HERITAGE COMMERCE CORP
Form 10-Q
May 04, 2012

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended March 31, 2012

OR

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

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

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

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

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

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

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

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

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

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

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

The Registrant had 26,286,501 shares of Common Stock outstanding on April 13, 2012.

HERITAGE COMMERCE CORP
QUARTERLY REPORT ON FORM 10-Q
TABLE OF CONTENTS

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

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

Competition for loans and deposits and failure to attract or retain deposits and loans;

Local, regional, and national economic conditions and events and the impact they may have on us and our customers, and our assessment of that impact on our estimates including, the allowance for loan losses;

Risks associated with concentrations in real estate related loans;

Changes in the level of nonperforming assets and charge-offs and other credit quality measures, and their impact on the adequacy of the Company's allowance for loan losses and the Company's provision for loan losses;

The effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Federal Open Market Committee of the Federal Reserve Board;

Stability of funding sources and continued availability of borrowings;

Our ability to raise capital or incur debt on reasonable terms;

Regulatory limits on Heritage Bank of Commerce's ability to pay dividends to the Company;

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

The impact of reputational risk on such matters as business generation and retention, funding and liquidity;

Oversupply of inventory and continued deterioration in values of California commercial real estate;

A prolonged slowdown in construction activity;

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

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

Changes in consumer spending, borrowings and saving habits;

Table of Contents

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

The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;

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

The ability to increase market share and control expenses; and

Our success in managing the risks involved in the foregoing items.

We are not able to predict all the factors that may affect future results. You should not place undue reliance on any forward looking statement, which speaks only as of the date of this Report on Form 10-Q. Except as required by applicable laws or regulations, we do not undertake any obligation to update or revise any forward looking statement, whether as a result of new information, future events or otherwise.

Table of Contents

Part I FINANCIAL INFORMATION

ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HERITAGE COMMERCE CORP

CONSOLIDATED BALANCE SHEETS (Unaudited)

	March 31, 2012	December 31, 2011
	(Dollars in thousands, except per share data)	
Assets		
Cash and due from banks	$ 20,450	$ 20,861
Interest-bearing deposits in other financial institutions	48,215	52,011
Total cash and cash equivalents	68,665	72,872
Securities available-for-sale, at fair value	385,826	380,455
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	4,778	753
Loans held-for-sale other, at lower of cost or fair value, including deferred costs	184	413
Loans, including deferred costs	756,894	764,591
Allowance for loan losses	(20,306)	(20,700)
Loans, net	736,588	743,891
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	9,928	9,925
Company owned life insurance	47,067	46,388
Premises and equipment, net	7,883	7,980
Intangible assets	2,368	2,491
Accrued interest receivable and other assets	42,011	41,026
Total assets	$ 1,305,298	$ 1,306,194
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	$ 356,618	$ 344,303
Demand, interest-bearing	144,022	134,119
Savings and money market	292,009	282,478
Time deposits under $100	27,949	28,557
Time deposits $100 and over	168,726	168,874
Time deposits CDARS	6,198	6,371
Time deposits brokered	84,728	84,726
Total deposits	1,080,250	1,049,428
Subordinated debt	23,702	23,702
Accrued interest payable and other liabilities	41,450	35,233
Total liabilities	1,145,402	1,108,363
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		
		39,846

Series A fixed rate cumulative preferred stock, 40,000 shares issued and outstanding (liquidation preference of $40,250) at December 31, 2011				
Discount on Series A preferred stock				(833)
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at March 31, 2012 and December 31, 2011 (liquidation preference of $21,004 at March 31, 2012 and December 31, 2011)		19,519		19,519
Common stock, no par value; 60,000,000 shares authorized; 26,286,501 shares issued and outstanding at March 31, 2012 and 26,295,001 shares issued and outstanding at December 31, 2011		131,302		131,172
Retained earnings		7,887		7,172
Accumulated other comprehensive income		1,188		955
Total shareholders' equity		159,896		197,831
Total liabilities and shareholders' equity	$	1,305,298	$	1,306,194

See notes to consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended March 31, 2012	2011
	(Dollars in thousands, except per share data)	
Interest income:		
Loans, including fees	$ 10,316	$ 10,989
Securities	3,097	1,963
Interest-bearing deposits in other financial institutions	36	34
Total interest income	13,449	12,986
Interest expense:		
Deposits	716	1,271
Subordinated debt	474	466
Other		53
Total interest expense	1,190	1,790
Net interest income before provision for loan losses	12,259	11,196
Provision for loan losses	100	770
Net interest income after provision for loan losses	12,159	10,426
Noninterest income:		
Service charges and fees on deposit accounts	590	567
Servicing income	460	411
Increase in cash surrender value of life insurance	429	425
Gain on sale of SBA loans	36	379
Gain on sale of securities	27	
Other	181	135
Total noninterest income	1,723	1,917
Noninterest expense:		
Salaries and employee benefits	5,667	5,393
Professional fees	1,211	839
Occupancy and equipment	996	1,038
Software subscriptions	290	255
Low income housing investment losses	269	162
Data processing	245	220
FDIC deposit insurance premiums	225	524
Insurance expense	224	241
Other real estate owned expense	115	21
Other	1,614	1,738
Total noninterest expense	10,856	10,431
Income before income taxes	3,026	1,912
Income tax expense	951	331
Net income	2,075	1,581

Dividends and discount accretion on preferred stock		(1,206)		(596)
Net income available to common shareholders	$	869	$	985
Earnings per common share:				
Basic	$	0.03	$	0.03
Diluted	$	0.03	$	0.03

See notes to consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	Three Months Ended March 31,	
	2012	**2011**
	(Dollars in thousands)	
Net income	$ 2,075	$ 1,581
Net unrealized holding gains (losses) on available-for-sale securities and I/O strips	372	(367)
Reclassification adjustment for (gains) realized in income	(27)	
Deferred income taxes	(145)	154
Change in unrealized gains (losses) on available-for-sale securities and I/O strips, net of deferred income taxes	200	(213)
Net pension and other benefit plan liability adjustment	57	105
Deferred income tax	(24)	(44)
Change in pension and other benefit plan liability, net of deferred income taxes	33	61
Other comprehensive income (loss)	233	(152)
Total comprehensive income	$ 2,308	$ 1,429

