39,229	39,183
Accrued interest payable and other liabilities	53,136	50,041
Total liabilities	2,514,557	2,572,213
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized; none issued and outstanding		
at March 31, 2018 and December 31, 2017	—	—
Common stock, no par value; 60,000,000 shares authorized; 38,269,789 shares issued		
and outstanding at March 31, 2018 and 38,200,883 shares issued and outstanding at December 31, 2017	219,208	218,355
Retained earnings	66,739	62,136
Accumulated other comprehensive loss	(14,956)	(9,252)
Total shareholders' equity	270,991	271,239
Total liabilities and shareholders' equity	\$ 2,785,548	\$ 2,843,452

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands, except per share amounts)	
Interest income:		
Loans, including fees	\$ 22,284	\$ 20,398
Securities, taxable	3,862	2,877
Securities, exempt from Federal tax	560	566
Other investments and interest- bearing deposits in other financial institutions	1,171	856
Total interest income	27,877	24,697
Interest expense:		
Deposits	958	871
Subordinated debt	571	—
Total interest expense	1,529	871
Net interest income before provision for loan losses	26,348	23,826
Provision for loan losses	506	321
Net interest income after provision for loan losses	25,842	23,505
Noninterest income:		
Service charges and fees on deposit accounts	902	740
Increase in cash surrender value of life insurance	363	422
Gain on sales of SBA loans	235	324
Servicing income	181	285
Gain (loss) on sales of securities	87	(6)
Other	427	530
Total noninterest income	2,195	2,295
Noninterest expense:		
Salaries and employee benefits	9,777	9,486
Occupancy and equipment	1,106	1,068
Professional fees	684	1,071
Other	4,423	3,703
Total noninterest expense	15,990	15,328
Income before income taxes	12,047	10,472
Income tax expense	3,238	3,934

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Net income	\$ 8,809	\$ 6,538
Earnings per common share:		
Basic	\$ 0.23	\$ 0.17
Diluted	\$ 0.23	\$ 0.17

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Net income	\$ 8,809	\$ 6,538
Other comprehensive income:		
Change in net unrealized holding (losses) gains on available-for-sale securities and I/O strips	(7,985)	845
Deferred income taxes	2,315	(355)
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(11)	(13)
Deferred income taxes	3	5
Reclassification adjustment for losses (gains) realized in income	(87)	6
Deferred income taxes	26	(2)
Change in unrealized gains on securities and I/O strips, net of deferred income taxes	(5,739)	486
Change in net pension and other benefit plan liability adjustment	50	39
Deferred income taxes	(15)	(16)
Change in pension and other benefit plan liability, net of deferred income taxes	35	23
Other comprehensive (loss) income	(5,704)	509
Total comprehensive income	\$ 3,105	\$ 7,047

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

	Three Months Ended March 31, 2018 and 2017				Total Shareholders' Equity
	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Loss	
Balance, January 1, 2017	37,941,007	\$ 215,237	\$ 52,527	\$ (7,914)	\$ 259,850
Net income	—	—	6,538	—	6,538
Other comprehensive loss	—	—	—	509	509
Issuance of restricted stock awards, net	1,492	—	—	—	—
Amortization of restricted stock awards, net of forfeitures and taxes	—	221	—	—	221
Cash dividend declared \$0.10 per share	—	—	(3,795)	—	(3,795)
Stock option expense, net of forfeitures and taxes	—	216	—	—	216
Stock options exercised	52,586	365	—	—	365
Balance, March 31, 2017	37,995,085	\$ 216,039	\$ 55,270	\$ (7,405)	\$ 263,904
Balance, January 1, 2018	38,200,883	\$ 218,355	\$ 62,136	\$ (9,252)	\$ 271,239
Net income	—	—	8,809	—	8,809
Other comprehensive loss	—	—	—	(5,704)	(5,704)
Amortization of restricted stock awards, net of forfeitures and taxes	—	228	—	—	228
Cash dividend declared \$0.11 per share	—	—	(4,206)	—	(4,206)
Stock option expense, net of forfeitures and taxes	—	176	—	—	176
Stock options exercised	68,906	449	—	—	449
Balance, March 31, 2018	38,269,789	\$ 219,208	\$ 66,739	\$ (14,956)	\$ 270,991

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 8,809	\$ 6,538
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	1,131	1,066
(Gain) loss on sale of securities available-for-sale	(87)	6
Gain on sale of SBA loans	(235)	(324)
Proceeds from sale of SBA loans originated for sale	3,041	4,103
Net change in SBA loans originated for sale	(2,246)	(3,861)
Provision for loan losses	506	321
Increase in cash surrender value of life insurance	(363)	(422)
Depreciation and amortization	196	190
Amortization of other intangible assets	241	345
Stock option expense, net	176	216
Amortization of restricted stock awards, net	228	221
Amortization of subordinated debt issuance costs	46	—
Effect of changes in:		
Accrued interest receivable and other assets	3,288	5,057
Accrued interest payable and other liabilities	(2,297)	(1,052)
Net cash provided by operating activities	12,434	12,404
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(15,193)	(47,296)
Purchase of securities held-to-maturity	(5,022)	(27,736)
Maturities/paydowns/calls of securities available-for-sale	14,957	12,740
Maturities/paydowns/calls of securities held-to-maturity	13,002	9,876
Proceeds from sales of securities available-for-sale	38,754	6,536
Net change in loans	(8,559)	(9,079)
Changes in Federal Home Loan Bank stock and other investments	(6)	(7)
Purchase of premises and equipment	(46)	(212)
Net cash provided by (used in) investing activities	37,887	(55,178)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	(60,797)	67,947
Exercise of stock options	449	365
Payment of cash dividends	(4,206)	(3,795)
Net cash provided by financing activities	(64,554)	64,517

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Net increase (decrease) in cash and cash equivalents	(14,233)	21,743
Cash and cash equivalents, beginning of year	316,222	266,103
Cash and cash equivalents, end of year	\$ 301,989	\$ 287,846
Supplemental disclosures of cash flow information:		
Interest paid	\$ 977	\$ 891
Income taxes paid	4	3
Supplemental schedule of non-cash investing activity:		
Due to broker for securities purchased	\$ 5,439	\$ —
Transfer of loans held-for-sale to loan portfolio	\$ —	\$ 1,876

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2018

(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 (“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, 2017.

HBC is a commercial bank serving customers primarily located in Santa Clara, Alameda, Contra Costa, and San Benito counties of California. CSNK Working Capital Finance Corp. a California corporation, dba Bay View Funding (“Bay View Funding”) is a wholly owned subsidiary of HBC, and provides business-essential working capital factoring financing to various industries throughout the United States. No customer accounts for more than 10% of revenue for HBC or the Company. The Company reports its results for two segments: banking and factoring. The Company’s management uses segment results in its operating and strategic planning.

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 ended March 31, 2018 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2018.

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 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers", which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The standard replaces most existing revenue recognition guidance in GAAP. The new standard was effective for the Company on January 1, 2018. Adoption of the standard did not have a material impact on the Company's consolidated financial statements and related disclosures as the Company's primary sources of revenues are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of the standard. The Company's revenue recognition pattern for revenue streams within the scope of the standard, including but not limited to service charges on deposit accounts and gains/losses on the sale of other real estate owned ("OREO"), did not change significantly from current practice. The standard permits the use of either the full retrospective or modified retrospective transition method. The Company elected to use the modified retrospective transition method which requires application of the standard to uncompleted contracts at the date of adoption however, periods prior to the date of adoption were not

Table of Contents

retrospectively revised as the impact of the standard on uncompleted contracts at the date of adoption was not material. See Note 14 – Revenue Recognition for more information.

In January 2016, the FASB issued ASU No. 2016-01, “Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities.” The guidance affects the accounting for equity investments, financial liabilities under the fair value option and the presentation and disclosure requirements of financial instruments. The standard was effective for the Company on January 1, 2018 and resulted in the use of an exit price rather than an entrance price to determine the fair value of financial instruments not measured at fair value on a non-recurring basis in the consolidated balance sheets. See Note 10 – Fair Value for further information regarding the valuation of these loans.

In March 2017, the FASB issued ASU 2017-07, Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. The standard amended existing guidance to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost. The amendments require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit costs are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. The amendments allow only the service cost component to be eligible for capitalization. The Company adopted the new guidance on January 1, 2018, and there was no material impact to the financial statements.

Newly Issued, but not yet Effective Accounting Standards

In February 2016, the FASB issued ASU No. 2016-02, Leases. The standard requires a lessee to recognize assets and liabilities on the balance sheet for leases with lease terms greater than 12 months. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right of use asset representing its right to use the underlying asset for the lease term. When measuring assets and liabilities arising from a lease, a lessee (and a lessor) should include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. Similarly, optional payments to purchase the underlying asset should be included in the measurement of lease assets and lease liabilities only if the lessee is reasonably certain to exercise that purchase option. Reasonably certain is a high threshold that is consistent with and intended to be applied in the same way as the reasonably assured threshold in the previous leases guidance. In addition, also consistent with the previous leases guidance, a lessee (and a lessor) should exclude most variable lease payments in measuring lease assets and lease liabilities, other than those that depend on an index or a rate or are in substance fixed payments. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight line basis over the lease term. The new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, and early adoption is permitted. We are currently evaluating the provisions of this ASU and have determined that the provisions of ASU No. 2016-02 will result in an increase in assets to recognize the present value of the lease obligations with a corresponding increase in liabilities; however, we do not expect this to have a material impact to the Company’s results of operations or cash flows.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments—Credit Losses: Measurement of Credit Losses on Financial Instruments. The standard is the final guidance on the new current expected credit loss (“CECL”) model. The amendments in this update replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to estimate future credit loss estimates. As CECL encompasses all financial assets carried at amortized cost, the requirement that reserves be established based on an organization’s reasonable and supportable estimate of expected credit losses extends to held-to-maturity debt securities. The update amends the accounting for credit losses on available for sale securities, whereby credit losses will be presented as an allowance as opposed to a write down. In addition, CECL will modify the accounting for purchased loans with credit deterioration since origination, so that reserves are established at the date of acquisition for purchased loans. Lastly, the amendment requires enhanced disclosures on the significant estimates and judgments used to estimate credit losses, as well as on the credit quality and underwriting standards of an organization’s portfolio. These disclosures require organizations to present the currently required credit quality disclosures disaggregated by the year of origination or vintage. The guidance allows for a modified retrospective approach with a cumulative effect adjustment to the balance sheet upon adoption (charge to retained earnings instead of the income statement). The new guidance is effective for public business entities for fiscal

Table of Contents

years, and interim periods within those years, beginning after December 15, 2019, and early adoption is permitted. We have formed a committee that is assessing our data and system needs and are evaluating the impact of adopting the new guidance. The committee has also selected a vendor to assist in generating loan level cash flows and disclosures. We expect to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, but cannot yet determine the magnitude of any such one-time adjustment or the overall impact of the new guidance on the consolidated financial statements.

In January 2017, the FASB issued accounting standards ASU No. 2017-04, Simplifying the Test for Goodwill Impairment. The provisions of the update eliminate the existing second step of the goodwill impairment test which provides for the allocation of reporting unit fair value among existing assets and liabilities, with the net remaining amount representing the implied fair value of goodwill. In replacement of the existing goodwill impairment rule, the update will provide that impairment should be recognized as the excess of any of the reporting unit's goodwill over the fair value of the reporting unit. Under the provisions of this update, the amount of the impairment is limited to the carrying value of the reporting unit's goodwill. For public business entities that are SEC filers, the amendments of the update will become effective in fiscal years beginning after December 15, 2019. Management does not expect the requirements of this update to have a material impact on the Company's financial position, results of operations or cash flows.

2) Shareholders' Equity and Earnings Per Share

Basic earnings per common share is computed by dividing net income, by the weighted average common shares outstanding. Diluted earnings per share reflect potential dilution from outstanding stock options using the treasury stock method. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	Three Months Ended	
	March 31,	
	2018	2017
	(Dollars in thousands, except per share amounts)	
Net income	\$ 8,809	\$ 6,538
Weighted average common shares outstanding for basic earnings		
per common share	38,240,495	37,957,999
Dilutive effect of stock options outstanding, using the treasury stock method	574,227	536,108

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Shares used in computing diluted earnings per common share	38,814,722	38,494,107
Basic earnings per share	\$ 0.23	\$ 0.17
Diluted earnings per share	\$ 0.23	\$ 0.17

Stock options for 275,000 and 246,500 shares of common stock were not considered in computing diluted earnings per common share for the three months ended March 31, 2018 and 2017, respectively, because they were antidilutive.

Table of Contents

3) Accumulated Other Comprehensive Income (Loss) (“AOCI”)

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

	Three Months Ended March 31, 2018 and 2017			
	Unrealized Gains (Losses) Available-for-Sale Securities and I/O Strips(1) (Dollars in thousands)	Unamortized Unrealized Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity	Defined Benefit Pension Plan Items	Total
Beginning balance January 1, 2018, net of taxes	\$ (362)	\$ 375	\$ (9,265)	\$ (9,252)
Other comprehensive income (loss) before reclassification, net of taxes	(5,670)	—	(5)	(5,675)
Amounts reclassified from other comprehensive income (loss), net of taxes	(61)	(8)	40	(29)
Net current period other comprehensive income (loss), net of taxes	(5,731)	(8)	35	(5,704)
Ending balance March 31, 2018, net of taxes	\$ (6,093)	\$ 367	\$ (9,230)	\$ (14,956)
Beginning balance January 1, 2017, net of taxes	\$ (540)	\$ 336	\$ (7,710)	\$ (7,914)
Other comprehensive income (loss) before reclassification, net of taxes	490	—	(7)	483
Amounts reclassified from other comprehensive income (loss), net of taxes	4	(8)	30	26
Net current period other comprehensive income (loss), net of taxes	494	(8)	23	509
Ending balance March 31, 2017, net of taxes	\$ (46)	\$ 328	\$ (7,687)	\$ (7,405)

Details About AOCI Components	Amounts Reclassified from AOCI(1) Three Months Ended March 31,		Affected Line Item Where Net Income is Presented
	2018	2017	
Unrealized gains on available-for-sale securities and I/O strips	\$ 87 (26)	\$ (6) 2	Gain (loss) on sales of securities Income tax expense

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	61	(4)	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity			
	11	13	Interest income on taxable securities
	(3)	(5)	Income tax expense
	8	8	Net of tax
Amortization of defined benefit pension plan items (1)			
Prior transition obligation	16	18	
Actuarial losses	(73)	(69)	
	(57)	(51)	Salaries and employee benefits
	17	21	Income tax benefit
	(40)	(30)	Net of tax
Total reclassification for the year	\$ 29	\$ (26)	

(1) This AOCI component is included in the computation of net periodic benefit cost (see Note 8—Benefit Plans) and includes split-dollar life insurance benefit plan.

Table of Contents

4) Securities

The amortized cost and estimated fair value of securities at March 31, 2018 and December 31, 2017 were as follows:

	Amortized Cost (Dollars in thousands)	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
March 31, 2018				
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 354,302	\$ 216	\$ (9,752)	\$ 344,766
Total	\$ 354,302	\$ 216	\$ (9,752)	\$ 344,766
Securities held-to-maturity:				
Agency mortgage-backed securities	\$ 307,083	\$ —	\$ (9,762)	\$ 297,321
Municipals - exempt from Federal tax	88,191	410	(2,285)	86,316
Total	\$ 395,274	\$ 410	\$ (12,047)	\$ 383,637
December 31, 2017				
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 378,339	786	(4,392)	\$ 374,733
Trust preferred securities	15,000	2,119	—	17,119
Total	\$ 393,339	\$ 2,905	\$ (4,392)	\$ 391,852
Securities held-to-maturity:				
Agency mortgage-backed securities	\$ 309,616	\$ 6	\$ (4,394)	\$ 305,228
Municipals - exempt from Federal tax	88,725	946	(607)	89,064
Total	\$ 398,341	\$ 952	\$ (5,001)	\$ 394,292

Securities with unrealized losses at March 31, 2018 and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

	Less Than 12 Months Fair Value	Unrealized (Losses)	12 Months or More Fair Value	Unrealized (Losses)	Total Fair Value	Unrealized (Losses)
March 31, 2018						
	(Dollars in thousands)					

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Securities available-for-sale:						
Agency mortgage-backed securities	\$ 199,375	\$ (5,107)	\$ 123,168	\$ (4,645)	\$ 322,543	\$ (9,752)
Total	\$ 199,375	\$ (5,107)	\$ 123,168	\$ (4,645)	\$ 322,543	\$ (9,752)
Securities held-to-maturity:						
Agency mortgage-backed securities	\$ 169,591	\$ (4,614)	\$ 121,549	\$ (5,148)	\$ 291,140	\$ (9,762)
Municipals - exempt from Federal tax	43,270	(1,189)	18,561	(1,096)	61,831	(2,285)
Total	\$ 212,861	\$ (5,803)	\$ 140,110	\$ (6,244)	\$ 352,971	\$ (12,047)

Table of Contents

December 31, 2017	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 185,824	\$ (1,623)	\$ 146,670	\$ (2,769)	\$ 332,494	\$ (4,392)
Total	\$ 185,824	\$ (1,623)	\$ 146,670	\$ (2,769)	\$ 332,494	\$ (4,392)
Securities held-to-maturity:						
Agency mortgage-backed securities	\$ 168,439	\$ (1,368)	\$ 130,759	\$ (3,026)	\$ 299,198	\$ (4,394)
Municipals - exempt from Federal tax	18,159	(182)	19,240	(425)	37,399	(607)
Total	\$ 186,598	\$ (1,550)	\$ 149,999	\$ (3,451)	\$ 336,597	\$ (5,001)

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 March 31, 2018 the Company held 493 securities (167 available-for-sale and 326 held to maturity), of which 377 had fair values below amortized cost. At March 31, 2018, there were \$123,168,000 of agency mortgage-back securities available-for-sale, \$121,549,000 of agency mortgage-backed securities held-to-maturity, and \$18,561,000 of municipal bonds held-to-maturity, carried with an unrealized loss for 12 months or more. The total unrealized loss for securities 12 months or more was \$10,889,000 at March 31, 2018. The 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 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 March 31, 2018.

