

HERITAGE COMMERCE CORP  
Form 10-Q  
November 09, 2007

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2007

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-23877

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

California

(State or Other Jurisdiction of Incorporation or  
Organization)

77-0469558

(I.R.S. Employer Identification  
Number)

150 Almaden Boulevard  
San Jose, California 95113

(Address of Principal Executive Offices including Zip Code)

(408) 947-6900

(Registrant's Telephone Number, Including Area Code)

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

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

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

The Registrant had 13,130,798 shares of Common Stock outstanding on November 1, 2007.

---

---

---

**Heritage Commerce Corp and Subsidiaries**  
**Quarterly Report on Form 10-Q**  
**Table of Contents**

| <b>PART I. FINANCIAL INFORMATION</b>  | <b>Page<br/>No.</b> |
|---|---------------------|
| Item 1. Consolidated Financial Statements (unaudited):  | <u>2</u>            |
| Consolidated Balance Sheets   | <u>2</u>            |
| Consolidated Income Statements  | <u>3</u>            |
| Consolidated Statements of Changes in Shareholders' Equity                                    | <u>4</u>            |
| Consolidated Statements of Cash Flows   | <u>5</u>            |
| Notes to Consolidated Financial Statements  | <u>6</u>            |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations | <u>12</u>           |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk                            | <u>31</u>           |
| Item 4. Controls and Procedures   | <u>31</u>           |
| <b>PART II. OTHER INFORMATION</b>   |                     |
| Item 1. Legal Proceedings   | <u>31</u>           |
| Item 1A. Risk Factors   | <u>31</u>           |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds                           | <u>31</u>           |
| Item 3. Defaults Upon Senior Securities   | <u>32</u>           |
| Item 4. Submission of Matters to a Vote of Security Holders                                   | <u>32</u>           |
| Item 5. Other Information   | <u>32</u>           |
| Item 6. Exhibits  | <u>33</u>           |
| <b>SIGNATURES</b>   | <u>33</u>           |
| <b>EXHIBIT INDEX</b>  | <u>34</u>           |



**Part I -- FINANCIAL INFORMATION**  
**ITEM 1 - CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**Heritage Commerce Corp**  
**Consolidated Balance Sheets (Unaudited)**

**September 30,**  
**2007**

**December 31,**  
**2006**

(Dollars in thousands)

| <b>Assets</b>  |    |           |    |           |
|--|----|-----------|----|-----------|
| Cash and due from banks  | \$ | 51,627    | \$ | 34,285    |
| Federal funds sold   |    | 42,600    |    | 15,100    |
| Total cash and cash equivalents  |    | 94,227    |    | 49,385    |
| Securities available-for-sale, at fair value   |    | 150,116   |    | 172,298   |
| Loans held for sale, at lower of cost or market  |    | -         |    | 17,234    |
| Loans, net of deferred origination costs   |    | 954,658   |    | 725,754   |
| Allowance for loan losses  |    | (11,472)  |    | (9,279)   |
| Loans, net   |    | 943,186   |    | 716,475   |
| <br>   |    |           |    |           |
| Federal Home Loan Bank and Federal Reserve   |    |           |    |           |
| Bank stock, at cost  |    | 7,653     |    | 6,113     |
| Company owned life insurance   |    | 38,270    |    | 36,174    |
| Premises and equipment, net  |    | 9,441     |    | 2,539     |
| Goodwill   |    | 42,996    |    | -         |
| Core deposit intangible asset  |    | 4,863     |    | -         |
| Accrued interest receivable and other assets   |    | 35,667    |    | 36,920    |
| Total assets   | \$ | 1,326,419 | \$ | 1,037,138 |
| <br>   |    |           |    |           |
| <b>Liabilities and Shareholders' Equity</b>  |    |           |    |           |
| Liabilities:   |    |           |    |           |
| Deposits   |    |           |    |           |
| Demand, noninterest bearing  | \$ | 263,244   | \$ | 231,841   |
| Demand, interest bearing   |    | 146,410   |    | 133,413   |
| Savings and money market   |    | 468,263   |    | 307,266   |
| Time deposits, under \$100   |    | 32,341    |    | 31,097    |
| Time deposits, \$100 and over  |    | 138,327   |    | 111,017   |
| Brokered deposits, \$100 and over  |    | 52,179    |    | 31,959    |
| Total deposits   |    | 1,100,764 |    | 846,593   |
| Notes payable to subsidiary grantor trusts   |    | 23,702    |    | 23,702    |
| Securities sold under agreement to repurchase  |    | 10,900    |    | 21,800    |
| Accrued interest payable and other liabilities   |    | 22,678    |    | 22,223    |
| Total liabilities  |    | 1,158,044 |    | 914,318   |
| <br>   |    |           |    |           |
| Shareholders' equity:  |    |           |    |           |
| Preferred stock, no par value; 10,000,000 shares authorized; none outstanding            |    | -         |    | -         |
| Common Stock, no par value; 30,000,000 shares authorized;                                |    |           |    |           |
| shares outstanding: 13,123,396 at September 30, 2007 and 11,656,943 at December 31, 2006 |    | 98,093    |    | 62,363    |
| Retained earnings  |    | 71,540    |    | 62,452    |
| Accumulated other comprehensive loss   |    | (1,258)   |    | (1,995)   |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|  |    |           |    |           |
|--|----|-----------|----|-----------|
| Total shareholders' equity                 |    | 168,375   |    | 122,820   |
| Total liabilities and shareholders' equity | \$ | 1,326,419 | \$ | 1,037,138 |

See notes to consolidated financial statements

2

---

**Heritage Commerce Corp**  
**Consolidated Income Statements (Unaudited)**

|   | Three Months Ended<br>September 30,           |           | Nine Months Ended<br>September 30, |           |
|---|---|-----------|------------------------------------|-----------|
|   | 2007  | 2006      | 2007                               | 2006      |
|   | (Dollars in thousands, except per share data) |           |                                    |           |
| Interest income:  |   |           |                                    |           |
| Loans, including fees                                     | \$ 19,282                                     | \$ 15,958 | \$ 49,541                          | \$ 46,023 |
| Securities, taxable                                       | 1,881   | 1,968     | 5,729                              | 5,646     |
| Securities, non-taxable                                   | 38  | 45        | 124                                | 136       |
| Interest bearing deposits in other financial institutions | 31  | 36        | 104                                | 96        |
| Federal funds sold  | 873   | 561       | 2,158                              | 2,319     |
| Total interest income                                     | 22,105  | 18,568    | 57,656                             | 54,220    |
| Interest expense:   |   |           |                                    |           |
| Deposits  | 7,663   | 5,027     | 17,669                             | 14,379    |
| Notes payable to subsidiary grantor trusts                | 585   | 587       | 1,749                              | 1,724     |
| Repurchase agreements and other                           | 76  | 140       | 333                                | 486       |
| Total interest expense                                    | 8,324   | 5,754     | 19,751                             | 16,589    |
| Net interest income                                       | 13,781  | 12,814    | 37,905                             | 37,631    |
| Provision for loan losses                                 | (500)   | -         | (736)                              | (603)     |
| Net interest income after provision for loan losses       | 14,281  | 12,814    | 38,641                             | 38,234    |
| Noninterest income:                                       |   |           |                                    |           |
| Gain on sale of Capital Group loan portfolio              | -   | -         | -                                  | 671       |
| Gain on sale of SBA loans                                 | 60  | 832       | 1,766                              | 2,500     |
| Servicing income  | 546   | 412       | 1,596                              | 1,321     |
| Increase in cash surrender value of life insurance        | 374   | 363       | 1,071                              | 1,070     |
| Service charges and fees on deposit accounts              | 344   | 354       | 954                                | 1,008     |
| Other   | 315   | 338       | 1,028                              | 880       |
| Total noninterest income                                  | 1,639   | 2,299     | 6,415                              | 7,450     |
| Noninterest expense:                                      |   |           |                                    |           |
| Salaries and employee benefits                            | 5,840   | 4,941     | 15,413                             | 14,703    |
| Occupancy   | 969   | 773       | 2,504                              | 2,324     |
| Professional fees   | 751   | 442       | 1,489                              | 1,289     |
| Advertising and promotion                                 | 206   | 206       | 808                                | 763       |
| Data processing   | 252   | 156       | 653                                | 498       |
| Client services   | 155   | 230       | 631                                | 772       |
| Low income housing investment losses and writedowns       | 233   | 257       | 588                                | 734       |
| Furniture and equipment                                   | 200   | 140       | 429                                | 397       |
| Core deposit intangible amortization                      | 167   | -         | 185                                | -         |
| Other   | 1,745   | 1,167     | 4,618                              | 4,085     |
| Total noninterest expense                                 | 10,518  | 8,312     | 27,318                             | 25,565    |
| Income before income taxes                                | 5,402   | 6,801     | 17,738                             | 20,119    |
| Income tax expense  | 2,162   | 2,448     | 6,450                              | 7,201     |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|                     |    |       |    |       |    |        |    |        |
|---------------------|----|-------|----|-------|----|--------|----|--------|
| Net income          | \$ | 3,240 | \$ | 4,353 | \$ | 11,288 | \$ | 12,918 |
| Earnings per share: |    |       |    |       |    |        |    |        |
| Basic               | \$ | 0.24  | \$ | 0.37  | \$ | 0.92   | \$ | 1.09   |
| Diluted             | \$ | 0.24  | \$ | 0.36  | \$ | 0.91   | \$ | 1.08   |