See notes to consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

	Three Months Ended March 31, 2012 and 2011							
	Preferred Stock			Common Stock		Retained Earnings/ (Accumulated Deficit)	Accumulated Other Comprehensive Income / (Loss)	Total Shareholders' Equity
	Shares	Amount	Discount	Shares	Amount			
	(Dollars in thousands, except share data)							
Balance, January 1, 2011	61,004	$ 59,365	$ (1,227)	26,233,001	$ 130,531	$ (1,866)	$ (4,651)	$ 182,152
Net income						1,581		1,581
Net change in unrealized gain/(loss) on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes							(213)	(213)
Net change in pension and other benefit plan liability, net of deferred income taxes							61	61
Amortization of restricted stock awards, net of forfeitures and taxes					(36)			(36)
Cash dividends accrued on Series A preferred stock						(500)		(500)
Accretion of discount on Series A preferred stock			96			(96)		
Stock option expense, net of fortfeitures and taxes					187			187
Balance, March 31, 2011	61,004	$ 59,365	$ (1,131)	26,233,001	$ 130,682	$ (881)	$ (4,803)	$ 183,232
Balance, January 1, 2012	61,004	$ 59,365	$ (833)	26,295,001	$ 131,172	$ 7,172	$ 955	$ 197,831
Net income						2,075		2,075
Net change in unrealized gain/(loss) on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes							200	200
Net change in pension and other benefit plan liability, net of deferred income taxes							33	33
Repurchase of Series A preferred stock	(40,000)	(40,000)						(40,000)
Series A preferred stock capitalized offering costs		154				(154)		
Forfeitures of restricted stock awards				(8,500)				
Amortization of restricted stock awards, net of forfeitures and taxes					28			28
Cash dividends paid on Series A preferred stock						(373)		(373)
Accretion of discount on Series A preferred stock			833			(833)		
Stock option expense, net of fortfeitures and taxes					102			102
Balance, March 31, 2012	21,004	$ 19,519	$	26,286,501	$ 131,302	$ 7,887	$ 1,188	$ 159,896

See notes to consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 2,075	$ 1,581
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	533	271
Gain on sale of securities available-for-sale	(27)	
Gain on sale of SBA loans	(36)	(379)
Proceeds from sale of SBA loans originated for sale	632	4,710
Net change in SBA loans originated for sale	(4,621)	(2,830)
Write-downs on other loans held-for-sale		29
Provision for loan losses	100	770
Increase in cash surrender value of life insurance	(429)	(425)
Depreciation and amortization	195	197
Amortization of other intangible assets	123	130
Gain on sale of foreclosed assets, net	(31)	(10)
Stock option expense, net	102	187
Amortization of restricted stock awards, net	28	(36)
Effect of changes in:		
Accrued interest receivable and other assets	818	874
Accrued interest payable and other liabilities	(609)	(4,799)
Net cash (used in) provided by operating activities	(1,147)	270
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(19,943)	(18,339)
Maturities/paydowns/calls of securities available-for-sale	18,858	7,872
Proceeds from sale of securities available-for-sale	2,280	
Proceeds from sale of other loans transferred to held-for-sale	220	
Net change in other loans transferred to held-for-sale		8
Net change in loans	5,239	39,924
Change in Federal Home Loan Bank and Federal Reserve Bank stock	(3)	136
Purchase of premises and equipment	(98)	(19)
Proceeds from sale of foreclosed assets	188	1,305
Purchase of company owned life insurance	(250)	
Net cash provided by investing activities	6,491	30,887
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	30,822	9,405
Repurchase of Series A Preferred Stock	(40,000)	
Payment of cash dividends preferred stock	(373)	
Net change in securities sold under agreement to repurchase		(5,000)
Net change in short-term borrowings		(271)
Net cash provided (used in) by financing activities	(9,551)	4,134
Net (decrease) increase in cash and cash equivalents	(4,207)	35,291
Cash and cash equivalents, beginning of period	72,872	72,177
Cash and cash equivalents, end of period	$ 68,665	$ 107,468
Supplemental disclosures of cash flow information:		
Interest paid	$ 1,557	$ 1,425

Income taxes paid		800		
Supplemental schedule of non-cash investing activity:				
Due to broker for securities purchased	$	11,921	$	8,231
Loans transferred to foreclosed assets		1,973		918
Cash dividend accrued on Series A preferred stock				500

See notes to consolidated financial statements

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2012

(Unaudited)

1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company") and its wholly owned subsidiary, Heritage Bank of Commerce (sometimes referred to as "HBC"), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes that were included in the Company's Form 10-K for the year ended December 31, 2011. The Company has also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III which are Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities.

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

In the Company'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, 2012 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2012.

Reclassifications

Certain reclassifications of prior year balances have been made to conform to the current year presentation. These reclassifications had no impact on the Company's consolidated financial position, results of operations or net change in cash and cash equivalents.

Adoption of New Accounting Standards

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

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

1) Basis of Presentation (Continued)

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

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

2) Earnings Per Share

Basic earnings per common share is computed by dividing net income, less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The 21,004 shares of Series C Preferred Stock remain outstanding as of March 31, 2012, and are convertible into 5,601,000 shares of common stock. The Series C Preferred Stock participate in the earnings of the Company and, therefore, the shares issued on the conversion of the Series C Preferred Stock are considered outstanding under the two-class method of computing basic earnings per common share during periods of earnings. Diluted earnings per share reflect potential dilution from outstanding stock options and common stock warrants, using the treasury stock method. The common stock warrant was antidilutive at March 31, 2012 and 2011. A

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

2) Earnings Per Share (Continued)

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

	For the Three Months Ended March 31,	
(Dollars in thousands)	**2012**	**2011**
Net income available to common shareholders	$ 869	$ 985
Less: net income allocated to Series C Preferred Stock	153	173
Net income allocated to common shareholders	$ 716	$ 812
Weighted average common shares outstanding for basic earnings per common share	26,289,334	26,233,001
Dilutive effect of stock options oustanding, using the the treasury stock method	27,220	7,161
Shares used in computing diluted earnings per common share	26,316,554	26,240,162

3) Securities

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

March 31, 2012	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	$ 331,496	$ 8,702	$ (17)	$ 340,181
Corporate bonds	10,353	283		10,636
Trust preferred securities	35,044	154	(189)	35,009
Total	$ 376,893	$ 9,139	$ (206)	$ 385,826

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

At March 31, 2012 and December 31, 2011, all agency mortgage-backed securities were issued by the Federal National Mortgage Association ("Fannie Mae") the Federal Home Loan Mortgage

12

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

3) Securities (Continued)

Corporation ("Freddie Mac"), or the Government National Mortgage Association ("Ginnie Mae"). At March 31, 2012 and December 31, 2011, trust preferred securities were issued by single entities. 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, 2012, the Company held 176 securities, of which nine had fair values below amortized cost. No securities had been carried with an unrealized loss for over 12 months. Unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not intend to sell any securities with an unrealized loss and does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company did not consider these securities to be other-than-temporarily impaired at March 31, 2012.