The proceeds from sales of securities and the resulting gains and losses were as follows for the periods indicated:

	Three Months Ended	
	2018	2017
	(Dollars in thousands)	
Proceeds	\$ 38,754	\$ 6,536
Gross gains	1,050	—
Gross losses	(963)	(6)

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

The amortized cost and estimated fair values of securities as of March 31, 2018 are shown by contractual maturity 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
Agency mortgage-backed securities	\$ 354,302	\$ 344,766
Total	\$ 354,302	\$ 344,766

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
Due after 3 months through one year	\$ 499	\$ 499
Due after one through five years	3,703	3,740
Due after five through ten years	23,442	23,434
Due after ten years	60,547	58,643
Agency mortgage-backed securities	307,083	297,321
Total	\$ 395,274	\$ 383,637

Table of Contents

Securities with amortized cost of \$38,863,000 and \$110,874,000 as of March 31, 2018 and December 31, 2017 were pledged to secure public deposits and for other purposes as required or permitted by law or contract.

5) Loans

Loans were as follows for the periods indicated:

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	\$ 572,790	\$ 573,296
Real estate:		
CRE	775,547	772,867
Land and construction	113,470	100,882
Home equity	76,087	79,176
Residential mortgages	42,868	44,561
Consumer	10,958	12,395
Loans	1,591,720	1,583,177
Deferred loan fees, net	(519)	(510)
Loans, net of deferred fees	1,591,201	1,582,667
Allowance for loan losses	(20,139)	(19,658)
Loans, net	\$ 1,571,062	\$ 1,563,009

At March 31, 2018 and December 31, 2017, total net loans included in the table above include \$55,633,000 and \$58,551,000, respectively, of the loans acquired in the Focus transaction that were not purchased credit impaired loans.

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

	Three Months Ended March 31, 2018			Total
	Commercial	Real Estate	Consumer	
	(Dollars in thousands)			
Beginning of period balance	\$ 10,608	\$ 8,950	\$ 100	\$ 19,658

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Charge-offs	(245)	—	—	(245)
Recoveries	157	63	—	220
Net (charge-offs) recoveries	(88)	63	—	(25)
Provision (credit) for loan losses	645	(155)	16	506
End of year balance	\$ 11,165	\$ 8,858	\$ 116	\$ 20,139

Table of Contents

	Three Months Ended March 31, 2017			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Beginning of period balance	\$ 10,656	\$ 8,327	\$ 106	\$ 19,089
Charge-offs	(366)	—	—	(366)
Recoveries	50	41	—	91
Net (charge-offs) recoveries	(316)	41	—	(275)
Provision (credit) for loan losses	912	(625)	34	321
End of period balance	\$ 11,252	\$ 7,743	\$ 140	\$ 19,135

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment, based on the impairment method at the following period ends:

	March 31, 2018			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 1,600	\$ —	\$ —	\$ 1,600
Collectively evaluated for impairment	9,565	8,858	116	18,539
Acquired with deteriorated credit quality	—	—	—	—
Total allowance balance	\$ 11,165	\$ 8,858	\$ 116	\$ 20,139
Loans:				
Individually evaluated for impairment	\$ 3,171	\$ 865	\$ —	\$ 4,036
Collectively evaluated for impairment	569,619	1,007,107	10,958	1,587,684
Acquired with deteriorated credit quality	—	—	—	—
Total loan balance	\$ 572,790	\$ 1,007,972	\$ 10,958	\$ 1,591,720

	December 31, 2017			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 290	\$ —	\$ —	\$ 290
Collectively evaluated for impairment	10,318	8,950	100	19,368
Acquired with deteriorated credit quality	—	—	—	—
Total allowance balance	\$ 10,608	\$ 8,950	\$ 100	\$ 19,658
Loans:				
Individually evaluated for impairment	\$ 1,775	\$ 998	\$ 1	\$ 2,774
Collectively evaluated for impairment	571,521	996,488	12,394	1,580,403
Acquired with deteriorated credit quality	—	—	—	—

Total loan balance	\$ 573,296	\$ 997,486	\$ 12,395	\$ 1,583,177
--------------------	------------	------------	-----------	--------------

Table of Contents

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of March 31, 2018 and December 31, 2017. The recorded investment included in the following table represents loan principal net of any partial charge-offs recognized on the loans. The unpaid principal balance represents the recorded balance prior to any partial charge-offs. The recorded investment in consumer loans collateralized by residential real estate property that are in process of foreclosure according to local requirements of the applicable jurisdiction are not material as of the periods indicated:

	March 31, 2018			December 31, 2017		
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
(Dollars in thousands)						
With no related allowance recorded:						
Commercial	\$ 1,285	\$ 1,254	\$ —	\$ 1,243	\$ 1,243	\$ —
Real estate:						
CRE	501	501	—	500	500	—
Land and construction	—	—	—	138	119	—
Home Equity	364	364	—	379	379	—
Consumer	—	—	—	1	1	—
Total with no related allowance recorded	2,150	2,119	—	2,261	2,242	—
With an allowance recorded:						
Commercial	1,931	1,917	1,600	589	532	290
Total with an allowance recorded	1,931	1,917	1,600	589	532	290
Total	\$ 4,081	\$ 4,036	\$ 1,600	\$ 2,850	\$ 2,774	\$ 290

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

	Three Months Ended March 31, 2018					Total
	Commercial	CRE	Land and Construction	Home Equity	Consumer	
(Dollars in thousands)						
Average of impaired loans during the period	\$ 2,474	\$ 501	\$ 59	\$ 371	\$ 1	\$ 3,406
Interest income during impairment	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Cash-basis interest recognized	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —

	Three Months Ended March 31, 2017					
	Real Estate					
	Commercial CRE		Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	\$ 3,239	\$ 665	\$ 197	\$ 259	\$ 2	\$ 4,362
Interest income during impairment	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Cash-basis interest recognized	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —

Table of Contents

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:

	March 31, 2018	March 31, 2017	December 31, 2017
	(Dollars in thousands)		
Nonaccrual loans - held-for-investment	\$ 3,637	\$ 5,200	\$ 2,250
Restructured and loans over 90 days past due and still accruing	158	207	235
Total nonperforming loans	3,795	5,407	2,485
Other restructured loans	241	126	289
Total impaired loans	\$ 4,036	\$ 5,533	\$ 2,774

The following table presents the nonperforming loans by class for the periods indicated:

	March 31, 2018			December 31, 2017		
	Nonaccrual (Dollars in thousands)	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
Commercial Real estate:	\$ 2,772	\$ 158	\$ 2,930	\$ 1,250	\$ 235	\$ 1,485
CRE	501	—	501	501	—	501
Land and construction	—	—	—	119	—	119
Home equity	364	—	364	379	—	379
Consumer	—	—	—	1	—	1
Total	\$ 3,637	\$ 158	\$ 3,795	\$ 2,250	\$ 235	\$ 2,485

The following tables present the aging of past due loans by class for the periods indicated:

	March 31, 2018			Total Past Due	Loans Not Past Due	Total
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due			
Commercial	\$ 4,495	\$ 877	\$ 1,267	\$ 6,639	\$ 566,151	\$ 572,790

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Real estate:						
CRE	—	—	501	501	775,046	775,547
Land and construction	—	—	—	—	113,470	113,470
Home equity	775	—	—	775	75,312	76,087
Residential mortgages	—	—	—	—	42,868	42,868
Consumer	—	—	—	—	10,958	10,958
Total	\$ 5,270	\$ 877	\$ 1,768	\$ 7,915	\$ 1,583,805	\$ 1,591,720

	December 31, 2017					
	30 - 59	60 - 89	90 Days or	Total	Loans Not	Total
	Days	Days	Greater	Past Due	Past Due	
	Past Due	Past Due	Past Due			
	(Dollars in thousands)					
Commercial	\$ 4,288	\$ 1,224	\$ 589	\$ 6,101	\$ 567,195	\$ 573,296
Real estate:						
CRE	—	—	500	500	772,367	772,867
Land and construction	—	—	119	119	100,763	100,882
Home equity	223	—	—	223	78,953	79,176
Residential mortgages	—	—	—	—	44,561	44,561
Consumer	—	—	—	—	12,395	12,395
Total	\$ 4,511	\$ 1,224	\$ 1,208	\$ 6,943	\$ 1,576,234	\$ 1,583,177

Table of Contents

Past due loans 30 days or greater totaled \$7,915,000 and \$6,943,000 at March 31, 2018 and December 31, 2017, respectively, of which \$2,357,000 and \$1,410,000 were on nonaccrual, respectively. At March 31, 2018, there were also \$1,280,000 of loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2017, there were also \$840,000 of 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.

Credit Quality Indicators

Concentrations of credit risk arise when a number of customers are engaged in similar business activities, or activities in the same geographic region, or have similar features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions. The Company's loan portfolio is concentrated in commercial (primarily manufacturing, wholesale, and service) and real estate lending, with the remaining 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 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, and it is probable that the Company will not receive payment of the full contractual principal and interest. Loans so classified have a well defined weakness or

weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. In addition, the Company no longer accrues interest on the loan because of the underlying weaknesses.

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

Loss. Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for loan losses. Therefore, there is no balance to report at March 31, 2018 and December 31, 2017.

Table of Contents

The following table provides a summary of the loan portfolio by loan type and credit quality classification at period end:

	March 31, 2018			December 31, 2017		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
Commercial	\$ 548,538	\$ 24,252	\$ 572,790	\$ 554,913	\$ 18,383	\$ 573,296
Real estate:						
CRE	769,707	5,840	775,547	766,988	5,879	772,867
Land and construction	113,470	—	113,470	100,763	119	100,882
Home equity	75,416	671	76,087	78,486	690	79,176
Residential mortgages	42,868	—	42,868	44,561	—	44,561
Consumer	10,958	—	10,958	12,394	1	12,395
Total	\$ 1,560,957	\$ 30,763	\$ 1,591,720	\$ 1,558,105	\$ 25,072	\$ 1,583,177

The increase in classified assets at March 31, 2018 was primarily due to seasonal advances on lines of credit associated with a lending relationship that was moved to classified loans in the fourth quarter of 2017, which totaled \$20.2 million at March 31, 2018, compared to \$12.5 million at December 31, 2017. 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 in accordance with the Company's underwriting policy.

The balance of troubled debt restructurings at March 31, 2018 was \$323,000, which included \$16,000 of nonaccrual loans and \$307,000 of accruing loans. The balance of troubled debt restructurings at December 31, 2017 was \$325,000, which included \$16,000 of nonaccrual loans and \$309,000 of accruing loans. Approximately \$2,500 and \$2,000 of specific reserves were established with respect to these loans as of March 31, 2018 and December 31, 2017.

There were no new loans modified as troubled debt restructurings during the three months ended March 31, 2018 and 2017.

During the three months ended March 31, 2018, there were no troubled debt restructurings in which the amount of principal or accrued interest owed from the borrower was forgiven or which resulted in a charge-off or change to the allowance for loan losses. The Company has committed to lend no additional amounts as of March 31, 2018 to customers with outstanding loans that are classified as troubled debt restructurings.

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 ended March 31, 2018 and 2017.

A loan that is a troubled debt restructuring on nonaccrual status may return to accruing status after a period of at least six months of consecutive payments in accordance with the modified terms.

6) Goodwill and Other Intangible Assets

Goodwill

At March 31, 2018, the carrying value of goodwill was \$45,664,000, which included \$13,044,000 of goodwill related to its acquisition of Bay View Funding and \$32,620,000 from its acquisition of Focus Business Bank (“Focus”).

Goodwill impairment exists when a reporting unit’s carrying value exceeds its fair value, which is determined through a qualitative assessment whether it is more likely than not that the fair value of equity of the reporting unit exceeds the carrying value (“Step Zero”). If the qualitative assessment indicates it is more likely than not that the fair value of equity of a reporting unit is less than book value, then a quantitative two-step impairment test is required. Step 1 includes the determination of the carrying value of the Company’s single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying

Table of Contents

amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess.

The Company completed its annual impairment analysis on the goodwill from the Bay View Funding and Focus acquisitions as of November 30, 2017 with the assistance of an independent valuation firm. Based on the Step Zero qualitative analysis performed, the Company determined that it is more likely than not that the fair value of the reporting unit exceeded its reported book value of equity at November 30, 2017. As such, no impairment was indicated and no further testing was required.

Other Intangible Assets

The core deposit intangible asset acquired in the acquisition of Focus in August 2015 was \$6,285,000. This asset is amortized over its estimated useful life of 10 years. Accumulated amortization of this intangible asset was \$2,189,000 and \$1,995,000 at March 31, 2018 and December 31, 2017, respectively.

Other intangible assets acquired in the acquisition of Bay View Funding in November 2014 included: a below market value lease intangible asset of \$109,000 (amortized over 3 years), customer relationship and brokered relationship intangible assets of \$1,900,000, (amortized over the 10 year estimated useful lives), and a non-compete agreement intangible asset of \$250,000 (amortized over 3 years). Accumulated amortization of the customer relationship and brokered relationship intangible assets was \$648,000 and \$601,000 at March 31, 2018 and December 31, 2017, respectively. The below market lease and non-compete agreement intangible assets were fully amortized at December 31, 2017.

Estimated amortization expense for 2018, the next five years and thereafter is as follows:

Year	Bay View Funding Customer & Brokered		Total Amortization Expense
	Focus Core Deposit Intangible (Dollars in thousands)	Relationship Intangible	
2018	\$ 775	\$ 190	\$ 965
2019	734	190	924
2020	716	190	906
2021	596	190	786
2022	502	190	692

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

2023	420	190	610
Thereafter	547	159	706
	\$ 4,290	\$ 1,299	\$ 5,589

Impairment testing of the intangible assets is performed at the individual asset level. Impairment exists if the carrying amount of the asset is not recoverable and exceeds its fair value at the date of the impairment test. For intangible assets, estimates of expected future cash flows (cash inflows less cash outflows) that are directly associated with an intangible asset are used to determine the fair value of that asset. Management makes certain estimates and assumptions in determining the expected future cash flows from core deposit and customer relationship intangibles including account attrition, expected lives, discount rates, interest rates, servicing costs and other factors. Significant changes in these estimates and assumptions could adversely impact the valuation of these intangible assets. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset. Based on its assessment, management concluded that there was no impairment of intangible assets at March 31, 2018 and December 31, 2017.

Table of Contents

7) Income Taxes

On December 22, 2017, the Tax Act was signed into law, which among other items reduces the federal corporate tax rate to 21% from 35%, effective January 1, 2018.

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 current 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.

Under generally accepted accounting principles, a valuation allowance is required 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 \$18,588,000, and \$16,247,000, at March 31, 2018, and December 31, 2017, 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 assets at March 31, 2018 and December 31, 2017 will be fully realized in future years.

The following table reflects the carry amounts of the low income housing investments included in accrued interest receivable and other assets, and the future commitments included in accrued interest payable and other liabilities for the periods indicated:

	March 31, 2018	Decemebr 31, 2017
	(Dollars in thousands)	
Low income housing investments	\$ 3,292	\$ 3,411
Future commitments	\$ 290	\$ 302

The Company expects future commitments of \$1,000 to be paid in 2018, and \$289,000 in 2019 through 2023.

For tax purposes, the Company had low income housing tax credits of \$106,000 and \$110,000 for the three months ended March 31, 2018 and March 31, 2017, respectively, and low income housing investment losses of \$119,000 and \$115,000, respectively. The Company recognized low income housing investment expense as a component of income tax expense.

8) Benefit Plans

Supplemental Retirement Plan

The Company has a supplemental retirement plan (the “Plan”) covering some current and some former key employees 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 March 31, 2018 2017 (Dollars in thousands)	
Components of net periodic benefit cost:		
Service cost	\$ 62	\$ 81
Interest cost	237	259
Amortization of net actuarial loss	73	69
Net periodic benefit cost	\$ 372	\$ 409

Table of Contents

Split Dollar Life Insurance Benefit Plan

The Company maintains life insurance policies for some current and some former directors and officers that are subject to split dollar life insurance agreements. The following table sets forth the funded status of the split dollar life insurance benefits for the periods indicated:

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$ 6,711	\$ 6,301
Interest cost	57	243
Actuarial (gain) loss	—	167
Projected benefit obligation at end of period	\$ 6,768	\$ 6,711

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Net actuarial loss	\$ 2,491	\$ 2,453
Prior transition obligation	1,216	1,238
Accumulated other comprehensive loss	\$ 3,707	\$ 3,691

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Amortization of prior transition obligation	\$ (16)	\$ (18)
Interest cost	57	61
Net periodic benefit cost	\$ 41	\$ 43

9) Fair Value

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

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

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

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).

Table of Contents

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).

	Balance (Dollars in thousands)	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets at March 31, 2018				
Available-for-sale securities:				
Agency mortgage-backed securities	\$ 344,766	—	\$ 344,766	—
I/O strip receivables	945	—	945	—
Assets at December 31, 2017				
Available-for-sale securities:				
Agency mortgage-backed securities	\$ 374,733	—	\$ 374,733	—
Trust preferred securities	17,119	—	17,119	—
I/O strip receivables	968	—	968	—

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 impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. The appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Foreclosed assets are valued at the time the loan is foreclosed upon and the asset is transferred to foreclosed assets. The fair value is based primarily on third party appraisals, less costs to sell. The appraisals may utilize a single valuation approach or a combination of approaches including the comparable sales and income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

	Fair Value Measurements Using			
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets at March 31, 2018				
Impaired loans - held-for-investment:				
Commercial	\$ 342	—	—	\$ 342
	\$ 342	—	—	\$ 342
Assets at December 31, 2017				
Impaired loans - held-for-investment:				
Commercial	\$ 242	—	—	\$ 242
Real estate:				
Land and construction	119	—	—	119
	\$ 361	—	—	\$ 361

Table of Contents

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:

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	\$ 1,942	\$ 651
Book value of impaired loans held-for-investment carried at cost	2,094	2,123
Total impaired loans held-for-investment	\$ 4,036	\$ 2,774
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	\$ 1,942	\$ 651
Specific valuation allowance	(1,600)	(290)
Impaired loans held-for-investment carried at fair value, net	\$ 342	\$ 361

Impaired loans held for investment which are measured primarily for impairment using the fair value of the collateral were \$4,036,000 at March 31, 2018. In addition, these loans had a specific valuation allowance of \$1,600,000 at March 31, 2018. Impaired loans held for investment totaling \$1,942,000 at March 31, 2018, were carried at fair value as a result of the aforementioned partial charge offs and specific valuation allowances at period end. The remaining \$2,094,000 of impaired loans were carried at cost at March 31, 2018, 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 three months of 2018 on impaired loans held for investment carried at fair value at March 31, 2018 resulted in an additional provision for loan losses of \$1,331,000.