See notes to consolidated financial  
statements

3

---



**Heritage Commerce Corp**  
**Consolidated Statements of Shareholders' Equity (Unaudited)**  
**Nine Months Ended September 30, 2007 and 2006**

|  | Common Stock                              |           | Retained Earnings |            | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Shareholder<br>Equity | Comprehensive<br>Income |
|--|---|-----------|-------------------|------------|---|--------------------------------|-------------------------|
|  | Shares                                    | Amount    | Earnings          | Loss       | Equity  | Income                         |                         |
|  | (Dollars in thousands, except share data) |           |                   |            |   |                                |                         |
| <b>Balance, January 1, 2006</b>  | 11,807,649                                | \$ 66,799 | \$ 47,539         | \$ (2,721) | \$ 111,617                                    |                                |                         |
| Net Income   | -   | -         | 12,918            | -          | 12,918  | \$                             | 12,918                  |
| Net change in unrealized<br>gain/loss on securities<br>available-for-sale and<br>Interest-Only strips, net of<br>reclassification<br>adjustment and deferred<br>income taxes | -   | -         | -                 | 211        | 211   |                                | 211                     |
| Decrease in minimum pension<br>liability, net of<br>deferred income taxes  | -   | -         | -                 | 204        | 204   |                                | 204                     |
| Total comprehensive income   |   |           |                   |            |   | \$                             | 13,333                  |
| Amortization of restricted stock<br>award  | -   | 115       | -                 | -          | 115   |                                |                         |
| Cash dividend declared on<br>common stock, \$0.15 per share  | -   | -         | (1,774)           | -          | (1,774)                                       |                                |                         |
| Common stock repurchased   | (282,900)                                 | (6,660)   | -                 | -          | (6,660)                                       |                                |                         |
| Stock options expense  | -   | 550       | -                 | -          | 550   |                                |                         |
| Stock options exercised,<br>including related tax benefits   | 156,548                                   | 2,155     | -                 | -          | 2,155   |                                |                         |
| <b>Balance, September 30, 2006</b>   | 11,681,297                                | \$ 62,959 | \$ 58,683         | \$ (2,306) | \$ 119,336                                    |                                |                         |
| <b>Balance, January 1, 2007</b>  | 11,656,943                                | \$ 62,363 | \$ 62,452         | \$ (1,995) | \$ 122,820                                    |                                |                         |
| Net Income   | -   | -         | 11,288            | -          | 11,288  | \$                             | 11,288                  |
| Net change in unrealized<br>gain/loss on securities<br>available-for-sale and<br>Interest-Only strips, net of<br>reclassification<br>adjustment and deferred<br>income taxes | -   | -         | -                 | 691        | 691   |                                | 691                     |
| Decrease in pension liability, net<br>of<br>deferred income taxes  | -   | -         | -                 | 46         | 46  |                                | 46                      |
| Total comprehensive<br>income  |   |           |                   |            |   | \$                             | 12,025                  |
| Issuance of 1,732,298 shares to<br>acquire Diablo Valley Bank, net<br>of offerings costs of \$214  | 1,732,298                                 | 41,183    | -                 | -          | 41,183  |                                |                         |
| Amortization of restricted stock<br>award  | -   | 115       | -                 | -          | 115   |                                |                         |
|  | -   | -         | (2,200)           | -          | (2,200)                                       |                                |                         |

|   |            |           |           |            |            |
|---|------------|-----------|-----------|------------|------------|
| Cash dividend declared on<br>common stock, \$0.18 per share |            |           |           |            |            |
| Common stock repurchased                                    | (339,700)  | (7,476)   | -         | -          | (7,746)    |
| Stock options expense, including<br>related tax benefits    | -          | 813       | -         | -          | 813        |
| Stock options exercised                                     | 73,855     | 1,095     | -         | -          | 1,095      |
| <b>Balance, September 30, 2007</b>                          | 13,123,396 | \$ 98,093 | \$ 71,540 | \$ (1,258) | \$ 168,375 |

See notes to consolidated financial statements

**Heritage Commerce Corp**  
**Consolidated Statements of Cash Flows (Unaudited)**

|   | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|--|-------------|
|   | <b>2007</b>                                | <b>2006</b> |
|   | <b>(Dollars in thousands)</b>              |             |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |  |             |
| Net income  | \$ 11,288                                  | \$ 12,918   |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |             |
| Depreciation and amortization   | 535  | 507         |
| Provision for loan losses   | (736)                                      | (603)       |
| Stock option expense  | 813  | 550         |
| Amortization of core deposit intangible   | 186  | -           |
| Amortization of restricted stock award  | 115  | 115         |
| Amortization (accretion) of discounts and premiums on securities                  | (22)                                       | (872)       |
| Gain on sale of Capital Group loan portfolio                                      | -  | (671)       |
| Gain on sale of SBA loans   | (1,766)                                    | (2,500)     |
| Proceeds from sales of SBA loans held for sale                                    | 35,529                                     | 48,703      |
| Originations of loans held for sale   | (21,372)                                   | (28,640)    |
| Maturities/paydowns/payoffs of loans held for sale                                | 338  | 833         |
| Increase in cash surrender value of life insurance                                | (1,071)                                    | (1,070)     |
| Effect of changes in:   |  |             |
| Accrued interest receivable and other assets                                      | 3,822                                      | 6,097       |
| Accrued interest payable and other liabilities                                    | (1,004)                                    | 891         |
| Net cash provided by operating activities   | 26,655                                     | 36,258      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |  |             |
| Net increase in loans   | (18,164)                                   | (28,578)    |
| Proceeds from sales of Capital Group loan portfolio                               | -  | 30,047      |
| Net decrease in Capital Group loan portfolio prior to sale                        | -  | 2,681       |
| Purchases of securities available-for-sale  | (9,322)                                    | (49,098)    |
| Maturities/paydowns/calls of securities available-for-sale                        | 45,008                                     | 75,530      |
| Purchase of premises and equipment  | (596)                                      | (460)       |
| Redemption (purchase) of other investments  | (823)                                      | (184)       |
| Cash received in bank acquisition, net of cash paid                               | 16,407                                     | -           |
| Net cash provided by investing activities   | 32,510                                     | 29,938      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |  |             |
| Net change in deposits  | 5,525                                      | (63,661)    |
| Payment of other liability  | (153)                                      | (1,378)     |
| Exercise of stock options, including related tax benefits                         | 1,095                                      | 2,155       |
| Common stock repurchased  | (7,476)                                    | (6,660)     |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|  |    |           |    |          |
|--|----|-----------|----|----------|
| Stock offering costs   |    | (214)     |    | -        |
| Payment of dividends   |    | (2,200)   |    | (1,774)  |
| Net decrease in securities sold under agreement to repurchase            |    | (10,900)  |    | (10,900) |
| Net cash used in financing activities                                    |    | (14,323)  |    | (82,218) |
| Net increase (decrease) in cash and cash equivalents                     |    | 44,842    |    | (16,022) |
| Cash and cash equivalents, beginning of period                           |    | 49,385    |    | 98,460   |
| Cash and cash equivalents, end of period                                 | \$ | 94,227    | \$ | 82,438   |
| Supplemental disclosures of cash flow information:                       |    |           |    |          |
| Cash paid during the period for:   |    |           |    |          |
| Interest   | \$ | 20,041    | \$ | 16,919   |
| Income taxes   | \$ | 3,687     | \$ | 780      |
| Supplemental schedule of non-cash investing and financing activities:    |    |           |    |          |
| Transfer of portfolio loans to loans held for sale                       | \$ | -         | \$ | 7,797    |
| Transfer of loans held for sale to portfolio loans                       | \$ | 4,505     | \$ | 4,383    |
| Loans transferred to foreclosed assets                                   | \$ | 487       | \$ | -        |
| Summary of assets acquired, and liabilities assumed through acquisition: |    |           |    |          |
| Cash and cash equivalents  | \$ | 41,807    | \$ | -        |
| Securities available-for-sale  | \$ | 12,214    | \$ | -        |
| Net loans  | \$ | 203,793   | \$ | -        |
| Goodwill and core deposit intangible asset                               | \$ | 48,045    | \$ | -        |
| Premises and equipment   | \$ | 6,841     | \$ | -        |
| Corporate owned life insurance   | \$ | 1,025     | \$ | -        |
| Federal Home Loan Bank Stock   | \$ | 717       | \$ | -        |
| Other assets, net  | \$ | 2,686     | \$ | -        |
| Deposits   | \$ | (248,646) | \$ | -        |
| Other liabilities  | \$ | (1,685)   | \$ | -        |
| Common stock issued to acquire Diablo Valley Bank                        | \$ | 41,397    | \$ | -        |
| See notes to consolidated financial statements                           |    |           |    |          |

5

**HERITAGE COMMERCE CORP**  
**Notes to Consolidated Financial Statements**  
**September 30, 2007**  
**(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 (“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, 2006. The Company has also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III which are Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities.

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

In 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.

Certain amounts reported in previous consolidated financial statements have been reclassified to conform to the 2007 presentation.

The results for the three and nine months ended September 30, 2007 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2007.

***Adoption of New Accounting Standards***

In February, 2006, FASB issued Statement 155, *Accounting for Certain Hybrid Instruments*. This standard amended the guidance in Statement 133, *Accounting for Derivative Instruments and Hedging Activities*, and Statement 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Statement 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation and clarifies which interest-only and principal-only strips are not subject to the requirements of Statement 133. Statement 155 is effective for all financial instruments acquired or issued after the beginning of an entity’s first fiscal year that begins after September 15, 2006. The adoption of this standard did not have a material impact on the Company’s financial statements.

In March, 2006, FASB issued Statement 156, *Accounting for Servicing of Financial Assets - An Amendment of FASB Statement No. 140*. This standard amends the guidance in Statement 140, with respect to the accounting for separately recognized servicing assets and servicing liabilities. Among other requirements, Statement 156 requires an entity to

recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations, including a transfer of loans with servicing retained that meets the requirements for sale accounting. Statement 156 is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of this standard did not have a material impact on the Company's financial statements.

In June 2006, FASB issued FASB Interpretation ("FIN") 48, *Accounting for Uncertainty in Income Taxes*. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement 109, *Accounting for Income Taxes*. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006.

The Company adopted FIN 48 as of January 1, 2007. Under FIN 48, a tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The adoption of this standard did not have a material impact on the Company's financial statements.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of the State of California. The Company is no longer subject to examination by taxing authorities for years before 2004. The Company does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense. The Company did not have any significant amounts accrued for interest and penalties at September 30, 2007.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-5, *Accounting for Purchases of Life Insurance - Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4 (Accounting for Purchases of Life Insurance)*. This issue requires that a policyholder consider contractual terms of a life insurance policy in determining the amount that could be realized under the insurance contract. It also requires that if the contract provides for a greater surrender value if all individual policies in a group are surrendered at the same time, that the surrender value be determined based on the assumption that policies will be surrendered on an individual basis. Lastly, the issue discusses whether the cash surrender value should be discounted when the policyholder is contractually limited in its ability to surrender a policy. This issue is effective for fiscal years beginning after December 15, 2006. The adoption of this issue did not have a material impact on the financial statements.