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

The amortized cost and fair values of debt securities as of March 31, 2012, by contractual maturity, are shown below. The expected maturities will differ from contractual maturities if borrowers have the right to call or pre-pay obligations with or without call or pre-payment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after one through five years	$ 904	$ 961
Due after five through ten years	9,449	9,675
Due after ten years	35,044	35,009
Agency mortgage-backed securities	331,496	340,181
Total	$ 376,893	$ 385,826

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

4) Loans

Loans were as follows:

	March 31, 2012	December 31, 2011
	(Dollars in thousands)	
Loans held-for-sale:		
Loans held-for-sale SBA	$ 4,778	$ 753
Loans held-for-sale other	184	413
Total loans held-for-sale	$ 4,962	$ 1,166
Loans held-for-investment:		
Commercial	$ 357,906	$ 366,590
Real estate:		
Commercial and residential	319,914	311,479
Land and construction	18,583	23,016
Home equity	48,444	52,017
Consumer	11,810	11,166
Loans	756,657	764,268
Deferred loan origination costs and fees, net	237	323
Loans, including deferred costs	756,894	764,591
Allowance for loan losses	(20,306)	(20,700)
Loans, net	$ 736,588	$ 743,891

Changes in the allowance for loan losses were as follows:

	Three Months Ended March 31, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 13,215	$ 7,338	$ 147	$ 20,700
Charge-offs	(910)	(45)		(955)
Recoveries	461			461
Net charge-offs	(449)	(45)		(494)
Provision/(credit) for loan losses	968	(884)	16	100
Balance, end of period	$ 13,734	$ 6,409	$ 163	$ 20,306

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

4) Loans (Continued)

	Three Months Ended March 31, 2011			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 13,952	$ 10,363	$ 889	$ 25,204
Charge-offs	(1,119)	(995)		(2,114)
Recoveries	139	10		149
Net charge-offs	(980)	(985)		(1,965)
Provision/(credit) for loan losses	622	161	(13)	770
Balance, end of period	$ 13,594	$ 9,539	$ 876	$ 24,009

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

	March 31, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 2,641	$ 201	$ 2	$ 2,844
Collectively evaluated for impairment	11,093	6,208	161	17,462
Total allowance balance	$ 13,734	$ 6,409	$ 163	$ 20,306
Loans:				
Individually evaluated for impairment	$ 10,947	$ 5,633	$ 11	$ 16,591
Collectively evaluated for impairment	346,959	381,308	11,799	740,066
Total loan balance	$ 357,906	$ 386,941	$ 11,810	$ 756,657

	December 31, 2011			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 2,249	$ 76	$ 2	$ 2,327
Collectively evaluated for impairment	10,966	7,262	145	18,373

Total allowance balance	$	13,215	$	7,338	$	147	$	20,700
Loans:								
Individually evaluated for impairment	$	11,954	$	5,948	$	12	$	17,914
Collectively evaluated for impairment		354,636		380,564		11,154		746,354
Total loan balance	$	366,590	$	386,512	$	11,166	$	764,268

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

4) Loans (Continued)

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of March 31, 2012 and December 31, 2011. 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.

	March 31, 2012			December 31, 2011		
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
	(Dollars in thousands)					
With no related allowance recorded:						
Commercial	$ 4,730	$ 4,651	$	$ 7,644	$ 5,972	$
Real estate:						
Commercial and residential	1,134	1,134		2,916	2,057	
Land and construction	2,224	2,224		3,491	3,039	
Total with no related allowance recorded	8,088	8,009		14,051	11,068	
With an allowance recorded:						
Commercial	6,307	6,296	2,641	6,526	5,982	2,249
Real estate:						
Commercial and residential	2,275	2,275	201	80	80	44
Land and construction				817	740	32
Home Equity				32	32	
Consumer	11	11	2	12	12	2
Total with an allowance recorded	8,593	8,582	2,844	7,467	6,846	2,327
Total	$ 16,681	$ 16,591	$ 2,844	$ 21,518	$ 17,914	$ 2,327

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

	Three Months Ended March 31, 2012					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 11,450	$ 2,773	$ 3,002	$ 16	$ 11	$ 17,252
Interest income during impairment	$	$ 1	$ 14	$	$	$ 15
Cash-basis interest earned	$	$ 1	$ 14	$	$	$ 15

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

4) Loans (Continued)

	Three Months Ended March 31, 2011					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 13,814	$ 5,076	$ 8,015	$ 141	$ 895	$ 27,941
Interest income during impairment	$ 1	$	$	$ 1	$	$ 2
Cash-basis interest earned	$ 1	$	$	$	$	$ 1

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, 2012	March 31, 2011	December 31, 2011
	(Dollars in thousands)		
Nonaccrual loans held-for-sale	$ 184	$ 1,989	$ 186
Nonaccrual loans held-for-investment	14,005	22,896	14,353
Restructured and loans over 90 days past due and still accruing	2,155	282	2,291
Total	$ 16,344	$ 25,167	$ 16,830
Other restructured loans	$ 431	$ 1,389	$ 1,270
Impaired loans, excluding loans held-for-sale	$ 16,591	$ 24,567	$ 17,914

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

	March 31, 2012			December 31, 2011		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	$ 8,360	$ 2,155	$ 10,515	$ 8,876	$ 1,803	$ 10,679
Real estate:						
Commercial and residential	3,412		3,412	2,137		2,137
Land and construction	2,406		2,406	3,514	456	3,970
Home equity					32	32
Consumer	11		11	12		12

Total	$ 14,189	$ 2,155	$ 16,344	$ 14,539	$ 2,291	$ 16,830

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

4) Loans (Continued)

The following table presents the aging of past due loans as of March 31, 2012 by class of loans:

	March 31, 2012					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 2,987	$ 1,226	$ 4,199	$ 8,412	$ 349,494	$ 357,906
Real estate:						
Commercial and residential	854	1,455		2,309	317,605	319,914
Land and construction					18,583	18,583
Home equity					48,444	48,444
Consumer					11,810	11,810
Total	$ 3,841	$ 2,681	$ 4,199	$ 10,721	$ 745,936	$ 756,657

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

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

Past due loans 30 days or greater totaled $10,721,000 and $10,511,000 at March 31, 2012 and December 31, 2011, respectively, of which $6,576,000 and $6,312,000, respectively, were on nonaccrual. At March 31, 2012, there were also $7,428,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2011, there were also $8,041,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

4) Loans (Continued)

Credit Quality Indicators

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

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

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

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

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

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

4) Loans (Continued)

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

	March 31, 2012			December 31, 2011		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)					
Commercial	$ 328,099	$ 29,807	$ 357,906	$ 333,506	$ 33,084	$ 366,590
Real estate:						
Commercial and residential	304,243	15,671	319,914	294,653	16,826	311,479
Land and construction	12,508	6,075	18,583	15,343	7,673	23,016
Home equity	47,795	649	48,444	51,368	649	52,017
Consumer	11,405	405	11,810	10,853	313	11,166
Total	$ 704,050	$ 52,607	$ 756,657	$ 705,723	$ 58,545	$ 764,268

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

During the three months ended March 31, 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or more combination of the following: a reduction of the stated interest rate of the loan; or an extension of maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk.