At March 31, 2018, there were no foreclosed assets.

Impaired loans held for investment were \$2,774,000 at December 31, 2017. There were no partial charge offs at December 31, 2017. In addition, these loans had a specific valuation allowance of \$290,000 at December 31, 2017. Impaired loans held for investment totaling \$651,000 at December 31, 2017 were carried at fair value as a result of the aforementioned partial charge offs and specific valuation allowances at year end. The remaining \$2,123,000 of impaired loans were carried at cost at December 31, 2017, 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 2017 on impaired loans held for investment carried at fair value at December 31, 2017 resulted in an additional provision for loan losses of \$254,000.

At December 31, 2017, there were no foreclosed assets

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

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 the periods indicated:

	March 31, 2018			
	Valuation	Unobservable		Range
	Fair Value Techniques	Inputs		(Weighted Average)
	(Dollars in thousands)			
Impaired loans - held-for-investment: Commercial	\$ 342	Market Approach	Discount adjustment for differences between comparable sales	Less than 1 %

Table of Contents

	December 31, 2017		Unobservable	Range
	Fair Value	Valuation Techniques	Inputs	(Weighted Average)
	(Dollars in thousands)			
Impaired loans - held-for-investment:				
Commercial	\$ 242	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%
Real estate:				
Land and construction	119	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%

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.

The carrying amounts and estimated fair values of financial instruments at March 31, 2018 are as follows:

	Carrying Amounts (Dollars in thousands)	Estimated Fair Value			Total
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets:					
Cash and cash equivalents	\$ 301,989	\$ 301,989	\$ —	\$ —	\$ 301,989
Securities available-for-sale	344,766	—	344,766	—	344,766
Securities held-to-maturity	395,274	—	383,637	—	383,637
Loans (including loans held-for-sale), net	1,573,921	—	2,859	1,558,196	1,561,055
FHLB stock, FRB stock, and other investments	17,917	—	—	—	N/A
Accrued interest receivable	7,896	—	2,267	5,629	7,896
I/O strips receivables	945	—	945	—	945

Liabilities:

Time deposits	\$ 125,548	\$ —	\$ 125,709	\$ —	\$ 125,709
Other deposits	2,296,644	—	2,296,644	—	2,296,644
Subordinated debt	39,229	—	39,809	—	39,809
Accrued interest payable	895	—	895	—	895

Table of Contents

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2017:

	Carrying Amounts (Dollars in thousands)	Estimated Fair Value			Total
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets:					
Cash and cash equivalents	\$ 316,222	\$ 316,222	\$ —	\$ —	\$ 316,222
Securities available-for-sale	391,852	—	391,852	—	391,852
Securities held-to-maturity	398,341	—	394,292	—	394,292
Loans (including loans held-for-sale), net	1,566,428	—	3,419	1,507,967	1,511,386
FHLB stock, FRB stock, and other investments	17,911	—	—	—	N/A
Accrued interest receivable	7,985	—	2,423	5,562	7,985
I/O strips receivables	968	—	968	—	968
Liabilities:					
Time deposits	\$ 194,561	\$ —	\$ 194,844	\$ —	\$ 194,844
Other deposits	2,288,428	—	2,288,428	—	2,288,428
Subordinated debt	39,183	—	40,384	—	40,384
Accrued interest payable	389	—	389	—	389

The methods and assumptions, not previously discussed, used to estimate the fair value of loans, including loans held-for-sale, are described as follows:

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

The Company adopted ASU No. 2016-01, effective January 1, 2018. Adoption of the standard resulted in the use of an exit price rather than an entrance price to determine the fair value of loans, excluding loans held-for-sale, using discounted cash flow analyses as of March 31, 2018. The discount rates used to determine fair value use interest rate spreads that reflect factors such as liquidity, credit, and nonperformance risk of the loans, resulting in a level 3 classification.

Fair values of loans, excluding loans held-for-sale, were estimated as follows as of December 31, 2017: 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. The methods utilized to estimate the fair value of loans as of December 31, 2017 do not necessarily represent an exit price.

Impaired loans as of March 31, 2018 and December 31, 2017 are valued at the lower of cost or fair value as described previously.

10) Equity Plan

The Company maintained an Amended and Restated 2004 Equity Plan (the “2004 Plan”) for directors, officers, and key employees. The 2004 Plan was terminated on May 23, 2013. On May 23, 2013, the Company’s shareholders approved the 2013 Equity Incentive Plan (the “2013 Plan”). On May 25, 2017, the shareholders approved an amendment to the Heritage Commerce Corp 2013 Equity Incentive Plan to increase the number of shares available from 1,750,000 to 3,000,000 shares. The equity plans provide for the grant of incentive and nonqualified stock options and restricted stock. The equity plans provide that the option price for both incentive and nonqualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally options vest over four years. All options expire no later than ten years from the date of grant. Restricted stock is subject to time vesting. For the three months ended March 31, 2018, the Company granted 10,000 shares of nonqualified stock options and no shares of restricted stock. There were 1,518,099 shares available for the issuance of equity awards under the 2013 Plan as of March 31, 2018.

Table of Contents

Stock option activity under the equity plans is as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Total Stock Options				
Outstanding at January 1, 2018	1,602,732	\$ 9.54		
Granted	10,000	\$ 15.96		
Exercised	(68,906)	\$ 7.79		
Forfeited or expired	(3,000)	\$ 16.00		
Outstanding at March 31, 2018	1,540,826	\$ 9.64	6.18	\$ 10,624,596
Vested or expected to vest	1,448,376		6.18	\$ 9,987,120
Exercisable at March 31, 2018	1,101,536		5.26	\$ 8,764,801

Information related to the equity plans for the periods indicated:

	Three Months Ended March 31,	
	2018	2017
Intrinsic value of options exercised	\$ 560,332	\$ 375,122
Cash received from option exercise	\$ 449,294	\$ 365,031
Tax benefit realized from option exercises	\$ 164,978	\$ 155,648
Weighted average fair value of options granted	\$ 3.00	N/A

As of March 31, 2018, there was \$1,102,000 of total unrecognized compensation cost related to nonvested stock options granted under the equity plans. That cost is expected to be recognized over a weighted average period of approximately 2.47 years.

The fair value of each option grant is estimated on the date of grant using the Black Scholes option pricing model that uses the assumptions noted in the following table, including the weighted average assumptions for the option grants for the periods indicated:

	Three Months Ended March 31,	
	2018	2017
Expected life in months(1)	72	N/A
Volatility(1)	22 %	N/A
Weighted average risk-free interest rate(2)	2.58 %	N/A
Expected dividends(3)	2.51 %	N/A

- (1) The expected life of employee stock options represents the weighted average period the stock options are expected to remain outstanding based on historical experience. Volatility is based on the historical volatility of the stock price over the same period of the expected life of the option.
- (2) Based on the U.S. Treasury constant maturity interest rate with a term consistent with the expected life of the option granted.
- (3) Each grant's dividend yield is calculated by annualizing the most recent quarterly cash dividend and dividing that amount by the market price of the Company's common stock as of the grant date
-

Table of Contents

Restricted stock activity under the equity plans is as follows:

	Number	Weighted Average Grant Date Fair Value
Total Restricted Stock Award		
Nonvested shares at January 1, 2018	181,185	\$ 11.66
Vested	(5,000)	\$ 8.30
Nonvested shares at March 31, 2018	176,185	\$ 11.75

As of March 31, 2018, there was \$1,359,000 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the equity plans. The cost is expected to be recognized over a weighted average period of approximately 2.14 years.

11) Subordinated Debt

On May 26, 2017, the Company completed an underwritten public offering of \$40,000,000 aggregate principal amount of its fixed-to-floating rate subordinated notes (“Subordinated Debt”) due June 1, 2027. The Subordinated Debt initially bears a fixed interest rate of 5.25% per year. Commencing on June 1, 2022, the interest rate on the Subordinated Debt resets quarterly to the three-month LIBOR rate plus a spread of 336.5 basis points, payable quarterly in arrears. Interest on the Subordinated Debt is payable semi-annually on June 1 and December 1 of each year through June 1, 2022 and quarterly thereafter on March 1, June 1, September 1 and December 1 of each year through the maturity date or early redemption date. The Company at its option may redeem the Subordinated Debt, in whole or in part, on any interest payment date on or after June 1, 2022 without a premium.

12) Capital Requirements

The Company and its subsidiary bank are subject to various regulatory capital requirements administered by the banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Company’s financial statements and operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and HBC must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off balance sheet items as calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. There are no conditions or events since March 31, 2018, that management believes have changed the categorization of the Company or HBC as “well-capitalized.”

As of January 1, 2015, HCC and HBC along with other community banking organizations became subject to new capital requirements and certain provisions of the new rules will be phased in from 2015 through 2019. The Federal Banking regulators approved the new rules to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of The Dodd Frank

Wall Street Reform and Consumer Protection Act of 2010, as amended. The new capital rules establish a “capital conservation buffer,” which must consist entirely of common equity Tier 1 capital. The capital conservation buffer is to be phased-in over four years beginning on January 1, 2016. The buffer will be 0.625% of risk-weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. The Company and HBC must maintain a capital conservation buffer above the minimum risk-based capital requirements in order to avoid certain limitations on capital distributions, stock repurchases and discretionary bonus payments to executive officers. The Company’s consolidated capital ratios and the Bank’s capital ratios exceeded the regulatory guidelines for a well-capitalized financial institution under the Basel III regulatory requirements at March 31, 2018.

Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios (set forth in the tables below) of total, Tier 1 capital, and common equity Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of March 31, 2018 and December 31, 2017, the Company and HBC met all capital adequacy guidelines to which they were subject.

Table of Contents

The Company's consolidated capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of March 31, 2018, and December 31, 2017.

	Actual		Required For Capital Adequacy Purposes Under Basel III		
	Amount	Ratio	Amount	Ratio (1)	
	(Dollars in thousands)				
As of March 31, 2018					
Total Capital (to risk-weighted assets)	\$ 292,906	14.7 %	\$ 197,404	9.875	%
Tier 1 Capital (to risk-weighted assets)	\$ 232,905	11.7 %	\$ 157,423	7.875	%
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 232,905	11.7 %	\$ 127,438	6.375	%
Tier 1 Capital (to average assets)	\$ 232,905	8.6 %	\$ 108,864	4.000	%

(1) Includes 1.875% capital conservation buffer, effective January 1, 2018, except the Tier 1 Capital to average assets ratio.

	Actual		Required For Capital Adequacy Purposes Under Basel III		
	Amount	Ratio	Amount	Ratio (1)	
	(Dollars in thousands)				
As of December 31, 2017					
Total Capital (to risk-weighted assets)	\$ 288,754	14.4 %	\$ 185,338	9.250	%
Tier 1 Capital (to risk-weighted assets)	\$ 229,258	11.4 %	\$ 145,265	7.250	%
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 229,258	11.4 %	\$ 115,210	5.750	%
Tier 1 Capital (to average assets)	\$ 229,258	8.0 %	\$ 114,959	4.000	%

(1) Includes 1.25% capital conservation buffer, effective January 1, 2017, except the Tier 1 Capital to average assets ratio.

Table of Contents

HBC's actual capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of March 31, 2018, and December 31, 2017.

	Actual		To Be Well-Capitalized Under Basel III Regulatory Requirements				Required For Capital Adequacy Purposes Under Basel III	
	Amount (Dollars in thousands)	Ratio	Amount	Ratio	Amount	Ratio (1)	Amount	Ratio (1)
As of March 31, 2018								
Total Capital (to risk-weighted assets)	\$ 269,644	13.5 %	\$ 199,778	10.0 %	\$ 197,280	9.875 %		
Tier 1 Capital (to risk-weighted assets)	\$ 248,872	12.5 %	\$ 159,822	8.0 %	\$ 157,325	7.875 %		
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 248,872	12.5 %	\$ 129,855	6.5 %	\$ 127,358	6.375 %		
Tier 1 Capital (to average assets)	\$ 248,872	9.1 %	\$ 136,019	5.0 %	\$ 108,815	4.000 %		

(1) Includes 1.875% capital conservation buffer, effective January 1, 2018, except the Tier 1 Capital to average assets ratio.

	Actual		To Be Well-Capitalized Under Basel III Regulatory Requirements				Required For Capital Adequacy Purposes Under Basel III	
	Amount (Dollars in thousands)	Ratio	Amount	Ratio	Amount	Ratio (1)	Amount	Ratio (1)
As of December 31, 2017								
Total Capital (to risk-weighted assets)	\$ 265,102	13.2 %	\$ 200,274	10.0 %	\$ 185,253	9.250 %		
Tier 1 Capital (to risk-weighted assets)	\$ 244,790	12.2 %	\$ 160,219	8.0 %	\$ 145,198	7.250 %		
Common Equity Tier 1 Capital (to risk-weighted assets)	\$ 244,790	12.2 %	\$ 130,178	6.5 %	\$ 115,157	5.750 %		
Tier 1 Capital (to average assets)	\$ 244,790	8.5 %	\$ 143,655	5.0 %	\$ 114,924	4.000 %		

- (1) Includes 1.25% capital conservation buffer, effective January 1, 2017, except the Tier 1 Capital to average assets ratio.
-

The Subordinated Debt, net of unamortized issuance costs, totaled \$39,229,000 at March 31, 2018, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank.

Under California General Corporation Law, the holders of common stock are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available. The California Financial Code provides that a state licensed bank may not make a cash distribution to its shareholders in excess of the lesser of the following: (i) the bank's retained earnings; or (ii) the bank's net income for its last three fiscal years, less the amount of any distributions made by the bank to its shareholders during such period. However, a bank, with the prior approval of the Commissioner of the California Department of Business Oversight—Division of Financial Institutions ("DBO") may make a distribution to its shareholders of an amount not to exceed the greater of (i) a bank's retained earnings; (ii) its net income for its last fiscal year; or (iii) its net income for the current fiscal year. Also with the prior approval of the Commissioner of the DBO and the shareholders of the bank, the bank may make a distribution to its shareholders, as a reduction in capital of the bank. In the event that the Commissioner determines that the shareholders' equity of a bank is inadequate or that the making of a distribution by a bank would be unsafe or unsound, the Commissioner may order a bank to refrain from making such a proposed distribution. As of March 31, 2018, HBC would not be required to obtain regulatory approval, and the amount available for cash dividends is \$35,057,000. Similar restrictions applied to the

Table of Contents

amount and sum of loan advances and other transfers of funds from HBC to the parent company. HBC distributed dividends to HCC totaling \$4,000,000 for the three month ended March 31, 2018.

13) Loss Contingencies

The Company is involved in certain legal actions arising from normal business activities. Management, based upon the advice of legal counsel, believes the ultimate resolution of all pending legal actions will not have a material effect on the financial statements of the Company.

14) Revenue Recognition

On January 1, 2018, the Company adopted ASU No. 2014-09 (Topic 606) and all subsequent ASUs that modified Topic 606. As stated in Note 1 Basis of Presentation, the implementation of the new standard did not have a material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts were not adjusted and continue to be reported in accordance with our historic accounting under Topic 606.

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as fees associated with mortgage servicing rights, financial guarantees, gain on sale of securities, bank owned life insurance, gain on sales of SBA loans, and certain credit card fees are also not in scope of the new guidance. Topic 606 is applicable to noninterest revenue streams such as deposit related fees, interchange fees, and merchant income. However, the recognition of these revenue streams did not change significantly upon adoption of Topic 606. Substantially all of the Company's revenue is generated from contracts with customers. Noninterest revenue streams in-scope of Topic 606 are discussed below.

Service Charges on Deposit Accounts

Service charges on deposit accounts consist of account analysis fees (i.e., net fees earned on analyzed business and public checking accounts), monthly service fees, check orders, and other deposit account related fees. We sometimes charge customers fees that are not specifically related to the customer accessing its funds, such as account maintenance or dormancy fees. The amount of deposit fees assessed varies based on a number of factors, such as the type of customer and account, the quantity of transactions, and the size of the deposit balance. We charge, and in some circumstances do not charge, fees to earn additional revenue and influence certain customer behavior. An example would be where we do not charge a monthly service fee, or do not charge for certain transactions, for customers that

have a high deposit balance. Deposit fees are considered either transactional in nature (such as wire transfers, nonsufficient fund fees, and stop payment orders) or non-transactional (such as account maintenance and dormancy fees). These fees are recognized as earned or as transactions occur and services are provided. Check orders and other deposit account related fees are largely transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers' accounts.

Interchange Revenue

Interchange revenue primarily consists of interchange fees, volume-related incentives and ATM charges. As the card-issuing bank, interchange fees represent our portion of discount fees paid by merchants for credit / debit card transactions processed through the interchange network. The levels and structure of interchange rates are set by the credit card companies and are based on cardholder purchase volumes. The Company earns interchange income as cardholder transactions occur and interchange fees are settled on a daily basis. Since interchange fees are settled on a daily basis, the Company believes the application of Topic 606 to interchange fees would likely not lead to significantly different recognition and measurement outcomes when compared to our current accounting practice. In addition, the Company will continue to consider any constraint on the variability of consideration due to returns, refunds and chargebacks. ATM charges consist of fees received from non-customers using a bank-owned ATM and fees received for customers using a nonbank-owned ATM. These fees are earned when these types of ATM transactions occur.