#### ***Newly Issued but not yet Effective Accounting Standards***

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. This issue requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants' employment or retirement. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. This issue is effective for fiscal years beginning after December 15, 2007. Adoption of EITF Issue 06-4 is not expected to have a material effect on the Company's financial statements. In 2005, the Company began recognizing the cost of continuing life insurance coverage under split-dollar arrangements. The recorded liability for split-dollar life insurance coverage was \$1,305,000 and \$1,145,000 at September 30, 2007 and 2006, respectively.

In September 2006, FASB issued Statement 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The adoption of this standard is not expected to have a material impact on the Company's financial statements.

In February 2007, FASB issued Statement 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This statement provides companies with an option to report selected financial assets and liabilities at fair value. The Standard's objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. The standard requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company's choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. Statement 159 does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in Statements 157, *Fair Value Measurements*, and 107, *Disclosures about Fair Value of Financial Instruments*. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company has not completed its evaluation of Statement 159's potential effects on its financial statements.

## **2) Securities Available-for-Sale**

The following table shows the gross unrealized losses and fair value of the Company's securities with unrealized losses aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2007:

|   | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| (Dollars in thousands)                  |                     |                   |                   |                   |            |                   |
| U.S. Government Agencies                | \$ 4,745            | \$ 7              | \$ 4,912          | \$ 70             | \$ 9,657   | \$ 77             |
| Mortgage-Backed Municipals - Tax Exempt | 18,390              | 198               | 62,387            | 2,041             | 80,777     | 2,239             |
| Collateralized Mortgage Obligations     | -                   | -                 | 5,984             | 68                | 5,984      | 68                |
| Total                                   | \$ 23,135           | \$ 205            | \$ 76,263         | \$ 2,291          | \$ 99,398  | \$ 2,496          |

As of September 30, 2007, the Company held 91 securities, of which 55 had fair values below amortized cost. Forty-two securities have been carried with an unrealized loss for over 12 months. Unrealized losses were primarily due to higher interest rates. No security sustained a downgrade in credit rating. 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. Because the Company has the ability and intent to hold these securities until a recovery of fair value, which may be maturity, the Company does not consider these securities to be other-than-temporarily impaired at September 30, 2007.

Securities classified as U.S. Government Agencies as of September 30, 2007 and December 31, 2006 were issued by the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and the Federal Home Loan Bank.

The securities portfolio of the Company is also used as collateral to meet requirements imposed as a condition of deposit by some depositors, such as political subdivisions (public funds) and bankruptcy trustees, and other contractual obligations such as repurchase agreements. Securities with fair value of \$32,887,000 and \$53,283,000 as of September 30, 2007 and 2006 were pledged to secure public and certain other deposits as required by law or contract and other contractual obligations. A portion of these deposits can only be secured by U.S. Treasury securities.

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



### 3) Stock-Based Compensation

The Company has a stock option plan (the "Plan") for directors, officers, and key employees. The Plan provides for the grant of incentive and non-qualified stock options. The Plan provides that the option price for both incentive and non-qualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally, options vest over four years. All options expire no later than ten years from the date of grant. As of September 30, 2007, there are 120,555 shares available for future grants under the Plan. Option activity under the Plan is as follows:

|   | Number<br>of Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value |
|---|---------------------|--|---|---------------------------------|
| <b>Total Stock Options</b>                |                     |  |   |                                 |
| Options Outstanding at January 1, 2007    | 752,983             | \$ 16.56                                 |   |                                 |
| Granted                                   | 321,500             | \$ 23.02                                 |   |                                 |
| Exercised                                 | (73,855)            | \$ 9.56                                  |   |                                 |
| Forfeited or expired                      | (27,105)            | \$ 21.10                                 |   |                                 |
| Options Outstanding at September 30, 2007 | 973,523             | \$ 19.10                                 | 7.6   | \$ 2,015,000                    |
| Exercisable at September 30, 2007         | 451,611             | \$ 15.30                                 | 6.0   | \$ 2,651,000                    |

Information related to the stock option plan during the six months ended September 30, 2007 and 2006 follows:

|  | 2007         | 2006      |
|--|--------------|-----------|
| Intrinsic value of options exercised           | \$ 1,005,000 | 2,078,000 |
| Cash received from option exercise             | \$ 706,000   | 1,572,000 |
| Tax benefit realized from option exercises     | \$ 389,000   | 583,000   |
| Weighted average fair value of options granted | \$ 6.52      | 7.57      |

As of September 30, 2007, there was approximately \$3,657,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Company's stock plan. That cost is expected to be recognized over a weighted-average period of approximately 2.5 years.

The following table presents the assumptions used to estimate the fair value of options granted during the nine months ended September 30, 2007 and 2006, respectively:

|  | 2007 | 2006 |
|--|------|------|
| Expected life in months <sup>(1)</sup> | 72   | 84   |

|  |       |       |
|--|-------|-------|
| Volatility <sup>(1)</sup>                    | 22%   | 21%   |
| Risk-free<br>interest rate<br><sup>(2)</sup> | 4.65% | 4.84% |
| Expected<br>dividends <sup>(3)</sup>         | 1.05% | 0.86% |

- (1) Estimate based on historical experience. Volatility is based on the historical volatility of the stock over the most recent period that is generally commensurate with the expected life of the option.
- (2) Based on the U.S. Treasury constant maturity interest rate with a term consistent with the expected life of the options granted.
- (3) The Company began paying cash dividends on common stock in 2006. Each grant's dividend yield is calculated by annualizing the most recent quarterly cash dividend and dividing that amount by the market price of the Company's common stock as of the grant date.

The Company estimates the impact of forfeitures based on the Company's historical experience with previously granted stock options in determining stock option expense. The Company issues new shares of common stock to satisfy stock option exercises.

The Company awarded 51,000 restricted shares of common stock to Walter T. Kaczmarek, President and Chief Executive Officer of the Company, pursuant to the terms of a Restricted Stock Agreement dated March 17, 2005. The grant price was \$18.15. Under the terms of the Restricted Stock Agreement, the restricted shares will vest 25% per year at the end of years three, four, five and six, provided Mr. Kaczmarek is still with the Company. Compensation cost associated with the restricted stock issued is measured based on the market price of the stock at the grant date and is expensed on a straight-line basis over the service period. Restricted stock compensation expense was \$115,000 in each of the nine month periods ended September 30, 2007 and 2006, respectively.

**4) Earnings Per Share**

Basic earnings per share is computed by dividing net income by the weighted average common shares outstanding. Diluted earnings per share reflects potential dilution from outstanding stock options, using the treasury stock method. There were 536,553 and 215,093 stock options for three months ended September 30, 2007 and 2006 and 359,822 and 128,905 for nine months ended September 30, 2007 and 2006, respectively, considered to be antidilutive and excluded from the computation of diluted earnings per share. For each of the periods presented, net income is the same for basic and diluted earnings per share. Reconciliation of weighted average shares used in computing basic and diluted earnings per share is as follows:

|   | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2007</b>                                 | <b>2006</b> | <b>2007</b>                                | <b>2006</b> |
| Weighted average common shares outstanding - used in computing basic earnings per share | 13,235,087                                  | 11,781,135  | 12,211,945                                 | 11,812,718  |
| Dilutive effect of stock options outstanding, using the treasury stock method           | 152,897                                     | 176,089     | 171,740                                    | 192,214     |
| Shares used in computing diluted earnings per share                                     | 13,387,984                                  | 11,957,224  | 12,383,685                                 | 12,004,932  |

**5) Loans and the Allowance for Loan Losses**

Loans at period-end were as follows:

|                                     | <b>September<br/>30, 2007</b> | <b>December<br/>31, 2006</b> |
|-------------------------------------|-------------------------------|------------------------------|
|                                     | <b>(Dollars in thousands)</b> |                              |
| Commercial                          | \$ 378,777                    | \$ 300,611                   |
| Real estate - mortgage *            | 325,327                       | 239,041                      |
| Real estate - land and construction | 205,925                       | 143,834                      |
| Home equity                         | 39,771                        | 38,976                       |
| Consumer                            | 4,131                         | 2,422                        |
| Total loans                         | 953,931                       | 724,884                      |
| Deferred loan costs                 | 727                           | 870                          |
| Allowance for loan losses           | (11,472)                      | (9,279)                      |
| Loans, net                          | \$ 943,186                    | \$ 716,475                   |

\* Real estate mortgage loans are primarily secured by mortgages on commercial property.

Changes in allowance for loan losses were as follows:

**For the Nine Months Ended  
September 30,**

|  | <b>2007</b>                   | <b>2006</b> |
|--|-------------------------------|-------------|
|  | <b>(Dollars in thousands)</b> |             |
| Balance, beginning of period           | \$ 9,279                      | \$ 10,224   |
| Net recoveries (charge-offs)           | 804                           | (242)       |
| Provision for loan losses              | (736)                         | (603)       |
| Allowance acquired in bank acquisition | 2,125                         | -           |
| Balance, end of period                 | \$ 11,472                     | \$ 9,379    |

**6) Comprehensive Income**

Comprehensive income includes net income and other comprehensive income, which represents the changes in net assets during the period from non-owner sources. The Company's sources of other comprehensive income are unrealized gains and losses on securities available-for-sale and I/O strips, which are treated like available-for-sale securities, and the liability related to the Company's supplemental retirement plan. The items in other comprehensive income are presented net of deferred income tax effects. Reclassification adjustments result from gains or losses on securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized gains and losses. The Company's comprehensive income was as follows:

|   | <b>Three Months Ended</b>     |             | <b>Nine Months Ended</b> |             |
|---|-------------------------------|-------------|--------------------------|-------------|
|   | <b>September 30,</b>          |             | <b>September 30,</b>     |             |
|   | <b>2007</b>                   | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
|   | <b>(Dollars in thousands)</b> |             |                          |             |
| Net Income  | \$ 3,240                      | \$ 4,353    | \$ 11,288                | \$ 12,918   |
| Other comprehensive income (loss):  |                               |             |                          |             |
| Unrealized gains (losses) on available-for-sale securities and I/O strips during the period               | 2,021                         | 2,335       | 1,191                    | 364         |
| Deferred income tax   | (848)                         | (981)       | (500)                    | (153)       |
| Net unrealized gains (losses) on available-for-sale securities and I/O strips, net of deferred income tax | 1,173                         | 1,354       | 691                      | 211         |
| Pension liability adjustment during the period  | 26                            | 36          | 79                       | 352         |
| Deferred income tax   | (11)                          | (15)        | (33)                     | (148)       |
| Pension liability adjustment, net of deferred income tax  | 15                            | 21          | 46                       | 204         |
| Other comprehensive income (loss)   | 1,188                         | 1,375       | 737                      | 415         |
| Comprehensive income  | \$ 4,428                      | \$ 5,728    | \$ 12,025                | \$ 13,333   |

**7) Supplemental Retirement Plan**

The Company has a supplemental retirement plan covering current and former key executives and directors ("Plan"). The Plan is a nonqualified defined benefit plan. Benefits are unsecured as there are no Plan assets. The following table presents the amount of periodic cost recognized for the three and nine months ended September 30, 2007 and 2006:

|  | <b>Three Months Ended</b>     |             | <b>Nine Months Ended</b> |             |
|--|-------------------------------|-------------|--------------------------|-------------|
|  | <b>September 30,</b>          |             | <b>September 30,</b>     |             |
|  | <b>2007</b>                   | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
|  | <b>(Dollars in thousands)</b> |             |                          |             |
| Components of net periodic benefits cost |                               |             |                          |             |
| Service cost                             | \$ 184                        | \$ 200      | \$ 552                   | \$ 600      |
| Interest cost                            | 155                           | 138         | 465                      | 414         |
| Prior service cost                       | 9                             | 9           | 27                       | 27          |
| Amortization of loss                     | 17                            | 36          | 51                       | 108         |
| Net periodic cost                        | \$ 365                        | \$ 383      | \$ 1,095                 | \$ 1,149    |

**8) Commitments and Contingencies**

***Financial Instruments with Off-Balance Sheet Risk***

HBC is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its clients. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheets.