The book balance of troubled debt restructurings at March 31, 2012 was $7,442,000, which included $4,856,000 of nonaccrual loans and $2,586,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2011 was $7,396,000, which included $4,323,000 of nonaccrual loans and $3,073,000 of accruing loans. Approximately $1,429,000 and $574,000 in specific reserves were established with respect to these loans as of March 31, 2012 and December 31, 2011, respectively. As of March 31, 2012 and December 31, 2011, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

The following table presents loans by class modified as troubled debt restructurings during the three month period ended March 31, 2012:

	During the Three Months Ended March 31, 2012		
Troubled Debt Restructurings:	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
	(Dollars in thousands)		
Commercial	2	$ 412	$ 412
Total	2	$ 412	$ 412

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

4) Loans (Continued)

The troubled debt restructurings described above increased the allowance for loan losses by $27,000 through the allocation of specific reserves, and resulted in no net charge-offs during the three month period ended March 31, 2012.

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the three months ended March 31, 2012.

5) Income Taxes

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

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

The Company had net deferred tax assets of $21,274,000, and $21,870,000, at March 31, 2012, and December 31, 2011, respectively. After consideration of the matters in the preceding paragraph, the Company determined that a valuation allowance for deferred tax assets should be $0 at March 31, 2012 and December 31, 2011.

6) Benefit Plans

Supplemental Retirement Plan

The Company has a supplemental retirement plan (the "Plan") covering current and former key executives and directors. The Plan is a nonqualified defined benefit plan. Benefits are unsecured as

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

6) Benefit Plans (Continued)

there are no Plan assets. The following table presents the amount of periodic cost recognized for the periods indicated:

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
	(Dollars in thousands)	
Components of net periodic benefit cost:		
Service cost	$ 294	$ 236
Interest cost	193	206
Amortization of prior service cost	7	9
Amortization of net actuarial loss	63	31
Net periodic benefit cost	$ 557	$ 482

Split-Dollar Life Insurance Benefit Plan

The Company maintains life insurance policies for current and former directors and officers that are subject to split-dollar life insurance agreements. During 2011, participants in the split-dollar life insurance benefit plan agreed to amend their agreements related to the designation of beneficiaries for life insurance policies owned by the Company. The agreements were amended to provide a benefit for as long as the policies are in force, including a commitment to provide replacement coverage if the policies are ever surrendered.

The following table sets forth the funded status of the split-dollar life insurance benefits for the three months ended March 31, 2012 and the twelve months ended December 31, 2011:

	March 31, 2012	December 31, 2011
	(Dollars in thousands)	
Change in projected benefit obligation Projected benefit obligation at beginning of period	$ 4,525	$ 6,361
Interest cost	46	306
Actuarial (gain) loss	(10)	831
Amendments to split dollar agreements		(2,973)
Projected benefit obligation at end of period	$ 4,561	$ 4,525

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

6) Benefit Plans (Continued)

Amounts recognized in accumulated other comprehensive loss at March 31, 2012 and December 31, 2011 consist of the following:

	March 31, 2012	December 31, 2011
	(Dollars in thousands)	
Net actuarial loss	$ 484	$ 454
Prior transition obligation	1,754	1,776
Accumulated other comprehensive loss	$ 2,238	$ 2,230

7) Preferred Stock

Series A Preferred Stock

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

Series C Preferred Stock

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of $3.75 per share upon a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering.

The Series C Preferred Stock remains outstanding until it has been converted into common stock in accordance with its terms. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of $1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

8) Fair Value

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

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

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

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

Financial Assets and Liabilities Measured on a Recurring Basis

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

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

		Fair Value Measurements Using		
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(Dollars in thousands)		
Assets at March 31, 2012:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 340,181	$	$ 340,181	$
Corporate bonds	10,636		10,636	
Trust preferred securities	35,009		35,009	
I/O strip receivables	2,113		2,113	
Assets at December 31, 2011:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 350,348	$	$ 350,348	$
Trust preferred securities	30,107		30,107	
I/O strip receivables	2,094		2,094	

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

8) Fair Value (Continued)

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

Assets and Liabilities Measured on a Non-Recurring Basis

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

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

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

8) Fair Value (Continued)

		Fair Value Measurements Using		
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(Dollars in thousands)		
Assets at March 31, 2012:				
Impaired loans held-for-sale other:				
Real estate:				
Land and construction	$ 184		$ 184	
Impaired loans held-for-investment:				
Commercial	$ 5,674			$ 5,674
Real estate:				
Commercial and residential	3,016			3,016
Land and construction	1,724			1,724
Home equity				
Consumer	9			9
	$ 10,423			$ 10,423
Foreclosed assets:				
Commercial and residential	$ 283			$ 283
Land and construction	2,884			2,884
	$ 3,167			$ 3,167
Assets at December 31, 2011:				
Impaired loans held-for-sale other:				
Real estate:				
Land and construction	$ 186		$ 186	
Impaired loans held-for-investment:				
Commercial	$ 6,526			$ 6,526
Real estate:				
Commercial and residential	1,794			1,794
Land and construction	1,590			1,590
Home equity	32			32
Consumer	10			10
	$ 9,952			$ 9,952
Foreclosed assets:				
Commercial and residential	$ 156			$ 156
Land and construction	2,156			2,156

$	2,312	$	2,312

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

8) Fair Value (Continued)

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

	March 31, 2012	December 31, 2011
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	$ 13,267	$ 12,279
Book value of impaired loans held-for-investment carried at cost	3,324	5,635
Total impaired loans held-for-investment	$ 16,591	$ 17,914
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	$ 13,267	$ 12,279
Specific valuation allowance	(2,844)	(2,327)
Impaired loans held-for-investment carried at fair value, net	$ 10,423	$ 9,952

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were $16,591,000 at March 31, 2012, after partial charge-offs of $90,000 in the first three months of 2012. In addition, these loans had a specific valuation allowance of $2,844,000 at March 31, 2012. Impaired loans held-for-investment totaling $13,267,000 at Mach 31, 2012 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining $3,324,000 of impaired loans were carried at cost at March 31, 2012, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during the first three months of 2012 on impaired loans held-for-investment carried at fair value at March 31, 2012 resulted in an additional provision for loan losses of $713,000.

Foreclosed assets measured at fair value less costs to sell, had a net carrying amount of $3,167,000, which is made up of the outstanding balance of $3,167,000, with no valuation allowance at March 31, 2012.

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

8) Fair Value (Continued)

At December 31, 2011, other real estate owned had a net carrying amount of $2,312,000, made up of the outstanding balance of $2,312,000, with no valuation allowance at December 31, 2011.