Table of Contents

Merchant Services Revenue

Revenue from the Company's merchant services business consists principally of transaction and account management fees charged to merchants for the electronic processing of transactions. These fees are net of interchange fees paid to the credit card issuing bank, card company assessments, and revenue sharing amounts.

Based on the insignificant level of merchant services revenue, the Company has concluded that the application of Topic 606 to merchant services account management fees would likely not lead to significantly different recognition and measurement outcomes when compared to our current accounting practice. As a result, revenue from account management fees will continue to be recognized by the Company at the end of each month since the end of this measurement period allows us to reliably measure our progress towards completion of our performance obligation.

Other

Noninterest miscellaneous fees consist of charges for various other services including safe deposit box rentals, wire transfers, check cashing, telephone transfers, and online business banking. Given the insignificance of these amounts individually and in total, further consideration of these revenue streams under Topic 606 is not considered necessary.

The following presents noninterest income, segregated by revenue streams in-scope and out-of-scope of Topic 606, for the periods indicated.

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Noninterest Income In-scope of Topic 606:		
Service charges and fees on deposit accounts	\$ 478	\$ 465
Interchange fees	73	62
Merchant services revenue	44	46
Other	148	152
Total noninterest income in-scope of Topic 606	743	725
Noninterest Income Out-of-scope of Topic 606	1,452	1,570
Total noninterest income	\$ 2,195	\$ 2,295

15) Noninterest Expense

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

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Salaries and employee benefits	\$ 9,777	\$ 9,486
Occupancy and equipment	1,106	1,068
Professional fees	684	1,071
Acquisition and integration related costs	615	—
Software subscriptions	593	417
Insurance expense	407	352
Data processing	353	383
Other	2,455	2,551
Total	\$ 15,990	\$ 15,328

Table of Contents

16) Business Segment Information

The following presents the Company's operating segments. The Company operates through two business segments: Banking segment and Factoring segment. Transactions between segments consist primarily of borrowed funds. Intersegment interest expense is allocated to the Factoring segment based on the Company's prime rate and funding costs. The provision for loan loss is allocated based on the segment's allowance for loan loss determination which considers the effects of charge-offs. Noninterest income and expense directly attributable to a segment are assigned to it. Taxes are paid on a consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring originated by Bay View Funding.

	Three Months Ended March 31, 2018		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 24,731	\$ 3,146	\$ 27,877
Intersegment interest allocations	327	(327)	—
Total interest expense	1,529	—	1,529
Net interest income	23,529	2,819	26,348
Provision for loan losses	488	18	506
Net interest income after provision	23,041	2,801	—25,842
Noninterest income	2,086	109	2,195
Noninterest expense	14,467	1,523	15,990
Intersegment expense allocations	175	(175)	—
Income before income taxes	10,835	1,212	12,047
Income tax expense	2,880	358	3,238
Net income	\$ 7,955	\$ 854	\$ 8,809
Total assets	\$ 2,722,472	\$ 63,076	\$ 2,785,548
Loans, net of deferred fees	\$ 1,541,466	\$ 49,735	\$ 1,591,201
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

	Three Months Ended March 31, 2017		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 21,969	\$ 2,728	\$ 24,697
Intersegment interest allocations	260	(260)	—
Total interest expense	871	—	871
Net interest income	21,358	2,468	23,826
Provision for loan losses	311	10	321
Net interest income after provision	21,047	2,458	23,505
Noninterest income	2,115	180	2,295

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Noninterest expense	13,579	1,749	15,328
Intersegment expense allocations	133	(133)	—
Income before income taxes	9,716	756	10,472
Income tax expense	3,616	318	3,934
Net income	\$ 6,100	\$ 438	\$ 6,538
<hr/>			
Total assets	\$ 2,584,288	\$ 57,503	\$ 2,641,791
Loans, net of deferred fees	\$ 1,470,450	\$ 42,837	\$ 1,513,287
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

(1) Includes the holding company's results of operations

Table of Contents

17) Subsequent Events

The Company completed its previously announced merger of its wholly-owned bank subsidiary Heritage Bank of Commerce with Tri-Valley Bank (“Tri-Valley”) effective as of the close of business on April 6, 2018. The merger, which was first announced on December 20, 2017, was concluded following receipt of approval from Tri-Valley shareholders and all required regulatory approvals. Tri-Valley will be reflected in the Company’s results of operations in the second quarter of 2018.

Tri-Valley was a full-service California state-chartered commercial bank with branches in San Ramon and Livermore, California and served businesses and individuals primarily in Contra Costa and Alameda counties in Northern California. The Company has applied to close the San Ramon office in the third quarter of 2018.

The Company completed its previously announced merger of its wholly-owned bank subsidiary Heritage Bank of Commerce with United American Bank (“United American”) effective as of the close of business on May 4, 2018. The merger, which was first announced on January 11, 2018, was concluded following receipt of approval from United American shareholders and all required regulatory approvals. United American will be reflected in the Company’s results of operations in the second quarter of 2018.

United American Bank was a full-service commercial bank located in San Mateo County with full-service branches located in San Mateo, Redwood City and Half Moon Bay, California and serviced businesses, professionals and individuals. The Company has applied to close the Half Moon Bay office in the third quarter of 2018.

At March 31, 2018, Tri-Valley had approximately \$150.3 million in assets, \$125.2 million in net loans and \$131.4 million in deposits. At March 31, 2018, United American had approximately \$319.7 million in assets, \$218.3 million in net loans and \$286.6 million in deposits. At March 31, 2018, on a pro forma consolidated basis the combined company, including the Company, Tri-Valley, and United American, would have approximately \$3.3 billion in total assets, \$1.9 billion in total loans, and \$2.8 billion in total deposits.

The transactions will be accounted for using the acquisition method of accounting which requires, among other things, that the assets acquired and liabilities assumed be recognized at their fair values as of the acquisition dates. The acquisition related disclosures required by the accounting guidance cannot be made as the initial accounting for the business transactions is incomplete. Key financial data such as the determination of the fair values of the assets acquired and liabilities assumed is not yet available.

On April 26, 2018, the Company announced that its Board of Directors declared a \$0.11 per share quarterly cash dividend to holders of common stock. The dividend will be paid on May 24, 2018 to shareholders of record on May 10, 2018.

Table of Contents

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”), its wholly owned subsidiary, Heritage Bank of Commerce (“HBC”), and HBC’s wholly owned subsidiary, CSNK Working Capital Finance Corp., a California Corporation, dba Bay View Funding (“Bay View Funding”). 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 Co and its subsidiaries.

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are discussed in our Form 10 K for the year ended December 31, 2017. There are no changes to these policies as of March 31, 2018.

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, Contra Costa, San Mateo, and San Benito. 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 March 31, 2018, net income was \$8.8 million, or \$0.23 per average diluted common share, compared to \$6.5 million, or \$0.17 per average diluted common share, for the three months ended March 31, 2017.

The Company's annualized return on average tangible assets was 1.31% and annualized return on average tangible equity was 16.30% for the three months ended March 31, 2018, compared to 1.05% and 12.69%, respectively, for the three months ended March 31, 2017.

Tri-Valley Bank and United American Bank Mergers

The Company completed its previously announced merger of its wholly-owned bank subsidiary Heritage Bank of Commerce with Tri-Valley Bank ("Tri-Valley") effective as of the close of business on April 6, 2018. The merger, which was first announced on December 20, 2017, was concluded following receipt of approval from Tri-Valley shareholders and all required regulatory approvals. Tri-Valley will be reflected in the Company's results of operations in the second quarter of 2018.

Tri-Valley was a full-service California state-chartered commercial bank with branches in San Ramon and Livermore, California and served businesses and individuals primarily in Contra Costa and Alameda counties in Northern California. The Company has applied to close the San Ramon office in the third quarter of 2018.

The Company completed its previously announced merger of its wholly-owned bank subsidiary Heritage Bank of Commerce with United American Bank ("United American") effective as of the close of business on May 4, 2018. The merger, which was first announced on January 11, 2018, was concluded following receipt of approval from United American shareholders and all required regulatory approvals. United American will be reflected in the Company's results of operations in the second quarter of 2018.

Table of Contents

United American Bank was a full-service commercial bank located in San Mateo County with full-service branches located in San Mateo, Redwood City and Half Moon Bay, California and serviced businesses, professionals and individuals. The Company has applied to close the Half Moon Bay office in the third quarter of 2018.

At March 31, 2018, Tri-Valley had approximately \$150.3 million in assets, \$125.2 million in net loans and \$131.4 million in deposits. At March 31, 2018, United American had approximately \$319.7 million in assets, \$218.3 million in net loans and \$286.6 million in deposits. At March 31, 2018, on a pro forma consolidated basis the combined company, including the Company, Tri-Valley, and United American, would have approximately \$3.3 billion in total assets, \$1.9 billion in total loans, and \$2.8 billion in total deposits. The pre-tax acquisition costs incurred by the Company related to the Tri-Valley and the United American mergers totaled \$615,000 for the first quarter of 2018, and \$671,000 for the fourth quarter of 2017.

Factoring Activities - Bay View Funding

Based in Santa Clara, California, Bay View Funding provides business-essential working capital factoring financing to various industries throughout the United States. The following table reflects selected financial information for Bay View Funding for the periods indicated:

	March 31, 2018	March 31, 2017
	(Dollars in thousands)	
Total factored receivables	\$ 49,735	\$ 42,837
Average factored receivables for the three months ended	\$ 49,071	\$ 44,770
Total full time equivalent employees	35	37

First Quarter 2018 Highlights

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

- Net interest income before provision for loan losses increased 11% to \$26.3 million for the first quarter of 2018, compared to \$23.8 million for the first quarter of 2017, primarily due to an increase in the average balance of loans and investment securities, the impact of increases in the prime rate on loan yields and overnight funds.
- For the first quarter of 2018, the fully tax equivalent ("FTE") net interest margin increased 7 basis points to 4.13% from 4.06% for the first quarter of 2017, primarily due to a higher average balance of loans and securities, in conjunction with a lower average balance of lower yielding excess funds at the Federal Reserve Bank, and the impact of increases in the prime rate on loans yields and overnight funds, partially offset by the impact from the issuance of subordinated debt during the second quarter of 2017.

- The average yield on the loan portfolio increased to 5.76% for the first quarter of 2018, compared to 5.53% for the first quarter of 2017, primarily due to increases in the prime rate, partially offset by a decrease in the accretion of the loan purchase discount into loan interest income from the Focus Business Bank (“Focus”) acquisition. The average yield on the Company’s legacy loan portfolio (excluding the purchased residential loans, purchased commercial real estate (“CRE”) loans, factored receivables portfolio, and accretion of the loan purchase discount from the Focus transaction) increased 20 basis points for the first quarter of 2018, compared to the first quarter of 2017. The average yield on the purchased residential loans was 2.73% for the first quarter of 2018, compared to 2.52% for the first quarter of 2017. The average yield on the purchased CRE loans was 3.52% for the first quarter of 2018, compared to 3.50% the first quarter of 2017.
- The accretion of the loan purchase discount in loan interest income from the Focus transaction was \$57,000 for the first quarter of 2018, compared to \$213,000 for the first quarter of 2017. The total purchase discount on loans from the Focus loan portfolio was \$5.4 million at August 20, 2015 (“the acquisition date”), of which \$1.1 million was remaining as of March 31, 2018.

Table of Contents

- There was a \$506,000 provision for loan losses for the first quarter of 2018, compared to a \$321,000 provision for loan losses for the first quarter of 2017.
- Total noninterest income was \$2.2 million for the first quarter of 2018, compared to \$2.3 million for the first quarter of 2017.
- Total noninterest expense for the first quarter of 2018 increased to \$16.0 million, compared to \$15.3 million for the first quarter of 2017, primarily due to costs related to the merger transactions and higher salaries and employee benefits as a result of annual salary increases, partially offset by lower professional fees. The pre-tax acquisition costs incurred by the Company related to the Tri-Valley and the United American mergers totaled \$615,000 for the first quarter of 2018, and \$671,000 for the fourth quarter of 2017.
- The efficiency ratio for the first quarter of 2018 was 56.02%, compared to 58.68% for the first quarter of 2017.
- Income tax expense for the first quarter of 2018 was \$3.2 million, compared to \$3.9 million for the first quarter of 2017. The effective tax rate for the first quarter of 2018 was 26.9%, compared to 37.6% for the first quarter of 2017.

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

- Cash, other investments and interest bearing deposits in other financial institutions and securities available for sale, at fair value, increased 3% to \$646.8 million at March 31, 2018, from \$629.4 million at March 31, 2017, and decreased 9% from \$708.1 million at December 31, 2017.
- At March 31, 2018, securities held to maturity, at amortized cost, totaled \$395.3 million, compared to \$341.4 million at March 31, 2017, and \$398.3 million at December 31, 2017.
- Loans, excluding loans held for sale, increased \$77.9 million, or 5%, to \$1.59 billion at March 31, 2018, compared to \$1.51 billion at March 31, 2017, which included an increase of \$78.9 million, or 6% in the Company's legacy portfolio, and an increase of \$6.9 million in the factored receivables portfolio, partially offset by a decrease of \$6.7 million in purchased residential mortgage loans, and a decrease of \$1.2 million in purchased CRE loans. Loans increased \$8.5 million, or 1%, to \$1.59 billion at March 31, 2018, compared to \$1.58 billion at December 31, 2017, which included an increase of \$9.6 million, or 1% in the Company's legacy portfolio, partially offset by decrease of \$1.7 million in purchased residential mortgage loans, and a decrease of \$291,000 in purchased CRE loans.
- Nonperforming assets ("NPAs") were \$3.8 million, or 0.14% of total assets, at March 31, 2018, compared to \$5.6 million, or 0.21% of total assets, at March 31, 2017, and \$2.5 million, or 0.09% of total assets, at December 31, 2017.
- Classified assets were \$30.8 million at March 31, 2018, compared to \$10.4 million at March 31, 2017, and \$25.1 million at December 31, 2017. The increase in classified assets at March 31, 2018 was primarily due to loans associated with a lending relationship that was moved to classified loans in the fourth quarter of 2017, which totaled \$20.2 million at March 31, 2018, compared to \$12.5 million at December 31, 2017. There were no foreclosed assets

at March 31, 2018 and December 31, 2017, compared to foreclosed assets of \$183,000 at March 31, 2017.

- Net charge-offs totaled \$25,000 for the first quarter of 2018, compared to net charge-offs of \$275,000 for the first quarter of 2017, and net recoveries of \$201,000 for the fourth quarter of 2017.
- The allowance for loan losses at March 31, 2018 was \$20.1 million, or 1.27% of total loans, representing 530.67% of nonperforming loans. The allowance for loan losses at March 31, 2017 was \$19.1 million, or 1.26% of total loans, representing 353.89% of nonperforming loans. The allowance for loan losses at December 31, 2017 was \$19.7 million, or 1.24% of total loans, representing 791.07% of nonperforming loans.

Table of Contents

- Total deposits increased \$92.1 million, or 4%, to \$2.42 billion at March 31, 2018, compared to \$2.33 billion at March 31, 2017, and decreased \$60.8 million or 2% from \$2.48 billion at December 31, 2017. Deposits, excluding all time deposits and CDARS deposits, increased \$186.7 million, or 9%, to \$2.29 billion at March 31, 2018, from \$2.10 billion at March 31, 2017, and increased \$9.7 million from \$2.28 billion at December 31, 2017.
- Due to the maturity of State of California certificates of deposit, time deposits of \$250,000 and over decreased from \$164.8 million at March 31, 2017 to \$71.4 million at March 31, 2018. Time deposits of \$250,000 and over, were \$138.6 million at December 31, 2017. There were no certificates of deposit from the State of California at March 31, 2018, compared to \$85.1 million at March 31, 2017, and \$65.1 million at December 31, 2017.
- The ratio of noncore funding (which consists of time deposits of \$250,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase, subordinated debt, and short term borrowings) to total assets was 4.53% at March 31, 2018, compared to 6.60% at March 31, 2017, and 6.85% at December 31, 2017.
- The loan to deposit ratio was 65.69% at March 31, 2018, compared to 64.95% at March 31, 2017, and 63.74% at December 31, 2017.
- The Company's consolidated capital ratios exceeded regulatory guidelines and the Bank's capital ratios exceeded the regulatory guidelines for a well capitalized financial institution under the Basel III regulatory requirements at March 31, 2018.

	Heritage Commerce Corp	Heritage Bank of Commerce	Well-capitalized Financial Institution Basel III Regulatory Guidelines	Fully Phased-in Basel III Minimal Requirement(1) Effective January 1, 2019
Capital Ratios				
Total Risk-Based	14.7 %	13.5 %	10.0 %	10.5 %
Tier 1 Risk-Based	11.7 %	12.5 %	8.0 %	8.5 %
Common Equity Tier 1 Risk-based	11.7 %	12.5 %	6.5 %	7.0 %
Leverage	8.6 %	9.1 %	5.0 %	4.0 %

(1) Fully phased in Basel III requirements for both HCC and HBC include a 2.5% capital conservation buffer, except the leverage ratio.

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. 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. 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.

Total deposits increased \$92.1 million, or 4%, to \$2.42 billion at March 31, 2018, compared to \$2.33 billion at March 31, 2017, and decreased \$60.8 million or 2% from \$2.48 billion at December 31, 2017. Due to the maturity of State of California certificates of deposit, time deposits of \$250,000 and over decreased from \$164.8 million at March 31, 2017 to \$71.4 million at March 31, 2018. Time deposits of \$250,000 and over, were \$138.6 million at December 31, 2017. There were no certificates of deposit from the State of California at March 31, 2018, compared to \$85.1 million at March 31, 2017, and \$65.1 million at December 31, 2017. Deposits, excluding all time deposits and CDARS

Table of Contents

deposits, increased \$186.7 million, or 9%, to \$2.29 billion at March 31, 2018, from \$2.10 billion at March 31, 2017, and increased \$9.7 million from \$2.28 billion at December 31, 2017.