10

---

Heritage Bank of Commerce's exposure to credit loss in the event of non-performance of the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. HBC uses the same credit policies in making commitments and conditional obligations as it does for loans. Credit risk is the possibility that a loss may occur because a party to a transaction fails to perform according to the terms of the contract. HBC controls the credit risk of these transactions through credit approvals, limits, and monitoring procedures. Management does not anticipate any material losses as a result of these transactions.

Commitments to extend credit as of September 30, 2007 and December 31, 2006 were as follows:

|                              | <b>September<br/>30, 2007</b> | <b>December<br/>31, 2006</b> |
|------------------------------|-------------------------------|------------------------------|
|                              | <b>(Dollars in thousands)</b> |                              |
| Commitments to extend credit | \$ 465,225                    | \$ 310,200                   |
| Standby letters of credit    | 12,682                        | 12,020                       |
|                              | \$ 468,907                    | \$ 322,220                   |

Generally, commitments to extend credit as of September 30, 2007 are at variable rates, typically based on the prime rate (with a margin). Commitments generally expire within one year.

Commitments to extend credit are agreements to lend to a client as long as there is no violation of conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses. Since some of the commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. HBC evaluates each client's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by HBC upon the extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies but may include cash, marketable securities, accounts receivable, inventory, property, plant and equipment, income-producing commercial properties, and/or residential properties. Fair value of these instruments is not material.

Standby letters of credit are written with conditional commitments issued by HBC to guarantee the performance of a client to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to clients.

### **9) Acquisition of Diablo Valley Bank**

The Company completed its acquisition of Diablo Valley Bank on June 20, 2007. The transaction was valued at approximately \$65 million, including payments for cancellation of options for Diablo Valley Bank common stock. The merger consideration consisted of approximately \$24 million in cash and the issuance of 1,732,298 shares of the Company's common stock in exchange for all outstanding Diablo Valley Bank shares and stock options. Prior to closing, Diablo Valley Bank redeemed all of its outstanding Series A Preferred Stock for an aggregate of approximately \$6.7 million in cash (including dividend payments). The unaudited consolidated financial statements of the Company for the three and nine months ended September 30, 2007 include preliminary purchase accounting adjustments to record the assets and liabilities of Diablo Valley Bank at their estimated fair values. The preliminary purchase accounting adjustments are subject to further refinement as more information becomes available.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition. The Company is in the process of finalizing the purchase accounting for the acquisition.

|                           |           |
|---------------------------|-----------|
| Cash and cash equivalents | \$ 41,807 |
|                           | 12,214    |

|                                      |           |
|--------------------------------------|-----------|
| Securities<br>available-for-sale     |           |
| Net loans                            | 203,793   |
| Goodwill                             | 42,996    |
| Core deposit<br>intangible asset     | 5,049     |
| Premises and<br>equipment            | 6,841     |
| Corporate<br>owned life<br>insurance | 1,025     |
| Federal Home<br>Loan Bank Stock      | 717       |
| Other assets,<br>net                 | 2,686     |
| Total assets<br>acquired             | 317,128   |
| Deposits                             | (248,646) |
| Other liabilities                    | (1,685)   |
| Total<br>liabilities                 | (250,331) |
| Net assets<br>acquired               | \$ 66,797 |



The Company's cost to acquire Diablo Valley Bank is summarized as follows:

|  |           |
|--|-----------|
| Cash paid to Diablo Valley Bank common shareholders and stock option holders | \$ 24,002 |
| Common stock issued to Diablo Valley Bank shareholders                       | 41,397    |
| Total consideration  | 65,399    |
| Professional fees and other acquisition costs                                | 1,398     |
| Net assets acquired  | \$ 66,797 |

Diablo Valley Bank was acquired by the Company for several reasons. Diablo Valley Bank was a profitable and fast growing bank in a geographic area where the Company wants to expend. Diablo Valley Bank had experienced staff and the acquisition also enhanced the Company's position in the East Bay area in the cities of Danville and Pleasanton. The Company believes it can achieve significant cost savings from merging Diablo Valley Bank into Heritage Bank of Commerce.

The following table presents pro forma information for the periods ended September 30 as if the acquisition had occurred at the beginning of the period presented. The pro forma financial information is not necessarily indicative of the results of operations as they would have been had the transaction been effected on the assumed date and is not intended to be a projection of future results.

|                                | <b>Three Months Ended</b>                            |        | <b>Nine Months Ended</b> |        |
|--------------------------------|--|--------|--------------------------|--------|
|                                | <b>September 30,</b>                                 |        | <b>September 30,</b>     |        |
|                                | <b>2006</b>  |        | <b>2007</b>              |        |
|                                |  |        | <b>2006</b>              |        |
|                                | <b>(Dollars in thousands, except per share data)</b> |        |                          |        |
| Net interest income            | \$   | 14,981 | \$                       | 43,133 |
|                                |  |        | \$                       | 44,407 |
| Net income                     | \$   | 4,573  | \$                       | 12,429 |
|                                |  |        | \$                       | 13,793 |
| Net income per share - basic   | \$   | 0.34   | \$                       | 0.93   |
|                                |  |        | \$                       | 1.02   |
| Net income per share - diluted | \$   | 0.33   | \$                       | 0.92   |
|                                |  |        | \$                       | 1.00   |

### 10) Reclassifications

In the first quarter of 2006, the Company sold its Capital Group loan portfolio for \$30,047,000. In anticipation of the sale, these loans were classified as "loans held-for-sale" on the Company's consolidated balance sheet as of December 31, 2005. After the sale was consummated, the proceeds received from the sale were reported as "Proceeds from sales of loans held for sale" under operating activities on the Consolidated Statement of Cash Flows for the nine months ended September 30, 2006. The gain recognized on the sale was included in the "Gain on sale of loans" in the Consolidated Statement of Cash Flows for the nine months ended September 30, 2006. Since the Capital Group loan portfolio was not specifically acquired for resale, the proceeds from the sale of the portfolio have been reclassified as "Proceeds from sale of Capital Group loan portfolio." The net principal reductions on the Capital Group loan portfolio in 2006 have also been reclassified to "Net decrease in Capital Group loan portfolio prior to sale" under the category of "Cash Flows from Investing Activities." The gain on the sale of the portfolio has been separately reported as "Gain on sale of Capital Group loan portfolio" under Cash Flows from Operating Activities." Previously, the gain on the sale of the Capital Group loan portfolio was included in "Gain on sale of loans" under "Cash Flows from Operating Activities" in the Consolidated Statement of Cash Flows for the nine months ended September 30, 2006.

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

Discussions of certain matters in this Report on Form 10-Q 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 (the "Exchange Act"), and as such, may involve risks and uncertainties. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies, and expectations, are generally identifiable by the use of words such as "believe", "expect", "intend", "anticipate", "estimate", "project", "assume", "plan", "p", "forecast" or similar expressions. These forward-looking statements relate to, among other things, expectations of the business environment in which the Company operates, projections of future performance, potential future performance, potential future credit experience, perceived opportunities in the market, and statements regarding the Company's mission and vision. The Company's actual results, performance, and achievements may differ materially from the results, performance, and achievements expressed or implied in such forward-looking statements due to a wide range of factors. These factors include, but are not limited to, the successful integration of the business, customers, employees and operations of Diablo Valley Bank with the Company, changes in interest rates, reducing interest margins or increasing interest rate risk, general economic conditions nationally or, in the State of California, legislative and regulatory changes adversely affecting the business in which the Company operates, monetary and fiscal policies of the US Government, real estate valuations, the availability of sources of liquidity at a reasonable cost, competition in the financial services industry, and other risks. All of the Company's operations and most of its customers are located in California. In addition, acts and threats of terrorism or the impact of military conflicts have increased the uncertainty related to the national and California economic outlook and could have an effect on the future operations of the Company or its customers, including borrowers. See "Item 1A – Risk Factors" in this Report on Form 10-Q and in Item 1-A- Risk Factors" in our Annual Report on Form 10-K for the Year ended December 31, 2006 for further discussions of factors that could cause actual result to differ from forward looking statements. The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

## EXECUTIVE SUMMARY

This summary is intended to identify the most important matters on which management focuses when it evaluates the financial condition and performance of the Company. When evaluating financial condition and performance, management looks at certain key metrics and measures. The Company's evaluation includes an analysis including comparisons with peer group financial institutions and with 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.

The merger with Diablo Valley Bank ("DVB") was completed on June 20, 2007 for approximately \$65 million payable in approximately \$24 million in cash and 1,732,298 shares of the Company's common stock. The unaudited consolidated financial statements of the Company for the three and nine months ended September 30, 2007 include preliminary purchase accounting adjustments to record the assets and liabilities of DVB at their estimated fair values. The Company recorded goodwill in connection with the transaction of \$42,996,000 and a core deposit intangible asset, net of accumulated amortization, of \$4,863,000 at September 30, 2007. The Company experienced certain one-time expenses for the acquisition of DVB in the third quarter of 2007, which affected the Company's net income, including \$419,000 of compensation expense for DVB employees who are no longer with the Company.