The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at March 31, 2012:

	Fair Value (Dollars in thousands)	Valuation Techniques	Unobservable Inputs	Range (Weighted Average)
Impaired loans held-for-investment:				
Commercial	$ 5,674	Third party appraisal	Discount adjustment for differences between comparable sales	2% to 11% (7%)
Real estate:				
Commercial and residential	3,016	Third party appraisal	Discount adjustment for differences between comparable sales	6% to 11% (9%)
Land and construction	1,724	Third party appraisal	Discount adjustment for differences between comparable sales	2% to 3% (3%)
Foreclosed assets:				
Land and construction	2,884	Third party appraisal	Discount adjustment for differences between comparable sales	0% to 6% (6%)

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

8) Fair Value (Continued)

The carrying amounts and estimated fair values of financial instruments at March 31, 2012 are as follows:

	Carrying Amounts	Estimated Fair Value Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	(Dollars in thousands)				
Assets:					
Cash and cash equivalents	$ 68,665	$ 20,450	$ 48,215	$	$ 68,665
Securities available-for-sale	385,826		385,826		385,826
Loans (including loans held-for-sale), net	741,550		4,962	739,430	744,392
FHLB and FRB stock	9,928				N/A
Accrued interest receivable	4,542		4,542		4,542
Loan servicing rights and I/O strips receivables	2,843		5,205		5,205
Liabilities:					
Time deposits	$ 287,601	$	$ 288,528	$	$ 288,528
Other deposits	792,649		792,649		792,649
Subordinated debt	23,702			15,950	15,950
Accrued interest payable	416		416		416

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

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

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

8) Fair Value (Continued)

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

Cash and Cash Equivalents

The carrying amounts of cash and short-term instruments approximate fair values and are classified as either Level 1 or Level 2. Cash on hand and noninterest due from bank accounts are Level 1, whereas, interest bearing due from bank accounts and fed funds sold are Level 2.

Loans

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

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

FHLB and FRB Stock

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

Accrued Interest Receivable/Payable

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

Deposits

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2012

(Unaudited)

8) Fair Value (Continued)

Subordinated Debt

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

Off-balance Sheet Instruments

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

9) Loss Contingencies

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. The Company's accounting policy for legal costs related to loss contingencies is to accrue for the probable fees that can be reasonably estimated. The Company's accounting policy for uncertain recoveries is to recognize the anticipated recovery when realization is deemed probable. During the first quarter of 2012, the Company accrued $500,000 for probable costs related to an anticipated legal claim that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer. It is reasonably possible that the outcome may result in a liability exceeding the amount accrued in the financial statements; however, based on the status of the unasserted claim, a range of the reasonably possible gross loss or gross anticipated recoveries cannot be estimated.

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

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

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

Performance Overview

For the first quarter of 2012, net income was $2.1 million. Net income available to common shareholders was $869,000, or $0.03 per diluted common share, for the first quarter of 2012, which included $1.2 million in dividends and discount accretion on preferred stock. For the first quarter of 2011, net income was $1.6 million. Net income available to common shareholders was $985,000, or $0.03 per diluted common share, for the first quarter of 2011, which included $596,000 in dividends and discount accretion on preferred stock. The Company's annualized return on average assets was 0.64% and annualized return on average equity was 4.43% for the first quarter of 2012, compared to 0.51% and 3.51%, respectively, a year ago.

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

- The net interest margin increased 11 basis points to 4.06% for the first quarter of 2012, compared with 3.95% for the first quarter of 2011, and increased 19 basis points compared with 3.87% for the fourth quarter of 2011, primarily as a result of a higher yield on loans and a lower cost of deposits.
  - The yield on the loan portfolio was 5.41% for the first quarter of 2012, compared to 5.28% for the first quarter of 2011, and 5.39% for the fourth quarter of 2011.
  - The total cost of deposits decreased 25 basis points to 0.27% for the first quarter of 2012 from 0.52% for the first quarter of 2011, and decreased one basis point from 0.28% for the fourth quarter of 2011, primarily as a result of maturing higher-cost wholesale funding and growth in core deposits.
- Net interest income was $12.3 million for the first quarter of 2012, compared to $11.2 million for the first quarter of 2011, primarily due to an increase in the average balance of investment securities and a decrease in the rates paid on interest-bearing liabilities, partially offset by a decrease in average balance of loans.
- The provision for loan losses was $100,000 for the first quarter of 2012, compared to $770,000 for the first quarter of 2011. The decrease in 2012 compared to 2011 reflects a lower volume of classified assets and nonperforming loans, and contraction of the loan portfolio.
- Noninterest income decreased 10% to $1.7 million for the first quarter of 2012 from $1.9 million for the first quarter of 2011, primarily due to a decrease in the gain on sales of SBA loans to $36,000 for the first quarter of 2012, compared to $379,000 for the first quarter of 2011.

Table of Contents

Noninterest expense increased 4% to $10.9 million for the first quarter of 2012 from $10.4 million for the first quarter of 2011. The increase in noninterest expense from the first quarter of 2011 was primarily due to a $500,000 accrual for probable costs related to an anticipated legal claim that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer.

The efficiency ratio was 77.64% for the first quarter of 2012, compared to79.55% for the first quarter of 2011, primarily as a result of higher net interest income.

The income tax expense for the first quarter of 2012 was $951,000, as compared to $331,000 for the first quarter of 2011. The effective income tax rate was 31% for first quarter of 2012, compared to an effective income tax rate of 17% for the first quarter of 2011. The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes, and tax credits related to investments in low income housing limited partnerships.

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

Cash and due from banks, interest-bearing deposits in other financial institutions and securities available-for-sale increased 27% to $454.5 million at March 31, 2012, from $357.6 million at March 31, 2011, and remained relatively flat from $453.3 million at December 31, 2011.

Total loans, excluding loans held-for-sale, decreased $46.5 million, or 6%, to $756.9 million at March 31, 2012, compared to $803.4 million at March 31, 2011, and decreased $7.7 million, or 1%, from $764.6 million at December 31, 2011. Land and construction loans decreased $31.9 million, or 63%, to $18.6 million at March 31, 2012, compared to $50.5 million at March 31, 2011, and decreased $4.4 million, or 19%, from $23.0 million at December 31, 2011.

Classified assets (net of SBA guarantees) decreased to $54.2 million at March 31, 2012, compared to $81.4 million at March 31, 2011, and $59.5 million at December 31, 2011.

The allowance for loan losses at March 31, 2012, was $20.3 million, or 2.68% of total loans, representing 125.66% of nonperforming loans excluding nonaccrual loans in loans held-for-sale. The allowance for loan losses at March 31, 2011, was $24.0 million, or 2.99% of total loans, representing 103.59% of nonperforming loans excluding nonaccrual loans in loans held-for-sale. The allowance for loan losses at December 31, 2011, was $20.7 million, or 2.71% of total loans, representing 124.37% of nonperforming loans excluding nonaccrual loans in loans held-for-sale.