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. The Company manages liquidity to be able to meet unexpected sudden changes in levels of its assets or deposit liabilities without maintaining excessive amounts of balance sheet liquidity. Excess balance sheet liquidity can negatively impact the Company's interest margin. At March 31, 2018, we had \$302.0 million in cash and cash equivalents and approximately \$580.8 million in available borrowing capacity from various sources including the Federal Home Loan Bank ("FHLB"), the Federal Reserve Bank of San Francisco ("FRB"), Federal funds facilities with several financial institutions, and line of credit with a correspondent bank. The Company also had \$683.8 million at fair value in unpledged securities available at March 31, 2018. Our loan to deposit ratio was 65.69% at March 31, 2018, compared to 64.95% at March 31, 2017, and 63.74% at December 31, 2017.

Lending

Our lending business originates principally through our branch offices located in our primary markets. In addition, Bay View Funding provides factoring financing throughout the United States. Total loans, excluding loans held-for-sale, increased \$77.9 million, or 5%, to \$1.59 billion at March 31, 2018, compared to \$1.51 billion at March 31, 2017, which included an increase of \$78.9 million, or 6% in the Company's legacy portfolio, and an increase of \$6.9 million in the factored receivables portfolio, partially offset by a decrease of \$6.7 million in purchased residential mortgage loans. Loans increased \$8.5 million, or 1%, to \$1.59 billion at March 31, 2018, compared to \$1.58 billion at December 31, 2017, which included an increase of \$9.6 million, or 1% in the Company's legacy portfolio, partially offset by decrease of \$1.7 million in purchased residential mortgage loans, and a decrease of \$291,000 in purchased CRE loans. The loan portfolio remains well diversified with commercial and industrial ("C&I") loans accounting for 36% of the loan portfolio at March 31, 2018, which included \$49.7 million of factored receivables. CRE loans accounted for 49% of the total loan portfolio, of which 41% were occupied by businesses that own them. Land and construction loans accounted for 7% of total loans, consumer and home equity loans accounted for 5% of total loans, and residential mortgage loans accounted for the remaining 3% of total loans at March 31, 2018.

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). Net interest income increased 11% to \$26.3 million for the first quarter of 2018,

compared to \$23.8 million for the first quarter of 2017, primarily due to an increase in the average balance of loans and investment securities, in conjunction with a lower average balance of lower yielding excess funds at the Federal Reserve Bank, and the impact of increases in the prime rate on loans yields and overnight funds, partially offset by the impact from the issuance of subordinated debt during the second quarter of 2017.

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 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.

Table of Contents

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 will 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. 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.”

In June 2016, the FASB issued new guidance on measurement of credit losses on financial instruments, which is the final guidance on the new current expected credit loss (“CECL”) model. The new guidance will replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to estimate future credit loss estimates. Management is currently evaluating the impact of adopting CECL, which becomes effective for the Company on January 1, 2020. The effect of the adoption of CECL is currently unknown and could result in an increase to the allowance for loan losses and a charge to equity. Further discussion of the adoption of CECL appears in Note 1 – Basis of Presentation – Newly Issued, but not yet Effective Accounting Standards in the financial statements in this Form 10-Q.

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. Total noninterest expense for the first quarter of 2018 increased to \$16.0 million, compared to \$15.3 million for the first quarter of 2017, primarily due to costs related to the merger transactions and higher salaries and employee benefits as

a result of annual salary increases, partially offset by lower professional fees.

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.

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 and lending 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

Table of Contents

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.

Distribution, Rate and Yield

	Three Months Ended March 31, 2018				Three Months Ended March 31, 2017			
	Average Balance (Dollars in thousands)	Interest Income / Expense	Average Yield / Rate		Average Balance	Interest Income / Expense	Average Yield / Rate	
Assets:								
Loans, gross (1)(2)	\$ 1,568,589	22,284	5.76	%	\$ 1,495,823	\$ 20,398	5.53	%
Securities — taxable	695,003	3,862	2.25	%	547,667	2,877	2.13	%
Securities — exempt from Federal tax (3)	88,470	709	3.25	%	90,414	871	3.91	%
Other investments and interest- bearing deposits in other financial institutions	246,892	1,171	1.92	%	275,139	856	1.26	%
Total interest earning assets (3)	2,598,954	28,026	4.37	%	2,409,043	25,002	4.21	%
Cash and due from banks	33,943				32,834			
Premises and equipment, net	7,303				7,527			
Goodwill and other intangible assets	51,166				52,476			
Other assets	76,952				82,869			
Total assets	\$ 2,768,318				\$ 2,584,749			
Liabilities and shareholders' equity:								
Deposits:								
Demand, noninterest-bearing	\$ 945,848				\$ 887,008			
Demand, interest-bearing	608,523	302	0.20	%	559,245	288	0.21	%
Savings and money market	689,257	444	0.26	%	592,155	294	0.20	%
Time deposits — under \$100	17,288	12	0.28	%	20,414	15	0.30	%

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Time deposits — \$100 and over	126,951	198	0.63	%	201,838	273	0.55	%
CDARS — interest-bearing demand, money market and time deposits	16,460	2	0.05	%	8,894	1	0.05	%
Total interest-bearing deposits	1,458,479	958	0.27	%	1,382,546	871	0.26	%
Total deposits	2,404,327	958	0.16	%	2,269,554	871	0.16	%
Subordinated debt, net of issuance costs	39,199	571	5.91	%	—	—	N/A	
Short-term borrowings	39	—	0.00	%	76	—	0.00	%
Total interest-bearing liabilities	1,497,717	1,529	0.41	%	1,382,622	871	0.26	%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	2,443,565	1,529	0.25	%	2,269,630	871	0.16	%
Other liabilities	54,414				53,775			
Total liabilities	2,497,979				2,323,405			
Shareholders' equity	270,339				261,344			
Total liabilities and shareholders' equity	\$ 2,768,318				\$ 2,584,749			
Net interest income (3) / margin		26,497	4.13	%		24,131	4.06	%
Less tax equivalent adjustment (3)		(149)				(305)		
Net interest income		\$ 26,348				\$ 23,826		

(1) Includes loans held for sale. Nonaccrual loans are included in average balance.

(2) Yield amounts earned on loans include fees and costs. The accretion (amortization) of deferred loan fees (costs) into loan interest income was \$217,000 for the first quarter of 2018, compared to \$111,000 for the first quarter of 2017.

(3) Reflects tax equivalent adjustment for Federal tax exempt income based on a 21% tax rate for the first quarter of 2018, and a 35% tax rate for the first quarter of 2017.

Table of Contents

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 March 31, 2018 vs. 2017		
	Increase (Decrease)		
	Due to Change in:		
	Average	Average	Net
	Volume	Rate	Change
	(Dollars in thousands)		
Income from the interest earning assets:			
Loans, gross	\$ 1,039	\$ 847	\$ 1,886
Securities — taxable	824	161	985
Securities — exempt from Federal tax (1)	(16)	(146)	(162)
Other investments, and interest- bearing deposits in other financial institutions	(132)	447	315
Total interest income on interest earning assets (1)	1,715	1,309	3,024
Expense from the interest-bearing liabilities:			
Demand, interest-bearing	26	(12)	14
Savings and money market	64	86	150
Time deposits — under \$100	(2)	(1)	(3)
Time deposits — \$100 and over	(116)	41	(75)
CDARS — interest-bearing demand, money market and time deposits	1	—	1
Subordinated debt, net of issuance costs	571	—	571
Total interest expense on interest-bearing liabilities	544	114	658
Net interest income (1)	\$ 1,171	\$ 1,195	2,366
Less tax equivalent adjustment (1)			156
Net interest income			\$ 2,522

(1) Reflects tax equivalent adjustment for Federal tax exempt income based on a 21% tax rate for the first quarter of 2018, and a 35% tax rate for the first quarter of 2017.

The Company's net interest margin (FTE), expressed as a percentage of average earning assets, increased 7 basis points to 4.13% for the first quarter of 2018, from 4.06% for the first quarter of 2017. The increase was primarily due to a higher average balance of loans and securities, in conjunction with a lower average balance of lower yielding excess funds at the Federal Reserve Bank, and the impact of increases in the prime rate on loans yields and overnight funds, partially offset by the impact from the issuance of subordinated debt during the second quarter of 2017.

The average yield on the loan portfolio increased to 5.76% for the first quarter of 2018, compared to 5.53% for the first quarter of 2017, primarily due to increases in the prime rate, partially offset by a decrease in the accretion of the loan purchase discount into loan interest income from the Focus transaction. The average yield on the Company's legacy loan portfolio (excluding the purchased residential loans, purchased CRE loans, factored receivables portfolio, and accretion of the loan purchase discount from the Focus transaction) increased 20 basis points for the first quarter of 2018, compared to the first quarter of 2017. The average yield on the purchased residential loans was 2.73% for the first quarter of 2018, compared to 2.52% for the first quarter of 2017. The average yield on the purchased CRE loans was 3.52% for the first quarter of 2018, compared to 3.50% the first quarter of 2017.

Net interest income increased 11% to \$26.3 million for the first quarter of 2018, compared to \$23.8 million for the first quarter of 2017, primarily due to an increase in the average balance of loans and investment securities, and the impact of increases in the prime rate on loans yields and overnight funds.

Table of Contents

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 presented in the statements of income 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 evaluation of the adequacy of the Company's allowance for loan losses and charging the shortfall or excess, 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.

There was a \$506,000 provision for loan losses for the first quarter of 2018, compared to a provision for loan losses of \$321,000 for the first quarter of 2017. 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".

The allowance for loan losses totaled \$20.1 million, or 1.27% of total loans at March 31, 2018, compared to \$19.1 million, or 1.26% of total loans at March 31, 2017, and \$19.7 million, or 1.24% of total loans at December 31, 2017. Net charge-offs totaled \$25,000 for the first quarter of 2018, compared to net charge-offs of \$275,000 for the first quarter of 2017, and net recoveries of \$201,000 for the fourth quarter of 2017. The allowance for loan losses to total nonperforming loans was 530.67% at March 31, 2018, compared to 353.89% at March 31, 2017, and 791.07% at December 31, 2017.

Noninterest Income

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

	Three Months Ended		Increase (decrease)		
	March 31, 2018	2017	2018 versus 2017 Amount	Percent	
	(Dollars in thousands)				
Service charges and fees on deposit accounts	\$ 902	\$ 740	\$ 162	22	%
Increase in cash surrender value of life insurance	363	422	(59)	(14)	%
Gain on sales of SBA loans	235	324	(89)	(27)	%
Servicing income	181	285	(104)	(36)	%

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Gain (loss) on sales of securities	87	(6)	93	1,550	%
Other	427	530	(103)	(19)	%
Total	\$ 2,195	\$ 2,295	\$ (100)	(4)	%

Historically, a portion 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 three months ended March 31, 2018, SBA loan sales resulted in a \$235,000 gain, compared to a \$324,000 gain on sales of SBA loans for the three months ended March 31, 2017.

The servicing assets that result from the sales 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.

Table of Contents

Noninterest Expense

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

	Three Months Ended		Increase (Decrease)		
	March 31, 2018	2017	2018 versus 2017 Amount	Percent	
	(Dollars in thousands)				
Salaries and employee benefits	\$ 9,777	\$ 9,486	\$ 291	3	%
Occupancy and equipment	1,106	1,068	38	4	%
Professional fees	684	1,071	(387)	(36)	%
Acquisition and integration related costs	615	—	615	N/A	
Software subscriptions	593	417	176	42	%
Insurance expense	407	352	55	16	%
Data processing	353	383	(30)	(8)	%
Other	2,455	2,551	(96)	(4)	%
Total	\$ 15,990	\$ 15,328	\$ 662	4	%

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

Noninterest Expense by Category

	Three Months Ended March 31,			Percent of		
	2018	Percent of Total		2017	Percent of Total	
	(Dollars in thousands)					
Salaries and employee benefits	\$ 9,777	61	%	\$ 9,486	62	%
Occupancy and equipment	1,106	7	%	1,068	7	%
Professional fees	684	4	%	1,071	7	%
Acquisition and integration related costs	615	4	%	—	0	%
Software subscriptions	593	4	%	417	3	%
Insurance expense	407	3	%	352	2	%
Data processing	353	2	%	383	2	%
Other	2,455	15	%	2,551	17	%
Total	\$ 15,990	100	%	\$ 15,328	100	%

Total noninterest expense for the first quarter of 2018 was \$16.0 million, compared to \$15.3 million for the first quarter of 2017. The increase in noninterest expense in the first quarter of 2018 from the first quarter of 2017 was primarily due to costs related to the merger transactions and higher salaries and employee benefits as a result of annual salary increases, partially offset by lower professional fees. Full time equivalent employees were 271, 269, and 278 at March 31, 2018, March 31, 2017, and December 31, 2017, respectively.

Income Tax Expense

The Company computes its provision for income taxes on a quarterly 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, interest on tax-exempt securities, certain expenses that are not allowed as tax deductions, and tax credits.

On December 22, 2017, H.R.1, commonly known as the Tax Cuts and Jobs Act (the "Tax Act"), was signed into law, which among other items reduced the federal corporate tax rate to 21% from 35%, effective January 1, 2018. U.S. generally accepted accounting principles required companies to remeasure certain tax-related assets and liabilities as of the date of enactment of the new legislation with resulting tax effects accounted for in the reporting period of enactment. The Company concluded that the enactment of the Tax Act caused its net deferred tax assets ("DTA") to be

Table of Contents

remeasured at the new lower tax rate. The Company performed an analysis and determined the value of the net DTA should be reduced by \$7.1 million, which was recognized as a one-time, non-cash, incremental income tax expense in the fourth quarter of 2017.

The Company's Federal and state income tax expense for the three months ended March 31, 2018 was \$3.2 million compared to \$3.9 million for the quarter ended March 31, 2017. The following table shows the Company's effective income tax rates for the periods indicated:

	Three Months Ended March 31,	
	2018	2017
Effective income tax rate	26.9 %	37.6 %

The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 29.6% for the first quarter of 2018, and 42% for the first quarter of 2017, is primarily the result of tax exempt securities, the Company's investment in life insurance policies whose earnings are not subject to taxes, tax credits related to investments in low income housing limited partnerships, and Enterprise Zone hiring credits, and the tax benefit from the Company's stock-based compensation plans.

In March 2016, the FASB issued new guidance intended to simplify several areas of accounting for share-based compensation programs, including the income tax impact, classification on the statement of cash flows, and forfeitures. The Company adopted the new guidance on share-based compensation during the first quarter of 2017. All excess tax benefits and tax deficiencies (including tax benefits of dividends on share based payment awards) are recognized as income tax expense or benefit on the income statement. The tax effects of exercised or vested awards are treated as discrete items in the reporting period in which they occur. The adoption of this guidance resulted in a reduction to tax expense of \$110,000 for the first quarter of 2018, and \$112,000 for the first quarter of 2017.

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 the utilization of tax credit carryforwards and the net operating loss carryforwards for Federal and 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 the deferred tax assets 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 \$18.6 million at March 31, 2018, and \$16.2 million at December 31, 2017. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax assets at March 31, 2018, March 31, 2017, and December 31, 2017 will be fully realized in future years.

Table of Contents

Business Segment Information

The following presents the Company's operating segments. Transactions between segments consist primarily of borrowed funds. Intersegment interest expense is allocated to the Factoring segment based on the Company's prime rate and funding costs. The provision for loan loss is allocated based on the segment's allowance for loan loss determination which considers the effects of charge offs. Noninterest income and expense directly attributable to a segment are assigned to it. Taxes are paid on a consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring originated by Bay View Funding.

	Three Months Ended March 31, 2018		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 24,731	\$ 3,146	\$ 27,877
Intersegment interest allocations	327	(327)	—
Total interest expense	1,529	—	1,529
Net interest income	23,529	2,819	26,348
Provision for loan losses	488	18	506
Net interest income after provision	23,041	2,801	25,842
Noninterest income	2,086	109	2,195
Noninterest expense	14,467	1,523	15,990
Intersegment expense allocations	175	(175)	—
Income before income taxes	10,835	1,212	12,047
Income tax expense	2,880	358	3,238
Net income	\$ 7,955	\$ 854	\$ 8,809
Total assets	\$ 2,722,472	\$ 63,076	\$ 2,785,548
Loans, net of deferred fees	\$ 1,541,466	\$ 49,735	\$ 1,591,201
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

	Three Months Ended March 31, 2017		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	\$ 21,969	\$ 2,728	\$ 24,697
Intersegment interest allocations	260	(260)	—
Total interest expense	871	—	871
Net interest income	21,358	2,468	23,826
Provision for loan losses	311	10	321
Net interest income after provision	21,047	2,458	23,505
Noninterest income	2,115	180	2,295
Noninterest expense	13,579	1,749	15,328
Intersegment expense allocations	133	(133)	—
Income before income taxes	9,716	756	10,472

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Income tax expense	3,616	318	3,934
Net income	\$ 6,100	\$ 438	\$ 6,538
Total assets	\$ 2,584,288	\$ 57,503	\$ 2,641,791
Loans, net of deferred fees	\$ 1,470,450	\$ 42,837	\$ 1,513,287
Goodwill	\$ 32,620	\$ 13,044	\$ 45,664

(1) Includes the holding company's results of operations

Banking. Our banking segment's net income increased to \$8.0 million for the three months ended March 31, 2018, compared to net income of \$6.1 million for the three months ended March 31, 2017. Net interest income increased to \$23.5 million for the three months ended March 31, 2018, compared to \$21.4 million for the three months ended March 31, 2017, primarily as a result of an increase in the average balance of loans and investment securities, and the impact of increases in the prime rate on loan yields and overnight funds. The provision for loan losses was \$488,000 for the three months ended March 31, 2018, compared to \$311,000 for the three months ended March 31, 2017.