### *Performance Overview*

For the three months and nine months ended September 30, 2007, consolidated net income was \$3.2 million and \$11.3 million, compared to \$4.4 million and \$12.9 million for the three and nine months ended September 30, 2006, a decrease of 26% and 13%, respectively. Earnings per diluted share were \$0.24 and \$0.91 for the three and nine months ended September 30, 2007, compared to \$0.36 and \$1.08 for the three and nine months ended September 30, 2006, a decrease of 33% and 16%, respectively. The Company's return on average assets and return on average equity for the three months ended September 30, 2007 were 0.96% and 7.56%, compared to 1.61% and 14.43% for the quarter ended September 30, 2006, respectively. Return on average assets and return on average equity for the first nine months of 2007 were 1.31% and 10.60%, compared to 1.57% and 14.76% for the first nine months of 2006, respectively. The Company's return on average tangible assets and return on average tangible equity for the three months ended September 30, 2007 were 1.00% and 10.55%, compared to 1.61% and 14.43%, for the same period in 2006, respectively. Return on average tangible assets and return on average tangible equity for the first nine months of 2007 were 1.33% and 12.12%, compared to 1.57% and 14.76% for the first nine months of 2006, respectively.

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

- Net interest income increased 8% to \$13.8 million for the three months ended September 30, 2007, compared to \$12.8 million for the three months ended September 30, 2006 and increased 1% for the nine months ended September 30, 2007 compared to 2006, primarily due to an increase in average interest earning assets.
- Noninterest income decreased 29% to \$1.6 million for the three months ended September 30, 2007, compared to the three months ended September 30, 2006. Year-to-date noninterest income decreased 14% for the nine months ended September 30, 2007 from 2006, primarily because the gain on sale of SBA loans held for sale was significantly lower in the third quarter of 2007 due to the Company's change in its strategy regarding its SBA loan business. The Company is now retaining most of its SBA production in lieu of selling loans. The loans sold in the third quarter of 2007 were some of the loans classified as held for sale at June 30, 2007. The nine month period in 2006 also benefited from a \$671,000 nonrecurring gain on the sale of the Capital Group loan portfolio in the first

quarter of 2006.

- The efficiency ratio was 68.21% and 61.64% for the three and nine months ended September 30, 2007, compared to 55.00% and 56.71% for the respective prior year periods.
- Noninterest expense increased to \$10.5 million for the third quarter of 2007, compared to \$8.3 million for the third quarter of 2006. In the first nine months of 2007, noninterest expense increased to \$27.3 million from \$25.6 million for the first nine months a year ago. DVB acquisition related charges accounted for \$379,000, including \$167,000 for core deposit amortization, \$192,000 for a consulting agreement, and \$20,000 for a non-compete agreement. Compensation expense increased 18% for the third quarter of 2007 compared to the third quarter of 2006 and increased 5% for the first nine months of 2007 compared to a year ago. The increase was primarily due to the acquisition of DVB and the addition of senior bankers during the third quarter of 2007.
- A reverse provision for loan losses of \$500,000 was recorded in the third quarter of 2007 compared to no provision for loan losses in the third quarter of 2006. The year-to-date reverse provision for loan losses was \$736,000 in 2007, compared to a reverse provision of \$603,000 a year ago. The reverse provision in 2007 was due to continued improvement in credit quality and the recovery of a previously charged off loan.
- Nonperforming assets at September 30, 2007 increased to \$3.4 million, or 14%, from September 30, 2006 levels. Nonperforming assets decreased by \$950,000, or 22%, compared to December 31, 2006. Approximately \$2.4 million of the nonperforming assets at September 30, 2007 were acquired in the DVB merger.

### ***Deposits***

Growth in deposits is an important metric management uses to measure market share. The Company's depositors are primarily located in its local market area. Depending on loan demand and other funding requirements, the Company occasionally obtains deposits from wholesale sources including deposit brokers. The Company had \$52 million in brokered deposits at September 30, 2007. The Company also seeks deposits from title insurance companies and real estate exchange facilitators. 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.

### ***Lending***

Our lending business originates primarily through our branch offices. Commercial loans increased for the period ended September 30, 2007 from September 30, 2006, primarily from the DVB acquisition and increased loan demand reflecting the improving economy in our primary service area. Commercial real estate mortgage loans also increased from September 30, 2006, primarily due to general improvements in commercial income property markets. Commercial loans accounted for 40% of total loans at September 30, 2007. We will continue to use and improve existing products to expand market share at current locations.

### ***Net Interest Income***

The management of interest income and interest 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 net interest income and the net interest margin (net interest income divided by average earning assets).

Approximately 72% of the Company's loan portfolio is indexed to the prime rate. While the Federal Open Market Committee ("FOMC") decreased short term rates to 4.50% from 5.25% in September and October, 2007, the prime rate also decreased to 7.50% from 8.25%. The decreasing interest rate environment may have an unfavorable impact on the Company's net interest margin. Because of our focus on commercial lending to closely held businesses, the Company continues to have a high percentage of floating rate loans and other assets. Given the current volume, mix and repricing characteristics of our interest-bearing liabilities and interest-earning assets, we believe our interest rate spread is expected to increase in a rising rate environment, and decrease in a declining interest rate environment.

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.

### ***Management of Credit Risk***

Because of its focus on business banking, loans to single borrowing entities are often larger than would be found in a more consumer oriented bank with many smaller, more homogeneous loans. The average size of its loan relationships makes the Company more susceptible to larger losses. As a result of this concentration of larger risks, the Company has maintained an allowance for loan losses which is substantially higher than would be indicated by its actual historic loss experience.

### ***Noninterest Income***

While net interest income remains the largest single component of total revenues, noninterest income is an important component. Prior to the third quarter of 2007, a significant percentage of the Company's noninterest income is associated with its SBA lending activity, either as gains on the sale of loans sold in the secondary market or servicing income from loans sold with servicing retained. However, beginning in the third quarter of 2007, the Company decided to change its strategy regarding its SBA loan business. The Company is now retaining most new SBA production in lieu of selling the loans. As a result, the Company expects its noninterest income will be lower in the second half of 2007, compared to the second half of 2006. Noninterest income decreased 29% and 14%, respectively, for the three and nine months ended September 30, 2007 from the same periods a year ago.

Risks associated with the continuation of this level of noninterest income from SBA lending include the possibility that the federal government will eliminate or change SBA programs in a manner that becomes less attractive to the Company or to SBA borrowers. Higher than expected prepayments of SBA loans on which the Company has retained servicing could reduce the carrying value of the associated servicing asset and interest only strip.

### ***Noninterest Expense***

Management considers the control of operating expenses to be a critical element of the Company's performance. Over the last three years, the Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. These initiatives included a reduction in staff and the consolidation of operations under the common Heritage Bank brand and restructuring each department. Management monitors progress in reducing noninterest expense through review of the Company's efficiency ratio. The Company's efficiency ratio was 68.21% in the third quarter of 2007, compared with 55.00% in the third quarter of 2006, and 61.64% for the nine months ended September

30, 2007, compared to 56.71% for the nine months ended September 30, 2006. The increase in the efficiency ratio was primarily due to the acquisition of DVB and the hiring of several senior managers during the third quarter of 2007.

### *Capital Management and Share Repurchases*

Heritage Commerce Corp and Heritage Bank of Commerce meet the regulatory definition of “well capitalized” at September 30, 2007. As part of its asset and liability 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 July 26, 2007, the Board of Directors authorized the repurchase of up to an additional \$30 million of common stock over the next two years. During the third quarter of 2007, the Company repurchased 279,500 shares of its common stock with an average price of \$21.39 under the common stock repurchase program.

### **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 from the sale of loans, loan servicing fees, and customer service charges and fees as well as non-customer sources such as Company-owned life insurance. 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**

Net interest income is the largest component of the Company's total revenue. Net interest income is the difference between the interest and fees earned on loans and investments and interest expense on deposits and other liabilities. Net interest income depends on two factors: (1) the volume or balance of earning assets compared to the volume or balance of interest bearing deposits and liabilities, and (2) the interest rate earned on those earning assets compared with the interest rate on interest bearing liabilities. Net interest margin is net interest income expressed as a percentage of average earning assets. To maintain its net interest margin, the Company must manage the relationship between interest earned and paid.

The following 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.

**Average Balance, Rate and Yield**

|   | <b>For the Three Months Ended<br/>September 30,</b> |   |                                     |                            |   |                                     |
|---|---|---|-------------------------------------|----------------------------|---|-------------------------------------|
|   | <b>Average<br/>Balance</b>                          | <b>2007<br/>Interest<br/>Income /<br/>Expense</b> | <b>Average<br/>Yield /<br/>Rate</b> | <b>Average<br/>Balance</b> | <b>2006<br/>Interest<br/>Income /<br/>Expense</b> | <b>Average<br/>Yield /<br/>Rate</b> |
| <b>(Dollars in thousands)</b>                                   |   |   |                                     |                            |   |                                     |
| <b>Assets:</b>  |   |   |                                     |                            |   |                                     |
| Loans, gross  | \$ 939,023  | \$ 19,282   | 8.15%                               | \$ 739,121                 | \$ 15,958   | 8.57%                               |
| Securities  | 166,782   | 1,919   | 4.56%                               | 189,491                    | 2,013   | 4.21%                               |
| Interest bearing deposits<br>in other financial<br>institutions | 2,908   | 31  | 4.23%                               | 2,849                      | 36  | 5.01%                               |
| Federal funds sold  | 66,683  | 873   | 5.19%                               | 42,095                     | 561   | 5.29%                               |
| Total interest earning<br>assets                                | 1,175,396   | \$ 22,105   | 7.46%                               | 973,556                    | \$ 18,568   | 7.57%                               |
| Cash and due from banks   | 40,334  |   |                                     | 36,575                     |   |                                     |
| Premises and equipment,<br>net                                  | 9,430   |   |                                     | 2,450                      |   |                                     |
| Other assets  | 111,035   |   |                                     | 62,322                     |   |                                     |
| Total assets  | \$ 1,336,195  |   |                                     | \$ 1,074,903               |   |                                     |
| <b>Liabilities and<br/>shareholders' equity:</b>                |   |   |                                     |                            |   |                                     |
| Deposits:   |   |   |                                     |                            |   |                                     |
| Demand, interest bearing  | \$ 153,352  | \$ 863  | 2.23%                               | \$ 140,205                 | \$ 783  | 2.22%                               |
| Savings and money<br>market                                     | 460,596   | 3,981   | 3.43%                               | 357,003                    | 2,676   | 2.97%                               |
| Time deposits, under<br>\$100                                   | 33,379  | 327   | 3.89%                               | 30,987                     | 264   | 3.38%                               |
| Time deposits, \$100 and<br>over                                | 137,605   | 1,786   | 5.15%                               | 105,984                    | 979   | 3.66%                               |
| Brokered time deposits  | 59,265  | 706   | 4.73%                               | 34,031                     | 325   | 3.79%                               |
| Notes payable to<br>subsidiary grantor trusts                   | 23,702  | 585   | 9.79%                               | 23,702                     | 587   | 9.83%                               |
|   | 10,900  | 76  | 2.77%                               | 21,800                     | 140   | 2.55%                               |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|   |           |           |        |       |         |           |        |       |
|---|-----------|-----------|--------|-------|---------|-----------|--------|-------|
| Securities sold under agreement to repurchase |           |           |        |       |         |           |        |       |
| Total interest bearing liabilities            | 878,799   | \$        | 8,324  | 3.76% | 713,712 | \$        | 5,754  | 3.20% |
| Demand, noninterest bearing                   | 263,465   |           |        |       | 218,766 |           |        |       |
| Other liabilities                             | 23,795    |           |        |       | 22,735  |           |        |       |
| Total liabilities                             | 1,166,059 |           |        |       | 955,213 |           |        |       |
| Shareholders' equity                          | 170,136   |           |        |       | 119,690 |           |        |       |
| Total liabilities and shareholders' equity    | \$        | 1,336,195 |        |       | \$      | 1,074,903 |        |       |
| Net interest income / margin                  |           | \$        | 13,781 | 4.65% |         | \$        | 12,814 | 5.22% |