Nonperforming assets were $19.5 million, or 1.49% of total assets at March 31, 2012, compared to $26.1 million or 2.08% of total assets at March 31, 2011, and $19.1 million, or 1.47% of total assets at December 31, 2011.

Net loan charge-offs were $494,000 for the first quarter of 2012, compared to $2.0 million for the first quarter of 2011, and $1.6 million for the fourth quarter of 2011.

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

Noninterest-bearing demand deposits increased 10% to $356.6 million at March 31, 2012, from $325.1 million at March 31, 2011, and increased 4% from $344.3 million at December 31, 2011.

Interest-bearing demand deposits increased 6% to $144.0 million at March 31, 2012, from $135.9 million at March 31, 2011, and increased 7% from $134.1 million at December 31, 2011.

Table of Contents

Savings and money market deposits increased 11% to $292.0 million at March 31, 2012, from $262.8 million at March 31, 2011, and increased 3% from $282.5 million at December 31, 2011.

The ratio of noncore funding (which consists of time deposits $100,000 and over, CDARS deposits, brokered deposits, and short-term borrowings) to total assets was 19.89% at March 31, 2012, compared to 19.85% at March 31, 2011, and 19.90% at December 31, 2011.

The loan to deposit ratio was 70.07% at March 31, 2012, compared to 80.07% at March 31, 2011, and 72.86% at December 31, 2011.

Capital ratios substantially exceed regulatory requirements for a well-capitalized financial institution, both on a consolidated basis and at the bank level at March 31, 2012. The leverage ratio at the holding company was 12.7%, with a Tier 1 risk-based capital ratio of 16.6%, and a total risk-based capital ratio of 17.9% at March 31, 2012. The leverage ratio for HBC was 11.9%, with a Tier 1 risk-based capital ratio of 15.6%, and a total risk-based capital ratio of 16.9% at March 31, 2012. The regulatory well-capitalized guidelines are a minimum of a 5% leverage ratio, a 6% Tier 1 risk-based capital ratio, and a 10% total risk-based capital ratio.

Significant First Quarter 2012 Events

On March 7, 2012, the Company repaid the $40 million of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") issued to the U.S. Treasury Department under the TARP Capital Purchase Program and paid the final dividend of approximately $122,000, in accordance with approvals received from the U.S. Treasury and the Federal Reserve. The Company used available cash and proceeds from a $30 million cash distribution approved by the California State Department of Financial Institutions ("DFI") from HBC to the Company. The Series A Preferred Stock was recorded at a discount, and the repurchase accelerated the accretion of the discount on the Series A Preferred Stock. While the accelerated accretion did not impact net income, it resulted in a one-time non-cash reduction in net income available to common shareholders of approximately $765,000 in the first quarter of 2012. Total dividends and discount accretion on preferred stock, including the accelerated accretion, reduced net income available to common shareholders by $1.2 million in the first quarter of 2012. While participating in the TARP Capital Purchase Program, the Company paid $6.6 million in cash dividends to the U.S. Treasury. The repayment of the TARP funds will save the Company $2.0 million in preferred dividend payments on an annual basis, beginning in the second quarter of 2012.

In conjunction with the issuance of the Series A Preferred Stock, the Company issued a warrant to the U.S. Treasury to purchase 462,963 shares of the Company's common stock at an exercise price of $12.96 per share in November 2008. The warrant is exercisable immediately and will expire after a period of 10 years from issuance and is transferable by the U.S. Treasury. At the time the Company repurchased the Series A Preferred Stock, it did not repurchase the related warrant. The warrant was outstanding as of the date of this report.

Deposits

The composition and cost of the Company's deposit base are important in analyzing the Company's net interest margin and balance sheet liquidity characteristics. Except for brokered time deposits, the Company's depositors are generally located in its primary market area. Depending on loan demand and other funding requirements, the Company also obtains deposits from wholesale sources including deposit brokers. The Company had $84.7 million in brokered deposits at March 31, 2012, compared to $97.8 million at March 31, 2011, and $84.7 million at December 31, 2011. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators increased to $30.6 million at March 31, 2012, compared to $34.7 million at March 31, 2011, and decreased from

$37.6 million at December 31, 2011. Certificates of deposit from the State of California totaled $50 million at March 31, 2012, compared to none at March 31, 2011, and $50 million at December 31, 2011. The Company has a policy to monitor all deposits that may be sensitive to interest rate changes to help assure that liquidity risk does not become excessive due to concentrations. Deposits at March 31, 2012 were $1.1 billion, compared to $1.0 billion at March 31, 2011 and December 31, 2011.

HBC is a member of the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program allows customers with deposits in excess of FDIC insured limits to obtain coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through this program are considered brokered deposits under regulatory guidelines. Deposits in the CDARS program totaled $6.2 million at March 31, 2012, compared to $21.0 million at March 31, 2011, and $6.4 million at December 31, 2011.

Liquidity

Our liquidity position refers to our ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely fashion. At March 31, 2012, we had $68.7 million in cash and cash equivalents and approximately $336.7 million in available borrowing capacity from various sources including the Federal Home Loan Bank ("FHLB"), the Federal Reserve Bank of San Francisco ("FRB"), and Federal funds facilities with several financial institutions. The Company also had $288.7 million in unpledged securities available at March 31, 2012. Our loan to deposit ratio decreased to 70.07% at March 31, 2012, compared to 80.07% at March 31, 2011, and 72.86% at December 31, 2011, primarily due to a reduction in the loan portfolio.

Lending

Our lending business originates primarily through our branch offices located in our primary market. The Company also has an additional SBA loan production office in Santa Rosa, California. The total loan portfolio remains well diversified with commercial and industrial ("C&I") loans accounting for 47% of the portfolio at March 31, 2012. Commercial and residential real estate loans accounted for 42% of the total loan portfolio at March 31, 2012, of which 49% were owner-occupied by businesses. We have actively lowered our exposure to land and construction loans and our overall credit risk on these portfolios has been reduced. Land and construction loans decreased $31.9 million to $18.6 million at March 31, 2012, compared to $50.5 million at March 31, 2011, and accounted for 3% of our total loan portfolio at March 31, 2012, compared to 6% at March 31, 2011, and 3% at December 31, 2011. Consumer and home equity loans accounted for the remaining 8% of total loans at March 31, 2012. The yield on the loan portfolio was 5.41% for the first quarter of 2012 and compared to 5.28% for the first quarter of 2011, and 5.39% for the fourth quarter of 2011. Loans, excluding loans held-for-sale, decreased 6% to $756.9 million at March 31, 2012, from $803.4 million at March 31, 2011, and decreased 1% from $764.6 million at December 31, 2011. The decline in gross loans in the first quarter of 2012 was primarily due to diminished loan demand, loan payoffs exceeding draw downs of loan commitments and the result of efforts to reduce classified loans. Lower volume of loan originations can be attributed in part to lower demand for certain types of credit as well as more selectivity with respect to the types of loans the Company chooses to originate.