Noninterest

48

Table of Contents

income was \$2.1 million for the three months ended March 31, 2018 and March 31, 2017. Noninterest expense increased to \$14.5 million for the three months ended March 31, 2018, compared to \$13.6 million for the three months ended March 31, 2017, primarily due to costs related to the merger transactions and higher salaries and employee benefits, as a result of annual salary increases.

Factoring. Bay View Funding's primary business operation is purchasing and collecting factored receivables. Factored receivables are receivables that have been transferred by the originating organization and typically have not been subject to previous collection efforts. In a factoring transaction Bay View Funding directly purchases the receivables generated by its clients at a discount to their face value. The transactions are structured to provide the clients with immediate working capital when there is a mismatch between payments to the client for a good and service and the payment of operating costs incurred to provide such good or service. The average life of the factored receivables was 35 days for the first quarter of 2018, compared to 37 days for the first three months ended March 31, 2017. The balance of the purchased receivables as of March 31, 2018 and 2017 was \$49.7 million and \$42.8 million, respectively. Bay View Funding's net income was \$854,000 for the three months ended March 31, 2018, compared to \$438,000 for the three months ended March 31, 2017. Net interest income increased to \$2.8 million for the three months ended March 31, 2018, compared to \$2.5 million for the three months ended March 31, 2017, primarily due to an increase in the average yield on the factored receivables portfolio, and an increase in the average balance of factored receivables outstanding. The provision for loan losses was \$18,000 for the three months ended March 31, 2018, compared to \$10,000 for the three months ended March 31, 2017. Noninterest income was \$109,000 for the three months ended March 31, 2018, compared to \$180,000 for the three months ended March 31, 2017, primarily due to a decrease in fees. Noninterest expense decreased to \$1.5 million for the three months ended March 31, 2018, compared to \$1.7 million for the three months ended March 31, 2017, primarily due to lower professional fees.

FINANCIAL CONDITION

As of March 31, 2018, total assets increased to \$2.79 billion, compared to \$2.64 billion at March 31, 2017. Total deposits decreased from \$2.84 billion at December 31, 2017, primarily due to the maturity of \$65.0 million of State of California certificates of deposits in the first quarter of 2018. Securities available for sale, at fair value, were \$344.8 million at March 31, 2018, an increase of 1% from \$341.6 million at March 31, 2017, and a decrease of 12% from \$391.9 million at December 31, 2017. Securities held to maturity, at amortized cost, were \$395.3 million at March 31, 2018, an increase of 16% from \$341.4 million at March 31, 2017, and a decrease of 1% from \$398.3 million at December 31, 2017. Total loans, excluding loans held for sale, increased \$77.9 million, or 5%, to \$1.59 billion at March 31, 2018, compared to \$1.15 billion at March 31, 2017, which included an increase of \$78.9 million, or 6%, in the Company's legacy loan portfolio, and an increase of \$6.9 million in the factored receivables portfolio, partially offset by a decrease of \$6.7 million in purchased residential mortgage loans, and a decrease of \$1.2 million in purchased CRE loans. Loans increased \$8.5 million, or 1%, to \$1.59 billion at March 31, 2018, compared to \$1.58 billion at December 31, 2017, which included an increase of \$9.6 million, or 1% in the Company's legacy portfolio, and an increase of \$909,000 in the factored receivables portfolio, partially offset by decrease of \$1.7 million in purchased residential mortgage loans, and a decrease of \$291,000 in purchased CRE loans.

Total deposits increased \$92.1 million, or 4%, to \$2.42 billion at March 31, 2018, compared to \$2.33 billion at March 31, 2017, and decreased \$60.8 million, or 2%, from \$2.48 billion at December 31, 2017. Primarily due to the runoff of certificates of deposit from the State of California, time deposits of \$250,000 and over decreased to \$71.4 million at March 31, 2018, compared to \$164.8 million at March 31, 2017, and \$138.6 million at December 31, 2017. There were no certificates of deposit from the State of California at March 31, 2018, compared to \$85.1 million at March 31, 2017, and \$65.1 million at December 31, 2017. Deposits, excluding all time deposits and CDARS, deposits increased \$186.7 million, or 9%, to \$2.29 billion at March 31, 2018, from \$2.10 billion at March 31, 2017, and increased \$9.7 million from \$2.28 billion at December 31, 2017.

Table of Contents

Securities Portfolio

The following table reflects the balances for each category of securities at the dates indicated:

	March 31, 2018	2017	December 31, 2017
	(Dollars in thousands)		
Securities available-for-sale (at fair value):			
Agency mortgage-backed securities	\$ 344,766	\$ 325,446	\$ 374,733
Trust preferred securities	—	16,144	17,119
Total	\$ 344,766	\$ 341,590	\$ 391,852
Securities held-to-maturity (at amortized cost):			
Agency mortgage-backed securities	\$ 307,083	\$ 251,162	\$ 309,616
Municipals — exempt from Federal tax	88,191	90,221	88,725
	\$ 395,274	\$ 341,383	\$ 398,341

The following table summarizes the weighted average life and weighted average yields of securities at March 31, 2018:

	Weighted Average Life								Total Amount	
	Within One Year or Less		After One and Within Five Years		After Five and Within Ten Years		After Ten Years			
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield		
	(Dollars in thousands)									
Securities available-for-sale (at fair value):										
Agency mortgage-backed securities	\$ —	—	\$ 209,248	2.21 %	\$ 135,518	2.46 %	\$ —	—	\$ 344,766	2.34 %
	\$ —	—	\$ 209,248	2.21 %	\$ 135,518	2.46 %	\$ —	—	\$ 344,766	2.34 %
Securities held-to-maturity (at amortized cost):										
Agency mortgage-backed securities	\$ —	—	\$ 126,874	1.74 %	\$ 149,947	2.36 %	\$ 30,262	3.11 %	\$ 307,083	2.22 %
Municipals exempt from Federal tax (1)	3,201	3.26 %	27,736	3.29 %	17,899	3.26 %	39,355	3.15 %	88,191	3.24 %
	\$ 3,201	3.26 %	\$ 154,610	2.02 %	\$ 167,846	2.45 %	\$ 69,617	3.13 %	\$ 395,274	2.50 %

(1) Reflects tax equivalent adjustment for Federal tax exempt income based on a 35% tax rate.

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.

The Company's portfolio may include: (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) single entity issue trust preferred securities, which generally enhance the yield on the portfolio; and (v) corporate bonds, which also enhance the yield on the portfolio.

The Company classifies its securities as either available for sale or held to maturity at the time of purchase. 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 investment securities available for sale portfolio totaled \$344.8 million at March 31, 2018, an increase of 1% from \$341.6 million at March 31, 2017, and a decrease of 12% from \$391.9 million at December 31, 2017. At March

Table of Contents

31, 2018, the Company's securities available-for-sale portfolio was comprised of \$344.8 million agency mortgage-backed securities (all issued by U.S. Government sponsored entities). The pre-tax unrealized loss on securities available-for-sale at March 31, 2018 was (\$9.5) million, compared to a pre-tax unrealized loss on securities available-for-sale of (\$1.1) million at March 31, 2017, and a pre-tax unrealized loss on securities available-for-sale of (\$1.5) million at December 31, 2017. All other factors remaining the same, when market interest rates are rising, the Company will experience a lower unrealized gain (or a higher unrealized loss) on the securities portfolio. During the first quarter of 2018, the Company purchased \$15.2 million of agency mortgage-backed investment securities available-for-sale, with a weighted average book yield of 2.59%, and a weighted average duration of 4.62 years. During the first quarter of 2018, the Company sold \$38.7 million of investment securities (\$23.7 million mortgage-backed securities and \$15.0 million trust preferred securities), which resulted in a net gain on sale of securities of \$87,000.

At March 31, 2018, investment securities held to maturity totaled \$395.3 million, an increase of 16% from \$341.4 million at March 31, 2017, and a decrease of 1% from \$398.3 million at December 31, 2017. At March 31, 2018, the Company's securities held-to-maturity portfolio was comprised of \$307.1 million agency mortgage-backed securities, and \$88.2 million tax-exempt municipal bonds. During the first quarter of 2018, the Company purchased \$10.5 million of agency mortgage-backed securities held-to-maturity, with a weighted average book yield of 3.00%, and a weighted average duration of 6.23 years.

The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities.

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 57% of total assets at March 31, 2018 and March 31, 2017, and represented 56% at December 31, 2017. The ratio of loans to deposits was 65.69% at March 31, 2018, compared to 64.95% at March 31, 2017, and 63.74% at December 31, 2017.

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:

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

	March 31, 2018			March 31, 2017			December 31, 2017		
	Balance	% to Total		Balance	% to Total		Balance	% to Total	
	(Dollars in thousands)								
Commercial	\$ 572,790	36	%	\$ 609,353	40	%	\$ 573,296	36	%
Real estate:									
CRE	775,547	49	%	679,989	45	%	772,867	49	%
Land and construction	113,470	7	%	81,101	6	%	100,882	6	%
Home equity Residential mortgages	76,087	4	%	80,360	5	%	79,176	5	%
Consumer	42,868	3	%	49,569	3	%	44,561	3	%
Total Loans	10,958	1	%	13,807	1	%	12,395	1	%
Deferred loan fees, net	1,591,720	100	%	1,514,179	100	%	1,583,177	100	%
Loans, net of deferred fees	(519)	—		(892)	—		(510)	—	
Allowance for loan losses	1,591,201	100	%	1,513,287	100	%	1,582,667	100	%
Loans, net	(20,139)			(19,135)			(19,658)		
	\$ 1,571,062			\$ 1,494,152			\$ 1,563,009		

The Company's loan portfolio is concentrated in commercial loans, (primarily manufacturing, wholesale, and services oriented entities), and commercial real estate, with the remaining balance in land development and construction, home equity, purchased residential mortgages, and consumer loans. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 63% of its gross loans were secured by real property at March 31, 2018 and December 31, 2017, compared to 59% at March 31, 2017. While no specific industry concentration is considered significant, the Company's bank lending operations are substantially located in areas that are dependent on the technology and real estate industries and their supporting companies.

Table of Contents

The Company has established concentration limits in its loan portfolio for commercial real estate loans, commercial loans, construction loans and unsecured lending, among others. All loan types are within established limits. The Company uses underwriting guidelines to assess the borrowers' historical cash flow to determine debt service, and we further stress test the debt service under higher interest rate scenarios. Financial and performance covenants are used in commercial lending to allow the Company to react to a borrower's deteriorating financial condition should that occur.

The Company's commercial loans are made for working capital, financing the purchase of equipment or for other business purposes. Commercial loans include loans with maturities ranging from thirty days to one year and "term loans" with maturities normally ranging from one to five years. Short term business loans are generally intended to finance current transactions and typically provide for periodic principal payments, with interest payable monthly. Term loans normally provide for floating interest rates, with monthly payments of both principal and interest.

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such guaranteed loans (collectively referred to as "SBA loans"). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold the Company retains the servicing rights for the sold portion. During the first quarter ended March 31, 2018, loans were sold resulting in a gain on sales of SBA loans of \$235,000, compared to \$324,000 for the first quarter ended March 31, 2017.

The Company's factoring receivables are from the operations of Bay View Funding whose primary business is purchasing and collecting factored receivables. Factored receivables are receivables that have been transferred by the originating organization and typically have not been subject to previous collection efforts. These receivables are acquired from a variety of companies, including but not limited to service providers, transportation companies, manufacturers, distributors, wholesalers, apparel companies, advertisers, and temporary staffing companies. The portfolio of factored receivables is included in the Company's commercial loan portfolio. The average life of the factored receivables was 35 days for the first quarter of 2018, compared to 37 days for the first quarter of 2017. The balance of the purchased receivables was \$49.7 million at March 31, 2018, compared to \$42.8 million at March 31, 2017, and \$48.8 million at December 31, 2017.

The commercial loan portfolio of \$572.8 million at March 31, 2018 decreased \$36.6 million from \$609.4 million at March 31, 2017, and remained relatively flat from \$573.3 million at December 31, 2017. C&I usage was 37% at March 31, 2018, compared to 40% at March 31, 2017, and 37% at December 31, 2017.

The Company's CRE loans consist primarily of loans based on the borrower's cash flow and are secured by deeds of trust on commercial property to provide a secondary source of repayment. The Company generally restricts real estate term loans to no more than 75% of the property's appraised value or the purchase price of the property depending on the type of property and its utilization. The Company offers both fixed and floating rate loans. Maturities CRE loans

are generally between five and ten years (with amortization ranging from fifteen to twenty five years and a balloon payment due at maturity), however, SBA and certain other real estate loans that can be sold in the secondary market may be granted for longer maturities.

The CRE loan portfolio increased \$95.5 million, or 14%, to \$775.5 million at March 31, 2018, compared to \$680.0 million at March 31, 2017, which included an increase of \$96.7 million, or 15%, in the Company's legacy portfolio, partially offset by a decrease of \$1.2 million in purchased CRE loans. The CRE loan portfolio remained relatively flat from \$772.9 million at December 31, 2017.

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Construction loans are provided only in our market area, and the Company has extensive controls for the disbursement process. Land and construction loans increased \$32.4 million to \$113.5 million at March 31, 2018, compared to \$81.1 million at March 31, 2017, and increased \$12.6 million from \$100.9 million at December 31, 2017.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 75% loan to value ratio.

Table of Contents

During the year ended December 31, 2016, the Company purchased jumbo single family residential mortgage loans totaling \$57.5 million, all of which are domiciled in California, with an average loan principal amount of approximately \$834,000 per loan, and weighted average yield of 3.00%, net of servicing fees to the servicer. Residential mortgage loans outstanding at March 31, 2018 totaled \$42.9 million, compared to \$49.6 million at March 31, 2017, and \$44.6 million at December 31, 2017.

Additionally, the Company makes consumer loans for the purpose of financing automobiles, various types of consumer goods, and other personal purposes. Consumer loans generally provide for the monthly payment of principal and interest. Most of the Company's consumer loans are secured by the personal property being purchased or, in the instances of home equity loans or lines, real property.

With certain exceptions, state chartered banks are permitted to make extensions of credit to any one borrowing entity up to 15% of the bank's capital and reserves for unsecured loans and up to 25% of the bank's capital and reserves for secured loans. For HBC, these lending limits were \$46.1 million and \$76.8 million at March 31, 2018, respectively.

Loan Maturities

The following table presents the maturity distribution of the Company's loans (excluding loans held for sale) as of March 31, 2018. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall Street Journal. As of March 31, 2018, approximately 50% of the Company's loan portfolio consisted of floating interest rate loans.

	Due in One Year or Less (Dollars in thousands)	Over One Year But Less than Five Years	Over Five Years	Total
Commercial	\$ 455,624	\$ 88,827	28,339	\$ 572,790
Real estate:				
CRE	96,917	270,478	408,152	775,547
Land and construction	112,431	97	942	113,470
Home equity	70,901	1,490	3,696	76,087
Residential mortgages	520	—	42,348	42,868
Consumer	10,885	73	—	10,958
Loans	\$ 747,278	\$ 360,965	\$ 483,477	\$ 1,591,720
Loans with variable interest rates	\$ 672,627	45,103	74,531	\$ 792,261
Loans with fixed interest rates	74,651	315,862	408,946	799,459
Loans	\$ 747,278	\$ 360,965	\$ 483,477	\$ 1,591,720

Loan Servicing

As of March 31, 2018 and 2017, \$132.8 million and \$159.1 million, respectively, in SBA loans were serviced by the Company for others. Activity for loan servicing rights was as follows:

	Three Months Ended	
	March 31,	
	2018	2017
	(Dollars in thousands)	
Beginning of period balance	\$ 1,373	\$ 1,854
Additions	56	78
Amortization	(205)	(174)
End of period balance	\$ 1,224	\$ 1,758

Loan servicing rights are included in accrued interest receivable and other assets on the unaudited consolidated balance sheets and reported net of amortization. There was no valuation allowance as of March 31, 2018 and 2017, as the fair value of the assets was greater than the carrying value.

Table of Contents

Activity for the I/O strip receivable was as follows:

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Beginning of period balance	\$ 968	\$ 1,067
Unrealized holding loss	(23)	(22)
End of period balance	\$ 945	\$ 1,045

Credit Quality

Financial institutions generally have a certain level of exposure to credit quality risk, and could potentially receive less than a full return of principal and interest if a debtor becomes unable or unwilling to repay. Since loans are the most significant assets of the Company and generate the largest portion of its revenues, the Company's management of credit quality risk is focused primarily on loan quality. Banks have generally suffered their most severe earnings declines as a result of customers' inability to generate sufficient cash flow to service their debts and/or downturns in national and regional economies and declines in overall asset values including real estate. In addition, certain debt securities that the Company may purchase have the potential of declining in value if the obligor's financial capacity to repay deteriorates.

The Company's policies and procedures identify market segments, set goals for portfolio growth or contraction, and establish limits on industry and geographic credit concentrations. In addition, these policies establish the Company's underwriting standards and the methods of monitoring ongoing credit quality. The Company's internal credit risk controls are centered in underwriting practices, credit granting procedures, training, risk management techniques, and familiarity with loan customers as well as the relative diversity and geographic concentration of our loan portfolio.

The Company's credit risk may also be affected by external factors such as the level of interest rates, employment, general economic conditions, real estate values, and trends in particular industries or geographic markets. As an independent community bank serving a specific geographic area, the Company must contend with the unpredictable changes in the general California market and, particularly, primary local markets. The Company's asset quality has suffered in the past from the impact of national and regional economic recessions, consumer bankruptcies, and depressed real estate values.

Nonperforming assets are comprised of the following: loans for which the Company is no longer accruing interest; restructured loans which have been current under six months; loans 90 days or more past due and still accruing interest (although they are generally placed on nonaccrual when they become 90 days past due, unless they are both well secured and in the process of collection); and foreclosed assets. Past due loans 30 days or greater totaled \$7.9 million and \$6.9 million at March 31, 2018 and December 31, 2017, respectively, of which \$2.4 million and \$1.4 million were on nonaccrual. At March 31, 2018, there were also \$1.3 million loans less than 30 days past due included in nonaccrual loans held for investment. At December 31, 2017, there were also \$840,000 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. Loans may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. Foreclosed assets consist of properties acquired by foreclosure or similar means that management is offering or will offer for sale.