Note: Yields and amounts earned on loans include loan fees and costs. Nonaccrual loans are included in the average balance calculation above.



**For the Nine Months Ended  
September 30,**

|   | <b>2007</b>                   |                 | <b>Average</b> |                | <b>2006</b>     |                | <b>Average</b> |
|---|-------------------------------|-----------------|----------------|----------------|-----------------|----------------|----------------|
|   | <b>Average</b>                | <b>Interest</b> | <b>Yield /</b> | <b>Average</b> | <b>Interest</b> | <b>Average</b> | <b>Yield /</b> |
|   | <b>Balance</b>                | <b>Income /</b> | <b>Rate</b>    | <b>Balance</b> | <b>Income /</b> | <b>Balance</b> | <b>Rate</b>    |
|   |                               | <b>Expense</b>  |                |                | <b>Expense</b>  |                |                |
|   | <b>(Dollars in thousands)</b> |                 |                |                |                 |                |                |
| <b>Assets:</b>  |                               |                 |                |                |                 |                |                |
| Loans, gross  | \$ 800,468                    | \$ 49,541       | 8.27%          | \$ 738,272     | \$ 46,023       |                | 8.33%          |
| Securities  | 170,650                       | 5,853           | 4.59%          | 195,394        | 5,782           |                | 3.96%          |
| Interest bearing deposits<br>in other financial<br>institutions | 2,928                         | 104             | 4.75%          | 2,805          | 96              |                | 4.58%          |
| Federal funds sold  | 54,996                        | 2,158           | 5.25%          | 63,635         | 2,319           |                | 4.87%          |
| Total interest earning<br>assets                                | 1,029,042                     | \$ 57,656       | 7.49%          | \$ 1,000,106   | \$ 54,220       |                | 7.25%          |
| Cash and due from banks   | 36,299                        |                 |                | 36,584         |                 |                |                |
| Premises and equipment,<br>net                                  | 5,116                         |                 |                | 2,439          |                 |                |                |
| Other assets  | 80,029                        |                 |                | 63,813         |                 |                |                |
| Total assets  | \$ 1,150,486                  |                 |                | \$ 1,102,942   |                 |                |                |
| <b>Liabilities and<br/>shareholders' equity:</b>                |                               |                 |                |                |                 |                |                |
| Deposits:   |                               |                 |                |                |                 |                |                |
| Demand, interest bearing  | \$ 143,685                    | \$ 2,409        | 2.24%          | \$ 148,879     | \$ 2,451        |                | 2.20%          |
| Savings and money<br>market                                     | 369,268                       | 8,721           | 3.16%          | 359,642        | 7,455           |                | 2.77%          |
| Time deposits, under<br>\$100                                   | 31,873                        | 917             | 3.85%          | 32,475         | 761             |                | 3.13%          |
| Time deposits, \$100 and<br>over                                | 113,694                       | 3,865           | 4.55%          | 108,419        | 2,729           |                | 3.37%          |
| Brokered time deposits  | 51,359                        | 1,757           | 4.57%          | 34,849         | 983             |                | 3.77%          |
| Notes payable to<br>subsidiary grantor trusts                   | 23,702                        | 1,749           | 9.87%          | 23,702         | 1,724           |                | 9.72%          |
| Securities sold under<br>agreement to repurchase                | 16,266                        | 333             | 2.74%          | 26,653         | 486             |                | 2.44%          |
| Total interest bearing<br>liabilities                           | 749,847                       | \$ 19,751       | 3.52%          | 734,619        | \$ 16,589       |                | 3.02%          |
| Demand, noninterest<br>bearing                                  | 234,943                       |                 |                | 227,588        |                 |                |                |
| Other liabilities   | 23,319                        |                 |                | 23,687         |                 |                |                |
| Total liabilities   | 1,008,109                     |                 |                | 985,894        |                 |                |                |
| Shareholders' equity  | 142,377                       |                 |                | 117,048        |                 |                |                |
| Total liabilities and<br>shareholders' equity                   | \$ 1,150,486                  |                 |                | \$ 1,102,942   |                 |                |                |
| Net interest income /<br>margin                                 |                               | \$ 37,905       | 4.92%          |                | \$ 37,631       |                | 5.03%          |

Note: Yields and amounts earned on loans include loan fees and costs. Nonaccrual loans are included in the average balance calculation above.

The following Volume and Rate Variances table 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 in the average volume column.

**Volume and Rate Variances**

|   | <b>Three Months Ended September 30,<br/>2007 vs. 2006</b> |                         |                       |
|---|---|-------------------------|-----------------------|
|   | <b>Increase (Decrease) Due to Change In:</b>              |                         |                       |
|   | <b>Average<br/>Volume</b>                                 | <b>Average<br/>Rate</b> | <b>Net<br/>Change</b> |
|   | <b>(Dollars in thousands)</b>                             |                         |                       |
| Income from the interest earning assets:                  |   |                         |                       |
| Loans, gross  | \$ 4,099  | \$ (775)                | \$ 3,324              |
| Securities  | (259)   | 165                     | (94)                  |
| Interest bearing deposits in other financial institutions | 1   | (6)                     | (5)                   |
| Federal funds sold  | 322   | (10)                    | 312                   |
| Total interest income from interest earnings assets       | \$ 4,163  | \$ (626)                | \$ 3,537              |
| Expense from the interest bearing liabilities:            |   |                         |                       |
| Demand, interest bearing                                  | \$ 75   | \$ 5                    | \$ 80                 |
| Savings and money market                                  | 895   | 410                     | 1,305                 |
| Time deposits, under \$100                                | 23  | 40                      | 63                    |
| Time deposits, \$100 and over                             | 410   | 397                     | 807                   |
| Brokered time deposits                                    | 300   | 81                      | 381                   |
| Notes payable to subsidiary grantor trusts                | -   | (2)                     | (2)                   |
| Securities sold under agreement to repurchase             | (76)  | 12                      | (64)                  |
| Total interest expense on interest bearing liabilities    | \$ 1,627  | \$ 943                  | \$ 2,570              |
| Net interest income                                       | \$ 2,536  | \$ (1,569)              | \$ 967                |

|   | <b>Nine Months Ended June 30,<br/>2007 vs. 2006</b> |                         |                       |
|---|---|-------------------------|-----------------------|
|   | <b>Increase (Decrease) Due to Change In:</b>        |                         |                       |
|   | <b>Average<br/>Volume</b>                           | <b>Average<br/>Rate</b> | <b>Net<br/>Change</b> |
|   | <b>(Dollars in thousands)</b>                       |                         |                       |
| Income from the interest earning assets:                  |   |                         |                       |
| Loans, gross  | \$ 3,875  | \$ (357)                | \$ 3,518              |
| Securities  | (855)   | 926                     | 71                    |
| Interest bearing deposits in other financial institutions | 4   | 4                       | 8                     |
| Federal funds sold  | (341)   | 180                     | (161)                 |
| Total interest income from interest earnings assets       | \$ 2,683  | \$ 753                  | \$ 3,436              |
| Expense from the interest bearing liabilities:            |   |                         |                       |
| Demand, interest bearing                                  | \$ (85)   | \$ 43                   | \$ (42)               |
| Savings and money market                                  | 221   | 1,045                   | 1,266                 |
| Time deposits, under \$100                                | (18)  | 174                     | 156                   |
| Time deposits, \$100 and over                             | 175   | 961                     | 1,136                 |
| Brokered time deposits                                    | 566   | 208                     | 774                   |
| Notes payable to subsidiary grantor trusts                | -   | 25                      | 25                    |
| Securities sold under agreement to repurchase             | (213)   | 60                      | (153)                 |
| Total interest expense on interest bearing liabilities    | \$ 646  | \$ 2,516                | \$ 3,162              |

|                     |    |       |    |         |    |     |
|---------------------|----|-------|----|---------|----|-----|
| Net interest income | \$ | 2,037 | \$ | (1,763) | \$ | 274 |
|---------------------|----|-------|----|---------|----|-----|

17

---

Net interest income increased \$967,000 and \$274,000 for the three and nine months ended September 30, 2007 from 2006. The increase was primarily due to increases in interest earning assets partially offset by the decrease in short-term interest rates. 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, while a large base of the Company's core deposits are generally slower to re-price. Net interest income increased 8% to \$13.8 million for the third quarter of 2007. Year to date net interest income grew 1% to \$37.9 million.

The third quarter of 2007 net interest margin was 4.65%, down 46 basis points compared to 5.11% for the second quarter this year and 57 basis points from 5.22% in the third quarter a year ago. Year-to-date 2007, the net interest margin decreased 11 basis points to 4.92% from 5.03% for the first nine months of 2006. The decrease in net interest margin was due to the higher yield on deposit accounts. As a result, the average interest rate on savings and money market deposits increased 43 basis points to 3.43% for the third quarter of 2007, from 3.00% for the second quarter of 2007.