Net Interest Income

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

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

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

Management of Credit Risk

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

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

Noninterest Income

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

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

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company's performance. The Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. Nevertheless, noninterest expense increased $425,000 for the first quarter of 2012, compared to the first quarter of 2011. The increase in noninterest expense from the first quarter of 2011 was primarily due to a $500,000 accrual for probable costs related to an anticipated legal claim that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer and higher salaries and employee benefits expense.

Capital Management

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

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

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

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

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

At March 31, 2012, HBC's total risk-based capital ratio was 16.9%, compared to the 10% regulatory requirement for well-capitalized banks under the regulatory framework for prompt corrective actions. HBC's Tier 1 risk-based capital ratio of 15.6% and leverage ratio of 11.9% at March 31, 2012 also exceeded regulatory guidelines for well-capitalized banks under the prompt corrective actions framework. On a consolidated basis, the Company has a total risk-based capital ratio of 17.9%, a Tier 1 risk-based capital ratio of 16.6%, and a leverage ratio of 12.7% at March 31, 2012.

RESULTS OF OPERATIONS

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

Net Interest Income and Net Interest Margin

The level of net interest income depends on several factors in combination, including yields on earning assets, the cost of interest-bearing liabilities, the relative volumes of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and

Table of Contents

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

NET INTEREST INCOME AND NET INTEREST MARGIN	For the Three Months Ended March 31, 2012 Average Balance	Interest Income/ Expense	Average Yield/ Rate	For the Three Months Ended March 31, 2011 Average Balance	Interest Income/ Expense	Average Yield/ Rate
	(Dollars in thousands)					
Assets:						
Loans, gross(1)	$ 767,288	$ 10,316	5.41%	$ 843,777	$ 10,989	5.28%
Securities	389,919	3,097	3.19%	245,861	1,963	3.24%
Federal funds sold and interest-bearing deposits in other financial institutions	55,991	36	0.26%	60,423	34	0.23%
Total interest earning assets	1,213,198	13,449	4.46%	1,150,061	12,986	4.58%
Cash and due from banks	20,987			20,551		
Premises and equipment, net	7,978			8,330		
Goodwill and other intangible assets	2,441			2,961		
Other assets	67,381			66,430		
Total assets	$ 1,311,985			$ 1,248,333		
Liabilities and shareholders' equity:						
Deposits:						
Demand, noninterest-bearing	$ 347,291			$ 312,041		
Demand, interest-bearing	142,650	52	0.15%	135,756	67	0.20%
Savings and money market	288,202	166	0.23%	267,749	266	0.40%
Time deposits under $100	28,223	38	0.54%	33,207	71	0.87%
Time deposits $100 and over	169,694	256	0.61%	133,849	419	1.27%
Time deposits CDARS	6,262	3	0.19%	21,525	25	0.47%
Time deposits brokered	84,730	201	0.95%	95,064	423	1.80%
Total interest-bearing deposits	719,761	716	0.40%	687,150	1,271	0.75%
Total deposits	1,067,052	716	0.27%	999,191	1,271	0.52%
Subordinated debt	23,702	474	8.04%	23,702	466	7.97%
Securities sold under agreement to repurchase			N/A	2,889	24	3.37%
Short-term borrowings	39		N/A	2,734	29	4.30%
Total interest-bearing liabilities	743,502	1,190	0.64%	716,475	1,790	1.01%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,090,793	1,190	0.44%	1,028,516	1,790	0.71%
Other liabilities	32,671			37,366		
Total liabilities	1,123,464			1,065,882		
Shareholders' equity	188,521			182,451		
Total liabilities and shareholders' equity	$ 1,311,985			$ 1,248,333		

Net interest income / margin	$ 12,259	4.06%	$ 11,196	3.95%

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

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, 2012 vs. 2011 Increase (Decrease) Due to Change In:		
	Average Volume	**Average Rate**	**Net Change**
	(Dollars in thousands)		
Income from interest earning assets:			
Loans, gross	$ (1,034)	$ 361	$ (673)
Securities	1,147	(13)	1,134
Federal funds sold and interest-bearing deposits in other financial institutions	(3)	5	2
Total interest income from interest earnings assets	110	353	463
Expense on interest-bearing liabilities:			
Demand, interest-bearing	1	(16)	(15)
Savings and money market	13	(113)	(100)
Time deposits under $100	(7)	(26)	(33)
Time deposits $100 and over	53	(216)	(163)
Time deposits CDARS	(7)	(15)	(22)
Time deposits brokered	(24)	(198)	(222)
Subordinated debt		8	8
Securities sold under agreement to repurchase	(24)		(24)
Short-term borrowings	(29)		(29)
Total interest expense on interest-bearing liabilities	(24)	(576)	(600)
Net interest income	$ 134	$ 929	$ 1,063

The Company's net interest margin expressed as a percentage of average earning assets was 4.06% for the first quarter of 2012, an increase of 11 basis points from 3.95% for the first quarter of 2011, and an increase of 19 basis points from 3.87% for the fourth quarter of 2011. The increase in the net interest margin for the first quarter of 2012 was primarily attributed to a higher yield on loans and a lower cost of deposits. Net interest income for the first quarter of 2012 increased $1.1 million, or 9% from first quarter of 2011, primarily due to an increase in the average balance of investment securities, and a decrease in rates paid on interest-bearing liabilities.

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

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 shown in the statements of operations as the provision for loan losses. Specifically identifiable and quantifiable known losses are promptly charged off against the allowance. The provision for loan losses is determined by conducting a quarterly evaluation of the adequacy of the Company's allowance for loan losses and charging the shortfall, if any, to the current quarter's expense. This has the effect of creating variability in the amount and frequency of charges to the Company's earnings. The provision for loan losses and level of allowance for each period are dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of the quality of the loan portfolio, the valuation of problem loans and the general economic conditions in the Company's market area.

For the first quarter of 2012, the Company had a provision for loan losses of $100,000, compared to $770,000 for the first quarter of 2011. The decrease in provision for loan losses for the first quarter of 2012 compared to the same period in 2011 reflects the improvement in credit quality, lower charge-offs, and a decrease in the size of the loan portfolio.

The allowance for loan losses represented 2.68%, 2.99% and 2.71% of total loans at March 31, 2012, March 31, 2011, and December 31, 2011, respectively. Provisions for loan losses are charged to operations to bring the allowance for loan losses to a level deemed appropriate by the Company based on the factors discussed under "Allowance for Loan Losses".