Table of Contents

The following table summarizes the Company's nonperforming assets at the dates indicated:

	March 31, 2018		2017		December 31, 2017	
	(Dollars in thousands)					
Nonaccrual loans — held-for-investment	\$ 3,637		\$ 5,200		\$ 2,250	
Restructured and loans 90 days past due and still accruing	158		207		235	
Total nonperforming loans	3,795		5,407		2,485	
Foreclosed assets	—		183		—	
Total nonperforming assets	\$ 3,795		\$ 5,590		\$ 2,485	
Nonperforming assets as a percentage of loans plus foreclosed assets	0.24	%	0.37	%	0.16	%
Nonperforming assets as a percentage of total assets	0.14	%	0.21	%	0.09	%

Nonperforming assets were \$3.8 million, or 0.14% of total assets, at March 31, 2018, compared to \$5.6 million, or 0.21% of total assets, at March 31, 2017, and \$2.5 million, or 0.09% of total assets, at December 31, 2017. There were no foreclosed assets at March 31, 2018 and December 31, 2017, compared to \$183,000 at March 31, 2017.

The following table presents nonperforming loans by class at the dates indicated:

	March 31, 2018			December 31, 2017		
	Nonaccrual (Dollars in thousands)	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
Commercial Real estate:	\$ 2,772	\$ 158	\$ 2,930	\$ 1,250	\$ 235	\$ 1,485
CRE	501	—	501	501	—	501
Land and construction	—	—	—	119	—	119
Home equity	364	—	364	379	—	379
Consumer	—	—	—	1	—	1
Total	\$ 3,637	\$ 158	\$ 3,795	\$ 2,250	\$ 235	\$ 2,485

Loans with a well defined weakness, which are characterized by the distinct possibility that the Company will sustain a loss if the deficiencies are not corrected, are categorized as “classified.” Classified loans include all loans considered as substandard, substandard nonaccrual, and doubtful and may result from problems specific to a borrower’s business or from economic downturns that affect the borrower’s ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate). The principal balance of classified loans, was \$30.8 million at March 31, 2018, \$10.2 million at March 31, 2017, and \$25.1 million at December 31, 2017. The increase in classified assets at March 31, 2018 was primarily due to loans associated with a lending relationship that was moved to classified loans in the fourth quarter of 2017, which totaled \$20.2 million at March 31, 2018, compared to \$12.5 million at December 31, 2017. Loans held for sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses.

Table of Contents

The following table provides a summary of the loan portfolio by loan type and credit quality classification at the dates indicated:

	March 31, 2018			March 31, 2017			December 31, 2017		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)								
	\$ 548,538	\$ 24,252	\$ 572,790	\$ 601,657	\$ 7,696	\$ 609,353	\$ 554,913	\$ 18,383	\$ 573,296
	769,707	5,840	775,547	678,268	1,721	679,989	766,988	5,879	772,867
	113,470	—	113,470	80,906	195	81,101	100,763	119	100,882
	75,416	671	76,087	79,788	572	80,360	78,486	690	79,176
	42,868	—	42,868	49,569	—	49,569	44,561	—	44,561
	10,958	—	10,958	13,805	2	13,807	12,394	1	12,395
	\$ 1,560,957	\$ 30,763	\$ 1,591,720	\$ 1,503,993	\$ 10,186	\$ 1,514,179	\$ 1,558,105	\$ 25,072	\$ 1,583,177

The increase in classified assets at March 31, 2018 was primarily due to seasonal advances on lines of credit associated with a lending relationship that was moved to classified loans in the fourth quarter of 2017, which totaled \$20.2 million at March 31, 2018, compared to \$12.5 million at December 31, 2017. 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 in accordance with the Company's underwriting policy.

The following provides a rollforward of troubled debt restructurings ("TDRs"):

	Three Months Ended March 31, 2018		
	Performing TDRs	Nonperforming TDRs	Total
	(Dollars in thousands)		
Balance at January 1, 2018	\$ 309	\$ 16	\$ 325
Additions	46	—	46
Principal repayments	(48)	—	(48)
Balance at March 31, 2018	\$ 307	\$ 16	\$ 323

Three Months Ended March 31, 2017		
Performing TDRs	Nonperforming TDRs	Total

	(Dollars in thousands)		
Balance at January 1, 2017	\$ 131	\$ 2	\$ 133
Principal repayments	(5)	—	(5)
Balance at March 31, 2017	\$ 126	\$ 2	\$ 128

Allowance for Loan Losses

The allowance for loan losses is an estimate of probable incurred losses in the loan portfolio. Loans are charged off against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance for loan losses. Management's methodology for estimating the allowance balance consists of several key elements, which include specific allowances on individual impaired loans and the formula driven allowances on pools of loans with similar risk characteristics. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off.

Specific allowances are established for impaired loans. Management considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the loan agreement, including scheduled interest payments. Loans for which the terms have been modified with a concession granted, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. When a loan is considered to be impaired, the amount of impairment is measured based on the fair value of the collateral less costs to sell if the loan is collateral dependent, or on the present value of expected future cash flows or values that are observable in the secondary market. If the measure of the impaired loans is less than the investment in the loan, the deficiency will be charged off against the allowance for loan losses if the amount is a confirmed loss, or, alternatively, a specific allocation within the allowance will be established. Loans that are considered impaired are specifically excluded from the formula portion of the allowance for loan losses analysis.

Table of Contents

The estimated loss factors for pools of loans that are not impaired are based on determining the probability of default and loss given default for loans within each segment of the portfolio, adjusted for significant factors that, in management's judgment, affect collectability as of the evaluation date. The Company's historical delinquency experience and loss experience are utilized to determine the probability of default and loss given default for segments of the portfolio where the Company has experienced losses in the past. For segments of the portfolio where the Company has no significant prior loss experience, the Company uses quantifiable observable industry data to determine the probability of default and loss given default.

The following provides a summary of the risks associated with various segments of the Company's loan portfolio, which are factors management regularly considers when evaluating the adequacy of the allowance:

- Commercial loans consist primarily of commercial and industrial loans (business lines of credit), and other commercial purpose loans. Repayment of commercial and industrial loans is generally provided from the cash flows of the related business to which the loan was made. Adverse changes in economic conditions may result in a decline in business activity, which may impact a borrower's ability to continue to make scheduled payments. The factored receivables at Bay View Funding are included in the Company's commercial loan portfolio; however, they are evaluated for risk primarily based on the agings of the receivables. Faster turning receivables imply less risk and therefore warrant a lower associated allowance. Should the overall aging for the portfolio increase, this structure will by formula increase the allowance to reflect the increasing risk. Should the portfolio turn more quickly, it would reduce the associated allowance to reflect the reducing risk.
- Real estate loans consist primarily of loans secured by commercial and residential real estate. Also included in this segment are land and construction loans and home equity lines of credit secured by real estate. As the majority of this segment is comprised of commercial real estate loans, risks associated with this segment lay primarily within these loan types. Adverse economic conditions may result in a decline in business activity and increased vacancy rates for commercial properties. These factors, in conjunction with a decline in real estate prices, may expose the Company to the potential for losses if a borrower cannot continue to service the loan with operating revenues, and the value of the property has declined to a level such that it no longer fully covers the Company's recorded investment in the loan.
- Consumer loans consist primarily of a large number of small loans and lines of credit. The majority of installment loans are made for consumer and business purchases. Weakened economic conditions may result in an increased level of delinquencies within this segment, as economic pressures may impact the capacity of such borrowers to repay their obligations.

As a result of the matters mentioned above, changes in the financial condition of individual borrowers, economic conditions, historical loss experience and the condition of the various markets in which collateral may be sold may all affect the required level of the allowance for loan losses and the associated provision for loan losses.

It is the policy of management to maintain the allowance for loan losses at a level adequate for risks inherent in the loan portfolio. On an ongoing basis, we have engaged an outside firm to perform independent credit reviews of our loan portfolio. The Federal Reserve Board and the California Department of Business Oversight—Division of Financial Institutions also review the allowance for loan losses as an integral part of the examination process. Based on information currently available, management believes that the allowance for loan losses is adequate. However, the loan portfolio can be adversely affected if California economic conditions and the real estate market in the Company's market area were to weaken. Also, any weakness of a prolonged nature in the technology industry would have a negative impact on the local market. The effect of such events, although uncertain at this time, could result in an increase in the level of nonperforming loans and increased loan losses, which could adversely affect the Company's future growth and profitability. No assurance of the ultimate level of credit losses can be given with any certainty.

Table of Contents

The following tables summarize the Company's loan loss experience, as well as provisions and charges to the allowance for loan losses and certain pertinent ratios for the periods indicated:

	Three Months Ended March 31, 2018			
	Real		Consumer	Total
	Commercial	Estate		
	(Dollars in thousands)			
Beginning of period balance	\$ 10,608	\$ 8,950	\$ 100	\$ 19,658
Charge-offs	(245)	—	—	(245)
Recoveries	157	63	—	220
Net (charge-offs) recoveries	(88)	63	—	(25)
Provision (credit) for loan losses	645	(155)	16	506
End of period balance	\$ 11,165	\$ 8,858	\$ 116	\$ 20,139
RATIOS:				
Annualized net charge-offs (recoveries) to average loans (1)	0.02 %	(0.01) %	0.00 %	0.01 %
Allowance for loan losses to total loans (1)	0.70 %	0.56 %	0.01 %	1.27 %
Allowance for loan losses to nonperforming loans	294.20%	233.41 %	3.06 %	530.67 %

(1) Average loans and total loans exclude loans held for sale.

	Three Months Ended March 31, 2017			
	Real		Consumer	Total
	Commercial	Estate		
	(Dollars in thousands)			
Beginning of period balance	\$ 10,656	\$ 8,327	\$ 106	\$ 19,089
Charge-offs	(366)	—	—	(366)
Recoveries	50	41	—	91
Net (charge-offs) recoveries	(316)	41	—	(275)
Provision (credit) for loan losses	912	(625)	34	321
End of period balance	\$ 11,252	\$ 7,743	\$ 140	\$ 19,135
RATIOS:				
Annualized net charge-offs (recoveries) to average loans (1)	0.08 %	(0.01) %	0.00 %	0.07 %
Allowance for loan losses to total loans (1)	0.74 %	0.51 %	0.01 %	1.26 %
Allowance for loan losses to nonperforming loans	208.10%	143.20%	2.59 %	353.89 %

(1) Average loans and total loans exclude loans held for sale.

The following table provides a summary of the allocation of the allowance for loan losses by class at the dates indicated. The allocation presented should not be interpreted as an indication that charges to the allowance for loan losses will be incurred in these amounts or proportions, or that the portion of the allowance allocated to each category represents the total amount available for charge offs that may occur within these classes.

Table of Contents

Allocation of Allowance for Loan Losses

	March 31, 2018			2017			December 31, 2017		
	Allowance (Dollars in thousands)	Percent of Loans in each category to total loans	%	Allowance	Percent of Loans in each category to total loans	%	Allowance	Percent of Loans in each category to total loans	%
Commercial	\$ 11,165	36	%	\$ 11,252	40	%	\$ 10,608	36	%
Real estate:									
CRE	5,778	49	%	4,892	45	%	5,909	49	%
Land and construction	1,573	7	%	1,128	6	%	1,441	6	%
Home equity	1,311	4	%	1,437	5	%	1,390	5	%
Residential mortgages	196	3	%	286	3	%	210	3	%
Consumer	116	1	%	140	1	%	100	1	%
Total	\$ 20,139	100	%	\$ 19,135	100	%	\$ 19,658	100	%

The allowance for loan losses totaled \$20.1 million, or 1.27% of total loans at March 31, 2018, compared to \$19.1 million, or 1.26% of total loans at at March 31, 2017, and \$19.7 million, or 1.24% of total loans at December 31, 2017. The Company had net chargeoffs of \$25,000, or 0.01% of average loans, for the first quarter of 2018, compared to net charge-offs of \$275,000, or 0.07% of average loans, for the first quarter of 2017, and net recoveries of (\$201,000), or (0.05)% of average loans, for the fourth quarter of 2017.

The allowance for loan losses related to the commercial portfolio increased \$557,000, at March 31, 2018 from December 31, 2017, primarily due to an increase in classified commercial loans and net charge offs of \$88,000, resulting in a provision to the allowance for loan losses of \$645,000. The allowance for loan losses related to the real estate portfolio decreased \$92,000 at March 31, 2018 from December 31, 2017, due to net recoveries of \$63,000, resulting in a credit provision for loan losses of \$155,000.

Goodwill and Other Intangible Assets

On November 1, 2014, estimated goodwill of \$13.0 million resulted from the acquisition of Bay View Funding. On August 20, 2015, estimated goodwill of \$32.6 million resulted from the merger of Focus. Goodwill represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate a more accurate or

appropriate value for an asset or liability. Total goodwill at March 31, 2018 and December 31, 2017 was \$45.6 million, which consisted of \$13.0 million related to the Bay View Funding acquisition, and \$32.6 million related to the Focus acquisition.

The Company completed its annual impairment analysis on the goodwill from the Bay View Funding and Focus acquisitions as of November 30, 2017, with the assistance of an independent valuation firm. Based on the Step Zero qualitative analysis performed, the Company determined that it is more likely than not that the fair value of the Company's equity exceeded its reported book value of equity at November 30, 2017. As such, no impairment was indicated and no further testing was required.

Other intangible assets were \$5.3 million at March 31, 2018, compared to \$5.6 million at December 31, 2017. The core deposit intangible asset arising from the acquisition of Focus was \$4.1 million at March 31, 2018 and \$4.3 million at December 31, 2017, net of accumulated amortization. A customer relationship and brokered relationship, and intangible assets arising from the acquisition of Bay View Funding were \$1.3 million at March 31, 2018 and December 31, 2017, net of accumulated amortization. The below market lease and non-compete intangible assets were fully amortized at December 31, 2017.

Deposits

The composition and cost of the Company's deposit base are important components in analyzing the Company's net interest margin and balance sheet liquidity characteristics, both of which are discussed in greater detail in

Table of Contents

other sections herein. The Company's liquidity is impacted by the volatility of deposits from the propensity of that money to leave the institution for rate related or other reasons. Deposits can be adversely affected if economic conditions weaken in California, and the Company's market area in particular. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed \$250,000, as customers with balances of that magnitude are typically more rate sensitive than customers with smaller balances.

The following table summarizes the distribution of deposits and the percentage of distribution in each category of deposits for the periods indicated:

	March 31, 2018			March 31, 2017			December 31, 2017		
	Balance	% to Total		Balance	% to Total		Balance	% to Total	
	(Dollars in thousands)								
Demand, noninterest-bearing	\$ 975,846	40	%	\$ 917,037	39	%	\$ 989,753	40	%
Demand, interest-bearing	621,402	26	%	575,637	25	%	601,929	24	%
Savings and money market	688,217	28	%	606,116	26	%	684,131	27	%
Time deposits — under \$250	49,861	2	%	56,988	3	%	51,710	2	%
Time deposits — \$250 and over	71,446	3	%	164,824	7	%	138,634	6	%
CDARS — interest-bearing demand, money market and time deposits	15,420	1	%	9,485	—	%	16,832	1	%
Total deposits	\$ 2,422,192	100	%	\$ 2,330,087	100	%	\$ 2,482,989	100	%

The Company obtains deposits from a cross section of the communities it serves. The Company's business is not generally seasonal in nature. Public funds were less than 1% of deposits at March 31, 2018, and 4% at March 31, 2017, and 3% at December 31, 2017.

Total deposits increased \$92.1 million, or 4%, to \$2.42 billion at March 31, 2018, compared to \$2.33 billion at March 31, 2017, and decreased \$60.8 million, or 2%, from \$2.48 billion at December 31, 2017. Noninterest bearing demand deposits increased \$58.8 million at March 31, 2018 from March 31, 2017, and decreased \$13.9 million from December 31, 2017. Interest bearing demand deposits increased \$45.8 million at March 31, 2018 from March 31, 2017, and increased \$19.5 million from December 31, 2017. Savings and money market deposits increased \$82.1 million at March 31, 2018 from March 31, 2017, and increased \$4.1 million from December 31, 2017. Due to the maturity of State of California certificates of deposit, time deposits of \$250,000 and over decreased from \$164.8

million at March 31, 2017 to \$71.4 million at March 31, 2018. Time deposits of \$250,000 and over, were \$138.6 million at December 31, 2017. There were no certificates of deposit from the State of California at March 31, 2018, compared to \$85.1 million at March 31, 2017, and \$65.1 million at December 31, 2017. Deposits, excluding all time deposits and CDARS deposits, increased \$186.7 million, or 9%, to \$2.29 billion at March 31, 2018, from \$2.10 billion at March 31, 2017, and increased \$9.7 million from \$2.28 billion at December 31, 2017.

At March 31, 2018, the Company had no certificates of deposits from the State of California. At March 31, 2017, the Company had \$97.4 million (at fair value) of securities pledged for \$85.1 million in certificates of deposits from the State of California. At December 31, 2017, the Company had \$72.5 million (at fair value) of securities pledged for \$65.1 million in certificates of deposits from the State of California.

At March 31, 2018, the \$15.4 million CDARS deposits were comprised of \$9.1 million of interest-bearing demand deposits, \$2.1 million of money market accounts and \$4.2 million of time deposits. At March 31, 2017, the \$9.5 million CDARS deposits were comprised of \$3.9 million of interest-bearing demand deposits, \$2.5 million of money market accounts and \$3.1 million of time deposits. At December 31, 2017, the \$16.8 million CDARS deposits were comprised of \$10.9 million of interest-bearing demand deposits, \$1.7 million of money market accounts and \$4.2 million of time deposits.