### *Provision for Loan Losses*

Credit risk is inherent in the business of making loans. The Company maintains an allowance for loan losses through charges to earnings, which are shown in the income statement as the provision for loan losses. Specifically identifiable and quantifiable losses are immediately charged off against the allowance. The loan loss provision is determined by conducting a monthly evaluation of the adequacy of the Company's allowance for loan losses, and charging the shortfall, if any, to the current month's expense. A credit provision for loan losses is recorded if the allowance would otherwise be more than warranted because of a significant decrease in impaired loans or total loans or material net recoveries during a quarter. This has the effect of creating variability in the amount and frequency of charges to the Company's earnings. The loan loss provision and level of allowance for each period is dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of the quality of the loan portfolio, the valuation of problem loans and the general economic conditions in the Company's market area.

The Company had a reverse provision for loan losses of \$500,000 and \$736,000 for the three and nine months ended September 30, 2007, respectively, due to strong asset quality and sizable recoveries from previously charged-off loans. The Company had a reverse provision for loan losses of \$0 and \$603,000 for the three and nine months ended September 30, 2006, respectively. See additional discussion under the caption "Allowance for Loan Losses."

### *Noninterest Income*

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

|                         | <b>For the Three Months</b>   |             | <b>Increase (decrease)</b> |                |
|-------------------------|-------------------------------|-------------|----------------------------|----------------|
|                         | <b>Ended</b>                  |             | <b>2007 versus 2006</b>    |                |
|                         | <b>September 30,</b>          |             | <b>Amount</b>              | <b>Percent</b> |
|                         | <b>2007</b>                   | <b>2006</b> |                            |                |
|                         | <b>(Dollars in thousands)</b> |             |                            |                |
| Gain on sale of SBA     |                               |             |                            |                |
| loans                   | \$ 60                         | \$ 832      | \$ (772)                   | -93%           |
| Servicing income        | 546                           | 412         | 134                        | 33%            |
| Increase in cash        |                               |             |                            |                |
| surrender value of life |                               |             |                            |                |
| insurance               | 374                           | 363         | 11                         | 3%             |
| Service charges and     |                               |             |                            |                |
| fees on deposit         |                               |             |                            |                |
| accounts                | 344                           | 354         | (10)                       | -3%            |

|                          |          |          |          |      |
|--------------------------|----------|----------|----------|------|
| Other                    | 315      | 338      | (23)     | -7%  |
| Total noninterest income | \$ 1,639 | \$ 2,299 | \$ (660) | -29% |

**For the Nine Months**

|  | <b>Ended</b>                  |             | <b>Increase (decrease)</b> |                |
|--|-------------------------------|-------------|----------------------------|----------------|
|  | <b>September 30,</b>          |             | <b>2007 versus 2006</b>    |                |
|  | <b>2007</b>                   | <b>2006</b> | <b>Amount</b>              | <b>Percent</b> |
|  | <b>(Dollars in thousands)</b> |             |                            |                |
| Gain on sale of SBA loans                          | \$ 1,766                      | \$ 2,500    | \$ (734)                   | -29%           |
| Gain on sale of Capital Group loan portfolio       | -                             | 671         | (671)                      | -100%          |
| Servicing income                                   | 1,596                         | 1,321       | 275                        | 21%            |
| Increase in cash surrender value of life insurance | 1,071                         | 1,070       | 1                          | 0%             |
| Service charges and fees on deposit accounts       | 954                           | 1,008       | (54)                       | -5%            |
| Other  | 1,028                         | 880         | 148                        | 17%            |
| Total noninterest income                           | \$ 6,415                      | \$ 7,450    | \$ 1,035                   | -14%           |

Noninterest income is primarily comprised of the gain on sale of SBA and other guaranteed loans, SBA loan-servicing income, and increase in cash surrender value of the Company owned life insurance. In prior fiscal years and the first half of 2007, the Company had an ongoing program of originating SBA loans and selling the government guaranteed portion in the secondary market, while retaining the servicing of the whole loans. Gains or losses on SBA loans held for sale are recognized upon completion of the sale, and are based on the difference between the net sales proceeds and the relative fair value of the guaranteed portion of the loan sold compared to the relative fair value of the unguaranteed portion. The servicing assets that result from the sale of SBA loans, with servicing rights retained, are amortized over the lives of the loans using a method approximating the interest method.

Beginning in the third quarter of 2007, the Company decided to change its strategy regarding its SBA loan business. The Company is now retaining most new SBA production in lieu of selling the loans. As a result, the net gain on sale of loans was \$60,000 in the third quarter of 2007, compared to a gain on sale of SBA loans of \$832,000 in the third quarter of 2006. The loans sold in the third quarter of 2007 were in the held for sale portfolio at June 30, 2007. The short-term reduction in noninterest income should be offset in future years with higher interest income.

There was a \$671,000 nonrecurring gain on the sale of the Capital Group loan portfolio in the first quarter of 2006.

### *Noninterest Expense*

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

|   | <b>For the Three Months</b>   |                      | <b>Increase (decrease)</b> |                |
|---|-------------------------------|----------------------|----------------------------|----------------|
|   | <b>Ended</b>                  | <b>Ended</b>         | <b>2007 versus 2006</b>    |                |
|   | <b>September 30,</b>          | <b>September 30,</b> | <b>Amount</b>              | <b>Percent</b> |
|   | <b>2007</b>                   | <b>2006</b>          |                            |                |
|   | <b>(Dollars in thousands)</b> |                      |                            |                |
| Salaries and employee benefits                      | \$ 5,840                      | \$ 4,941             | \$ 899                     | 18%            |
| Occupancy   | 969                           | 773                  | 196                        | 25%            |
| Professional fees                                   | 751                           | 442                  | 309                        | 70%            |
| Advertising and promotion                           | 206                           | 206                  | -                          | 0%             |
| Data processing                                     | 252                           | 156                  | 96                         | 62%            |
| Client services                                     | 155                           | 230                  | (75)                       | -33%           |
| Low income housing investment losses and writedowns | 233                           | 257                  | (24)                       | -9%            |
| Furniture and equipment                             | 200                           | 140                  | 60                         | 43%            |
| Core deposit intangible amortization                | 167                           | -                    | 167                        | N/A            |
| Other   | 1,745                         | 1,167                | 578                        | 50%            |
| Total noninterest expense                           | \$ 10,518                     | \$ 8,312             | \$ 2,206                   | 27%            |

|   | <b>For the Nine Months</b>    |                      | <b>Increase (decrease)</b> |                |
|---|-------------------------------|----------------------|----------------------------|----------------|
|   | <b>Ended</b>                  | <b>Ended</b>         | <b>2007 versus 2006</b>    |                |
|   | <b>September 30,</b>          | <b>September 30,</b> | <b>Amount</b>              | <b>Percent</b> |
|   | <b>2007</b>                   | <b>2006</b>          |                            |                |
|   | <b>(Dollars in thousands)</b> |                      |                            |                |
| Salaries and employee benefits                      | \$ 15,413                     | \$ 14,703            | \$ 710                     | 5%             |
| Occupancy   | 2,504                         | 2,324                | 180                        | 8%             |
| Professional fees                                   | 1,489                         | 1,289                | 200                        | 16%            |
| Advertising and promotion                           | 808                           | 763                  | 45                         | 6%             |
| Data processing                                     | 653                           | 498                  | 155                        | 31%            |
| Client services                                     | 631                           | 772                  | (141)                      | -18%           |
| Low income housing investment losses and writedowns | 588                           | 734                  | (146)                      | -20%           |
| Furniture and equipment                             | 429                           | 397                  | 32                         | 8%             |
| Core deposit intangible amortization                | 185                           | -                    | 185                        | N/A            |
| Other   | 4,618                         | 4,085                | 533                        | 13%            |

|                           |           |           |          |    |
|---------------------------|-----------|-----------|----------|----|
| Total noninterest expense | \$ 27,318 | \$ 25,565 | \$ 1,753 | 7% |
|---------------------------|-----------|-----------|----------|----|



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

|   | <b>For The Three Months Ended September 30,</b> |                             |             |                             |
|---|---|-----------------------------|-------------|-----------------------------|
|   | <b>2007</b>                                     | <b>Percent<br/>of Total</b> | <b>2006</b> | <b>Percent<br/>of Total</b> |
|   | <b>(Dollars in thousands)</b>                   |                             |             |                             |
| Salaries and employee benefits                      | \$ 5,840  | 56%                         | \$ 4,941    | 59%                         |
| Occupancy   | 969   | 9%                          | 773         | 9%                          |
| Professional fees                                   | 751   | 7%                          | 442         | 5%                          |
| Advertising and promotion                           | 206   | 2%                          | 206         | 3%                          |
| Client services                                     | 252   | 2%                          | 156         | 2%                          |
| Data processing                                     | 155   | 1%                          | 230         | 3%                          |
| Low income housing investment losses and writedowns | 233   | 2%                          | 257         | 3%                          |
| Furniture and equipment                             | 200   | 2%                          | 140         | 2%                          |
| Intangible amortization                             | 167   | 2%                          | -           | 0%                          |
| Other   | 1,745   | 17%                         | 1,167       | 14%                         |
| Total noninterest expense                           | \$ 10,518                                       | 100%                        | \$ 8,312    | 100%                        |

|   | <b>For The Nine Months Ended September 30,</b> |                             |             |                             |
|---|--|-----------------------------|-------------|-----------------------------|
|   | <b>2007</b>                                    | <b>Percent<br/>of Total</b> | <b>2006</b> | <b>Percent<br/>of Total</b> |
|   | <b>(Dollars in thousands)</b>                  |                             |             |                             |
| Salaries and employee benefits                      | \$ 15,413                                      | 56%                         | \$ 14,703   | 58%                         |
| Occupancy   | 2,504  | 9%                          | 2,324       | 9%                          |
| Professional fees                                   | 1,489  | 6%                          | 1,289       | 5%                          |
| Advertising and promotion                           | 808  | 3%                          | 763         | 3%                          |
| Client services                                     | 653  | 2%                          | 498         | 2%                          |
| Data processing                                     | 631  | 2%                          | 772         | 3%                          |
| Low income housing investment losses and writedowns | 588  | 2%                          | 734         | 3%                          |
| Furniture and equipment                             | 429  | 2%                          | 397         | 1%                          |
| Intangible amortization                             | 185  | 1%                          | -           | 0%                          |
| Other   | 4,618  | 17%                         | 4,085       | 16%                         |
| Total noninterest expense                           | \$ 27,318                                      | 100%                        | \$ 25,565   | 100%                        |

The increase in compensation expense was primarily due to the acquisition of DVB and the Company hiring a number of experienced bankers during the third quarter of 2007. Third quarter one-time expense for DVB employees who are no longer with the company totaled \$419,000 pre-tax. Up front expenses associated with the hiring of new bankers for the East Bay expansion and SBA team totaled \$467,000 in the third quarter of 2007. The increase in occupancy, furniture and equipment was due to a opening new branch office in Walnut Creek during the third quarter of 2007, as well as the addition of the DVB offices. The increase in professional fees and data processing fees in the third quarter of 2007 was due to the additional branches and customer accounts after the merger with DVB. The Company also incurred amortization expense of \$167,000 and \$185,000 related to core deposit intangible from the DVB acquisition for the three and nine months ended September 30, 2007, respectively.