Noninterest Income

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

	For the Three Months Ended March 31,		Increase (decrease) 2012 versus 2011	
	2012	2011	Amount	Percent
	(Dollars in thousands)			
Service charges and fees on deposit accounts	$ 590	$ 567	$ 23	4%
Servicing income	460	411	49	12%
Increase in cash surrender value of life insurance	429	425	4	1%
Gain on sale of SBA loans	36	379	(343)	-91%
Gain on sale of securities	27		27	N/A
Other	181	135	46	34%
Total noninterest income	$ 1,723	$ 1,917	$ (194)	-10%

The decrease in noninterest income in first quarter of 2012 compared to the same period in 2011 was primarily attributable to a lower gain on the sale of SBA loans, offset by a modest gain on sale of securities and an increase in servicing income.

Historically, a significant percentage of the Company's noninterest income has been associated with its SBA lending activity, as gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. During the first quarter of 2012, SBA loan sales resulted in a $36,000 gain, compared to a $379,000 gain on sale of SBA loans in the first quarter of 2011. The servicing assets that result from the sale of SBA loans with servicing retained are amortized over the expected term of the loans using a method approximating the interest method. Servicing income generally declines as the respective loans are repaid.

Table of Contents

The increase in cash surrender value of life insurance approximates a 3.70% after tax yield on the policies. To realize this tax advantaged yield, the policies must be held until death of the insured individuals, who are current and former officers and directors of the Company.

Noninterest Expense

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

	For the Three Months Ended March 31, 2012	For the Three Months Ended March 31, 2011	Increase (decrease) 2012 versus 2011 Amount	Increase (decrease) 2012 versus 2011 Percent
	(Dollars in thousands)			
Salaries and employee benefits	$ 5,667	$ 5,393	$ 274	5%
Professional fees	1,211	839	372	44%
Occupancy and equipment	996	1,038	(42)	-4%
Software subscriptions	290	255	35	14%
Low income housing investment losses	269	162	107	66%
Data processing	245	220	25	11%
FDIC deposit insurance premiums	225	524	(299)	-57%
Insurance expense	224	241	(17)	-7%
Other real estate owned expense	115	21	94	448%
Other	1,614	1,738	(124)	-7%
Total noninterest expense	$ 10,856	$ 10,431	$ 425	4%

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

Noninterest Expense by Category

	For The Three Months Ended March 31, 2012	Percent of Total	2011	Percent of Total
	(Dollars in thousands)			
Salaries and employee benefits	$ 5,667	52%	$ 5,393	52%
Professional fees	1,211	11%	839	8%
Occupancy and equipment	996	9%	1,038	10%
Software subscriptions	290	3%	255	2%
Low income housing investment losses	269	3%	162	2%
Data processing	245	2%	220	2%
FDIC deposit insurance premiums	225	2%	524	5%
Insurance expense	224	2%	241	2%
Other real estate owned expense	115	1%	21	0%
Other	1,614	15%	1,738	17%
Total noninterest expense	$ 10,856	100%	$ 10,431	100%

Noninterest expense for the first quarter of 2012 increased 4% to $10.9 million, compared to $10.4 million for the first quarter of 2011, primarily due to higher salaries and employee benefits, higher professional fees, and higher low income housing investment losses. Salaries and employee benefits increased $274,000, or 5%, to $5.7 million for the first quarter of 2012, from $5.4 million for the first quarter of 2011. Full-time equivalent employees were 189 and 185 at March 31, 2012 and 2011,

Table of Contents

respectively. Professional fees increased $372,000, or 44%, to $1.2 million for the first quarter of 2012, compared to $839,000 for the first quarter of 2011. The increase in noninterest expense from the first quarter of 2011 was primarily due to a $500,000 accrual for probable costs related to an anticipated legal claim that has not yet been asserted, regarding an apparent transfer of funds for personal use by an authorized signatory of a customer. The claims, which have not been asserted as of the date of this report, relate to an apparent transfer of funds to personal use by an authorized signatory of a customer. FDIC deposit insurance premiums decreased $299,000, or 57%, to $225,000 for the first quarter of 2012, compared to $524,000 for the same period in 2011, due to a decrease in the FDIC deposit assessment rate.

Income Tax Expense

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

The Company's Federal and state income tax expense was $951,000 in the first quarter of 2012, compared to $331,000 in the first quarter of 2011. The following table shows the Company's effective income tax rates for the periods indicated:

	For the Three Months Ended March 31,	
	2012	**2011**
Effective income tax rate	31.4%	17.3%

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

The Company has net investments of $3.4 million in low-income housing limited partnerships as of March 31, 2012. These investments have generated annual tax credits of approximately $846,000 and $1.0 million in the years ended December 31, 2011 and 2010, respectively.

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

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

Table of Contents

At March 31, 2012, and December 31, 2011, the Company had net deferred tax assets of $21.3 million, and $21.9 million, respectively. At March 31, 2012 and December 31, 2011, after consideration of the matters in the preceding paragraph, the Company determined that a valuation allowance for deferred tax assets should be $0.

FINANCIAL CONDITION

As of March 31, 2012, total assets were $1.31 billion, compared to $1.26 billion as of March 31, 2011, and $1.31 billion at December 31, 2011. Total securities available-for-sale (at fair value) were $385.8 million at March 31, 2012, an increase of 54% from $250.1 million at March 31, 2011, and an increase of 1% from $380.5 million at December 31, 2011. The total loan portfolio, excluding loans held-for-sale, was $756.9 million at March 31, 2012, a decrease of 6% from $803.4 million at March 31, 2011, and a decrease of 1% from $764.6 million at December 31, 2011. Total deposits increased 8% to $1.08 billion at March 31, 2012, from $1.00 billion at March 31, 2011, and increased 3% from $1.05 billion at December 31, 2011. There were no securities sold under agreement to repurchase at March 31, 2012, March 31, 2011, and December 31, 2011.

Securities Portfolio

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

	March 31, 2012	March 31, 2011	December 31, 2011
	(Dollars in thousands)		
Securities available-for-sale (at fair value)			
Agency mortgage-backed securities	$ 340,181	$ 250,132	$ 350,348
Corporate bonds	10,636		
Trust preferred securities	35,009		30,107
Total	$ 385,826	$ 250,132	$ 380,455

The following table summarizes the weighted average life and weighted average yields of securities at March 31, 2012:

	March 31, 2012 Weighted Average Life									
	Within One Year		After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(Dollars in thousands)									
Securities available-for-sale (at fair value):										
Mortgage-Backed Securities Residential	$		$ 215,536	2.99%	$ 106,236	2.83%	$ 18,409	3.41%	$ 340,181	2.96%
Corporate bonds			961	2.68%	9,675	3.30%			10,636	3.24%
Trust preferred securities	35,009	6.40%							35,009	6.40%
	$ 35,009	6.40%	$ 216,497	2.99%	$ 115,911	2.87%	$ 18,409	3.41%	$ 385,826	3.28%

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