Table of Contents

The following table indicates the contractual maturity schedule of the Company's time deposits of \$250,000 and over, and all CDARS time deposits as of March 31, 2018:

	Balance	% of Total	
	(Dollars in thousands)		
Three months or less	\$ 37,063	49	%
Over three months through six months	17,305	23	%
Over six months through twelve months	14,881	19	%
Over twelve months	6,438	9	%
Total	\$ 75,687	100	%

The Company focuses primarily on providing and servicing business deposit accounts that are frequently over \$250,000 in average balance per account. As a result, certain types of business clients that the Company serves typically carry average deposits in excess of \$250,000. The account activity for some account types and client types necessitates appropriate liquidity management practices by the Company to help ensure its ability to fund deposit withdrawals.

Return on Equity and Assets

The following table indicates the ratios for return on average assets and average equity, and average equity to average assets for the periods indicated:

	Three Months Ended March 31,			
	2018		2017	
Return on average assets	1.29	%	1.03	%
Return on average tangible assets	1.31	%	1.05	%
Return on average equity	13.22	%	10.15	%
Return on average tangible equity	16.30	%	12.69	%
Average equity to average assets ratio	9.77	%	10.11	%

Off Balance Sheet Arrangements

In the normal course of business the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in the contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, but are not reflected on the Company's consolidated balance sheets. Total unused commitments to extend credit were \$697.9 million at March 31, 2018, compared to \$672.2 million at March 31, 2017, and \$687.4 million at December 31, 2017. Unused commitments represented 44% outstanding gross loans at March 31, 2018, and March 31, 2017, and 43% at December 31, 2017.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no certainty that lines of credit and letters of credit will ever be fully utilized. The following table presents the Company's commitments to extend credit for the periods indicated:

	March 31, 2018		2017		December 31, 2017	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)					
Unused lines of credit and commitments to make loans	\$ 108,101	\$ 576,005	\$ 15,637	\$ 639,774	\$ 102,505	\$ 570,190
Standby letters of credit	3,972	9,823	4,171	12,588	3,972	10,715
	\$ 112,073	\$ 585,828	\$ 19,808	\$ 652,362	\$ 106,477	\$ 580,905

Liquidity and Asset/Liability Management

Liquidity refers to the Company's ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely and cost effective fashion. At various times the Company requires funds to meet short term cash requirements brought about by loan growth or deposit outflows, the purchase of assets, or

Table of Contents

liability repayments. An integral part of the Company's ability to manage its liquidity position appropriately is the Company's large base of core deposits, which are generated by offering traditional banking services in its service area and which have historically been a stable source of funds. To manage liquidity needs cash inflows must be properly timed to coincide with anticipated outflows or sufficient liquidity resources must be available to meet varying demands. The Company manages liquidity to be able to meet unexpected sudden changes in levels of its assets or deposit liabilities without maintaining excessive amounts of balance sheet liquidity. Excess balance sheet liquidity can negatively impact the Company's interest margin. In order to meet short term liquidity needs the Company utilizes overnight Federal funds purchase arrangements and other borrowing arrangements with correspondent banks, solicits brokered deposits if cost effective deposits are not available from local sources, and maintains collateralized lines of credit with the FHLB and FRB. In addition, the Company can raise cash for temporary needs by selling securities under agreements to repurchase and selling securities available for sale.

One of the measures of liquidity is our loan to deposit ratio. Our loan to deposit ratio was 65.69% at March 31, 2018, compared to 64.95% at March 31, 2017, and 63.74% at December 31, 2017.

FHLB and FRB Borrowings and Available Lines of Credit

HBC has off balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. HBC can borrow from the FHLB on a short term (typically overnight) or long term (over one year) basis. HBC had no overnight borrowings from the FHLB at March 31, 2018, March 31, 2017, and December 31, 2017. HBC had \$239.4 million of loans pledged to the FHLB as collateral on an available line of credit of \$187.6 million at March 31, 2018, none of which was outstanding.

HBC can also borrow from the FRB's discount window. HBC had \$547.9 million of loans pledged to the FRB as collateral on an available line of credit of \$333.2 million at March 31, 2018, none of which was outstanding.

At March 31, 2018, HBC had Federal funds purchase arrangements available of \$55.0 million. There were no Federal funds purchased outstanding at March 31, 2018, March 31, 2017, and December 31, 2017.

The Company has a \$5.0 million line of credit with a correspondent bank, of which none was outstanding at March 31, 2018.

HBC may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase at March 31, 2018, March 31, 2017, and December 31, 2017.

Subordinated Debt

On May 26, 2017, the Company completed an underwritten public offering of \$40.0 million aggregate principal amount of its fixed-to-floating rate subordinated notes (“Subordinated Debt”) due June 1, 2027. The Subordinated Debt initially bears a fixed interest rate of 5.25% per year. Commencing on June 1, 2022, the interest rate on the Subordinated Debt resets quarterly to the three-month LIBOR rate plus a spread of 336.5 basis points. Interest on the Subordinated Debt is payable semi-annually on June 1 and December 1 of each year through June 1, 2022 and quarterly thereafter on March 1, June 1, September 1 and December 1 of each year through the maturity date or early redemption date. The Company, at its option, may redeem the Subordinated Debt, in whole or in part, on any interest payment date on or after June 1, 2022 without a premium. The Subordinated Debt, net of unamortized costs totaled \$39.2 million at March 31, 2018 and December 31, 2017, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank. The Company down streamed \$20.0 million of the proceeds to HBC during the second quarter of 2017.

Capital Resources

The Company uses a variety of measures to evaluate capital adequacy. Management reviews various capital measurements on a regular basis and takes appropriate action to ensure that such measurements are within established internal and external guidelines. The external guidelines, which are issued by the Federal Reserve and the FDIC, establish a risk adjusted ratio relating capital to different categories of assets and off balance sheet exposures.

Table of Contents

The following table summarizes risk based capital, risk weighted assets, and risk based capital ratios of the consolidated Company under the Basel III requirements for the periods indicated:

	March 31, 2018	March 31, 2017	December 31, 2017
	(Dollars in thousands)		
Capital components:			
Common equity Tier 1 capital	\$ 232,905	\$ 218,099	\$ 229,258
Additional Tier 1 capital	—	—	—
Tier 1 Capital	232,905	218,099	229,258
Tier 2 Capital	60,001	19,760	59,496
Total risk-based capital	\$ 292,906	\$ 237,859	\$ 288,754
Risk-weighted assets	\$ 1,999,026	\$ 1,909,720	\$ 2,003,652
Average assets for capital purposes	\$ 2,721,601	\$ 2,533,037	\$ 2,873,978
Capital ratios:			
Total risk-based capital	14.7	% 12.5	% 14.4
Tier 1 risk-based capital	11.7	% 11.4	% 11.4
Common equity Tier 1 risk-based capital	11.7	% 11.4	% 11.4
Leverage(1)	8.6	% 8.6	% 8.0

(1) Tier 1 capital divided by quarterly average assets (excluding intangible assets and disallowed deferred tax assets).

The following table summarizes risk based capital, risk-weighted assets, and risk-based capital ratios of HBC under the Basel III requirements for the periods indicated:

	March 31, 2018	March 31, 2017	December 31, 2017
	(Dollars in thousands)		
Capital components:			
Common equity Tier 1 capital	\$ 248,872	\$ 213,981	\$ 244,790
Additional Tier 1 capital	—	—	—
Tier 1 Capital	248,872	213,981	244,790
Tier 2 Capital	20,772	19,760	20,312
Total risk-based capital	\$ 269,644	\$ 233,741	\$ 265,102
Risk-weighted assets	\$ 1,997,776	\$ 1,909,040	\$ 2,002,736
Average assets for capital purposes	\$ 2,720,382	\$ 2,532,391	\$ 2,873,102

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

Capital ratios:

Total risk-based capital	13.5	%	12.2	%	13.2	%
Tier 1 risk-based capital	12.5	%	11.2	%	12.2	%
Common equity Tier 1 risk-based capital	12.5	%	11.2	%	12.2	%
Leverage(1)	9.1	%	8.4	%	8.5	%

(1) Tier 1 capital divided by quarterly average assets (excluding intangible assets and disallowed deferred tax assets).

Table of Contents

The following table presents the applicable well capitalized regulatory guidelines and the standards for minimum capital adequacy requirements under Basel III:

	Transitional Minimum Regulatory Requirement(1) Effective January 1, 2018		Fully Phased-in Minimum Regulatory Requirement(2) Effective January 1, 2019		Well-capitalized Financial Institution Regulatory Guidelines	
Capital ratios:						
Total risk-based capital	9.875	%	10.5	%	10.0	%
Tier 1 risk-based capital	7.875	%	8.5	%	8.0	%
Common equity Tier 1 risk-based capital	6.375	%	7.0	%	6.5	%
Leverage	4.000	%	4.0	%	5.0	%

(1) Includes 1.875% capital conservation buffer, except the leverage capital ratio.

(2) Includes 2.5% capital conservation buffer, except the leverage capital ratio.

The Basel III capital rules introduce a new “capital conservation buffer,” for banking organizations to maintain a common equity Tier 1 ratio more than 2.5% above these minimum risk weighted asset ratios. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of common equity Tier 1 to risk weighted assets above the minimum but below the capital conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The implementation of the capital conservation buffer was phased in beginning on January 1, 2016 at 0.625% and will be phased in over a four year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The capital conservation buffer increased to 1.875% beginning on January 1, 2018.

The Subordinated Debt, net of unamortized issuance costs, totaled \$39.2 million at March 31, 2018, and qualifies as Tier 2 capital for the Company under the guidelines established by the Federal Reserve Bank. The issuance of Subordinated Debt during the second quarter of 2017 resulted in an increase in the Company’s total risk based capital ratio at March 31, 2018, compared to March 31, 2017, but had no effect on the other regulatory capital ratios of the Company.

At March 31, 2018, the Company’s consolidated capital ratio exceeded regulatory guidelines and HBC’s capital ratios exceed the highest regulatory capital requirement of “well capitalized” under Basel III prompt corrective action provisions. Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios of total risk based capital, Tier 1 capital, and common equity Tier 1 (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital to average assets (as defined).

Management believes that, as of March 31, 2018, March 31, 2017, and December 31, 2017, the Company and HBC met all capital adequacy guidelines to which they were subject. There are no conditions or events since March 31, 2018, that management believes have changed the categorization of the Company or HBC as well capitalized.

At March 31, 2018, the Company had total shareholders' equity of \$271.0 million, compared to \$263.9 million at March 31, 2017, and \$271.2 million at December 31, 2017. At March 31, 2018, total shareholders' equity included \$219.2 million in common stock, \$66.7 million in retained earnings, and (\$14.9) million of accumulated other comprehensive loss.

The accumulated other comprehensive loss was (\$14.9) million at March 31, 2018, compared to (\$7.4) million at March 31, 2017, and (\$9.3) million at December 31, 2017. The unrealized gain loss on securities available for sale, net of taxes, included in accumulated other comprehensive loss was an unrealized loss of (\$6.8) million at March 31, 2018, compared to (\$653,000) at March 31, 2017, and (\$1.0) million at December 31, 2017. The components of accumulated other comprehensive loss, net of taxes, at March 31, 2018 include the following: an unrealized loss on available for sale securities of (\$6.8) million; the remaining unamortized unrealized gain on securities available for sale transferred to held to maturity of \$365,000; a split dollar insurance contracts liability of (\$3.7) million; a supplemental executive retirement plan liability of (\$5.5) million; and an unrealized gain on interest only strip from SBA loans of \$671,000.

Table of Contents

The book value per share was \$7.08 at March 31, 2018, compared to \$6.95 at March 31, 2017, and \$7.10 at December 31, 2017. The tangible book value per share was \$5.75 at March 31, 2018, compared to \$5.57 at March 31, 2017, and \$5.76 at December 31, 2017.

Market Risk

Market risk is the risk of loss of future earnings, fair values, or future cash flows that may result from changes in the price of a financial instrument. The value of a financial instrument may change as a result of changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market risk sensitive instruments. Market risk is attributed to all market risk sensitive financial instruments, including securities, loans, deposits and borrowings, as well as the Company's role as a financial intermediary in customer related transactions. The objective of market risk management is to avoid excessive exposure of the Company's earnings and equity to loss and to reduce the volatility inherent in certain financial instruments.

Interest Rate Management

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company's market risk exposure is primarily that of interest rate risk, and it has established policies and procedures to monitor and limit earnings and balance sheet exposure to changes in interest rates. The Company does not engage in the trading of financial instruments, nor does the Company have exposure to currency exchange rates.

The principal objective of interest rate risk management (often referred to as "asset/liability management") is to manage the financial components of the Company in a manner that will optimize the risk/reward equation for earnings and capital in relation to changing interest rates. The Company's exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximizing income. Management realizes certain risks are inherent, and that the goal is to identify and manage the risks. Management uses two methodologies to manage interest rate risk: (i) a standard GAP analysis; and (ii) an interest rate shock simulation model.

The planning of asset and liability maturities is an integral part of the management of an institution's net interest margin. To the extent maturities of assets and liabilities do not match in a changing interest rate environment, the net interest margin may change over time. Even with perfectly matched repricing of assets and liabilities, risks remain in the form of prepayment of loans or securities or in the form of delays in the adjustment of rates of interest applying to either earning assets with floating rates or to interest bearing liabilities. The Company has generally been able to control its exposure to changing interest rates by maintaining primarily floating interest rate loans and a majority of its

time certificates with relatively short maturities.

Interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Varying interest rate environments can create unexpected changes in prepayment levels of assets and liabilities, which may have a significant effect on the net interest margin and are not reflected in the interest sensitivity analysis table. Because of these factors, an interest sensitivity GAP report may not provide a complete assessment of the exposure to changes in interest rates.

The Company uses modeling software for asset/liability management in order to simulate the effects of potential interest rate changes on the Company's net interest margin, and to calculate the estimated fair values of the Company's financial instruments under different interest rate scenarios. The program imports current balances, interest rates, maturity dates and repricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company's interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Company's investment, loan, deposit and borrowed funds' portfolios. These rate projections can be shocked (an immediate and parallel change in all base rates, up or down) and ramped (an incremental increase or decrease in rates over a specified time period), based on current trends and econometric models or stable economic conditions (unchanged from current actual levels).

Table of Contents

The following table sets forth the estimated changes in the Company's annual net interest income that would result from the designated instantaneous parallel shift in interest rates noted, as of March 31, 2018. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

Change in Interest Rates (basis points)	Increase/(Decrease) in Estimated Net Interest Income		
	Amount (Dollars in thousands)	Percent	
+400	\$ 24,578	22.9	%
+300	\$ 18,770	17.5	%
+200	\$ 12,834	12.0	%
+100	\$ 6,536	6.1	%
0	\$ —	—	%
-100	\$ (10,651)	(9.9)	%
-200	\$ (21,422)	(20.0)	%

This data does not reflect any actions that we may undertake in response to changes in interest rates such as changes in rates paid on certain deposit accounts based on local competitive factors, which could reduce the actual impact on net interest income.

As with any method of gauging interest rate risk, there are certain shortcomings inherent to the methodology noted above. The model assumes interest rate changes are instantaneous parallel shifts in the yield curve. In reality, rate changes are rarely instantaneous. The use of the simplifying assumption that short term and long term rates change by the same degree may also misstate historic rate patterns, which rarely show parallel yield curve shifts. Further, the model assumes that certain assets and liabilities of similar maturity or period to repricing will react in the same way to changes in rates. In reality, certain types of financial instruments may react in advance of changes in market rates, while the reaction of other types of financial instruments may lag behind the change in general market rates. Additionally, the methodology noted above does not reflect the full impact of annual and lifetime restrictions on changes in rates for certain assets, such as adjustable rate loans. When interest rates change, actual loan prepayments and actual early withdrawals from certificates may deviate significantly from the assumptions used in the model. Finally, this methodology does not measure or reflect the impact that higher rates may have on adjustable rate loan clients' ability to service their debt. All of these factors are considered in monitoring the Company's exposure to interest rate risk.

ITEM 3—QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information concerning quantitative and qualitative disclosure or market risk called for by Item 305 of Regulation S-K is included as part of Item 2 above.

ITEM 4—CONTROLS AND PROCEDURES

Disclosure Control and Procedures

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of March 31, 2018. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded the Company's disclosure controls were effective as March 31, 2018, the period covered by this report on Form 10-Q.

During the three months ended March 31, 2018, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

Table of Contents

Part II—OTHER INFORMATION

ITEM 1—LEGAL PROCEEDINGS

The Company is involved in certain legal actions arising from normal business activities. Management, based upon the advice of legal counsel, believes the ultimate resolution of all pending legal actions will not have a material effect on the financial statements of the Company.

ITEM 1A—RISK FACTORS

In addition to the other information set forth in this Report, you should carefully consider the other factors discussed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10 K for the year ended December 31, 2017, which could materially affect our business, financial condition and/or operating results. There were no material changes from risk factors previously disclosed in our 2017 Annual Report on Form 10 K. The risk factors identified are in addition to those contained in any other cautionary statements, written or oral, which may be or otherwise addressed in connection with a forward looking statement or contained in any of our subsequent filings with the Securities and Exchange Commission.

ITEM 2—UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3—DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4—MINE SAFETY DISCLOSURES

None

ITEM 5—OTHER INFORMATION

None

ITEM 6—EXHIBITS

Exhibit	Description
3.1	<u>Heritage Commerce Corp Restated Articles of Incorporation, (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 16, 2009)</u>
3.2	<u>Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp as filed with the California Secretary of State on June 1, 2010 (incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-1 filed July 23, 2010).</u>
3.3	<u>Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 28, 2013)</u>
31.1	<u>Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002</u>
31.2	<u>Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002</u>
32.1	<u>Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350</u>
32.2	<u>Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350</u>
101.INS	XBRL Instance Document, filed herewith
101.SCH	XBRL Taxonomy Extension Schema Document, filed herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, filed herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, filed herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, filed herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, filed herewith

Table of Contents

SIGNATURES

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

Heritage Commerce Corp (Registrant)

Date: May 7, 2018 /s/ Keith A. Wilton
Keith A. Wilton
Chief Operating Officer

Date: May 7, 2018 /s/ Lawrence D. McGovern
Lawrence D. McGovern
Chief Financial Officer