### ***Income Tax Expense***

Income tax expense for the three and nine months ended September 30, 2007 was \$2.2 million and \$6.5 million, respectively, as compared to \$2.4 million and \$7.2 million for the same periods in 2006. The following table shows the effective income tax rate for each period:

|                              | <b>For the Three<br/>Months Ended<br/>September 30,<br/>2007</b> |       | <b>For the Nine<br/>Months Ended<br/>September 30,<br/>2006</b> |       |
|------------------------------|--|-------|---|-------|
| Effective income<br>tax rate | 40.0%  | 36.0% | 36.4%   | 35.8% |

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, tax credits related to investments in low income housing, and investments in tax-free municipal securities. The increase in the effective income tax rate for the third quarter of 2007 compared to the third quarter of 2006 was due to adjustments of \$181,000, based on preliminary findings from an audit of the Company's state tax returns.

**FINANCIAL CONDITION**

As of September 30, 2007, total assets were \$1.33 billion, compared to \$1.06 billion as of September 30, 2006. Total securities were \$150 million as of September 30, 2007, a decrease of 14% from \$174 million as of September 30, 2006. The total loan portfolio was \$955 million, an increase of \$241 million or 34%, compared to September 30, 2006. Total deposits were \$1.10 billion as of September 30, 2007, compared to \$876 million as of September 30, 2006. The increase in loans, deposits, and assets was primarily due to the DVB acquisition.

**Securities Portfolio**

The following table reflects the amortized cost and fair market values for each category of securities at the dates indicated:

**Investment Portfolio**

|   | <b>September 30,</b>          |             | <b>December</b> |
|---|-------------------------------|-------------|-----------------|
|   | <b>2007</b>                   | <b>2006</b> | <b>31,</b>      |
|   | <b>2006</b>                   |             |                 |
|   | <b>(Dollars in thousands)</b> |             |                 |
| Securities available-for-sale (at fair value) |                               |             |                 |
| U.S. Treasury                                 | \$ 4,955                      | \$ 5,942    | \$ 5,963        |
| U.S. Government Agencies                      | 46,146                        | 62,345      | 59,396          |
| Mortgage-Backed                               | 84,506                        | 87,548      | 90,186          |
| Municipals - Taxable                          | 499                           | -           | -               |
| Municipals - Tax Exempt                       | 5,984                         | 8,199       | 8,142           |
| Collateralized Mortgage Obligations           | 8,026                         | 9,769       | 8,611           |
| Total available-for-sale                      | \$ 150,116                    | \$ 173,723  | \$ 172,298      |

The following table summarizes the amounts and distribution of the Company's securities available-for-sale and the weighted average yields at September 30, 2007:

|   | <b>September 30, 2007</b>     |              |                       |              |                  |              |                        |              |               |              |
|---|-------------------------------|--------------|-----------------------|--------------|------------------|--------------|------------------------|--------------|---------------|--------------|
|   | <b>Maturity</b>               |              |                       |              |                  |              |                        |              |               |              |
|   | <b>After One and</b>          |              | <b>After Five and</b> |              | <b>Ten Years</b> |              | <b>After Ten Years</b> |              | <b>Total</b>  |              |
|   | <b>Within One Year</b>        | <b>Yield</b> | <b>Within Five</b>    | <b>Yield</b> | <b>Within</b>    | <b>Yield</b> | <b>Yield</b>           | <b>Yield</b> | <b>Yield</b>  | <b>Yield</b> |
|   | <b>Amount</b>                 |              | <b>Amount</b>         |              | <b>Amount</b>    |              | <b>Amount</b>          |              | <b>Amount</b> |              |
|   | <b>(Dollars in thousands)</b> |              |                       |              |                  |              |                        |              |               |              |
| Securities available-for-sale (at fair value) |                               |              |                       |              |                  |              |                        |              |               |              |
| U.S. Treasury                                 | \$ 4,955                      | 4.80%        | \$ -                  | -            | \$ -             | -            | \$ -                   | -            | \$ 4,955      | 4.80%        |
| U.S. Government Agencies                      | 34,753                        | 4.95%        | 11,393                | 4.52%        | -                | -            | -                      | -            | 46,146        | 4.84%        |
| Mortgage-Backed                               | -                             | -            | 1,799                 | 2.96%        | 6,248            | 4.43%        | 76,460                 | 4.54%        | 84,507        | 4.50%        |
| Municipals - Taxable                          | 499                           | 3.43%        | -                     | -            | -                | -            | -                      | -            | 499           | 3.43%        |
| Municipals - Tax Exempt                       | 3,956                         | 3.03%        | 2,028                 | 3.34%        | -                | -            | -                      | -            | 5,984         | 3.14%        |

|                    |           |       |           |       |           |       |           |       |            |       |
|--------------------|-----------|-------|-----------|-------|-----------|-------|-----------|-------|------------|-------|
| Collateralized     |           |       |           |       |           |       |           |       |            |       |
| Mortgage           |           |       |           |       |           |       |           |       |            |       |
| Obligations        | -         | -     | -         | -     | 5,046     | 5.55% | 2,979     | 4.84% | 8,025      | 5.29% |
| Total              |           |       |           |       |           |       |           |       |            |       |
| available-for-sale | \$ 44,163 | 4.75% | \$ 15,220 | 4.18% | \$ 11,294 | 4.93% | \$ 79,439 | 4.55% | \$ 150,116 | 4.60% |

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 any analysis of the financial condition of the Company. The investment portfolio serves the following purposes: (i) it can be readily reduced in size to provide liquidity for loan balance increases or deposit balance decreases; (ii) it provides a source of pledged assets for securing certain deposits and borrowed funds, as may be required by law or by specific agreement with a depositor or lender; (iii) it can be used as an interest rate risk management tool, since it provides a large base of assets, the maturity and interest rate characteristics of which can be changed more readily than the loan portfolio to better match changes in the deposit base and other funding sources of the Company; (iv) it is an alternative interest-earning use of funds when loan demand is weak or when deposits grow more rapidly than loans; and (v) it can enhance the Company's tax position by providing partially tax exempt income.

The Company classifies all of its securities as "Available-for-Sale". Accounting rules also allow for trading or "Held-to-Maturity" classifications, but the Company has no securities that would be classified as such. Even though management currently has the intent and the ability to hold the Company's securities for the foreseeable future, they are all currently classified as available-for-sale to allow flexibility with regard to the active management of the Company's portfolio. FASB Statement 115 requires available-for-sale securities to be marked to market with an offset to the accumulated other comprehensive income, a component of shareholders' equity. Monthly adjustments are made to reflect changes in the market value of the Company's available-for-sale securities.

The Company's securities portfolio is currently composed primarily of: (i) U.S. Treasury and Government Agency issues for liquidity and pledging; (ii) mortgage-backed securities, which in many instances can also be used for pledging, and which generally enhance the yield of the portfolio; (iii) municipal obligations, which provide tax free income and limited pledging potential; and (iv) collateralized mortgage obligations, which generally enhance the yield of the portfolio. The amortized cost of securities pledged as collateral for repurchase agreements, public deposits and for other purposes as required or permitted by law was \$34 million and \$54 million at September 30, 2007 and 2006, respectively.

Except for obligations of U.S. government agencies, no securities of a single issuer exceeded 10% of shareholders' equity at September 30, 2007. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or to otherwise mitigate interest rate risk.

The securities portfolio declined by \$24 million, or 14%, and decreased to 11% of total assets at September 30, 2007 from 16% at September 30, 2006. U.S. Treasury and U.S. Agency securities decreased to 34% of the portfolio at September 30, 2007 from 39% at September 30, 2006. The decrease was primarily due to maturities of U.S. Government Agency securities. Municipal securities, mortgage-backed securities and collateralized mortgage obligations remained fairly constant in the portfolio in the third quarter of 2007 compared to the third quarter of 2006. The Company invests in securities with the available cash based on market conditions and the Company's cash flow.

### Loans

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

Gross loans (including loans held for sale) represented 72% of total assets at September 30, 2007, as compared to 69% at September 30, 2006. The ratio of loans to deposits increased to 87% at September 30, 2007 from 81% at September 30, 2006. Competition for loans continues to intensify within the Company's markets. To help ensure that we remain competitive, we make every effort to be flexible and creative in our approach to structure loans.

The Loan Distribution table that follows sets forth the Company's gross loans outstanding and the percentage distribution in each category at the dates indicated.

### Loan Distribution

|  | September 30,<br>2007 |            | September 30,<br>2006 |            | December 31, 2006 |            |    |         |      |
|--|-----------------------|------------|-----------------------|------------|-------------------|------------|----|---------|------|
|  |                       | % to Total |                       | % to Total |                   | % to Total |    |         |      |
| (Dollars in thousands)                 |                       |            |                       |            |                   |            |    |         |      |
| Commercial                             | \$                    | 378,777    | 40%                   | \$         | 281,488           | 40%        | \$ | 300,611 | 42%  |
| Real estate -<br>mortgage              |                       | 325,327    | 34%                   |            | 227,732           | 32%        |    | 239,041 | 33%  |
| Real estate - land<br>and construction |                       | 205,925    | 22%                   |            | 160,137           | 22%        |    | 143,834 | 20%  |
| Home equity                            |                       | 39,771     | 4%                    |            | 41,784            | 6%         |    | 38,976  | 5%   |
| Consumer                               |                       | 4,131      | 0%                    |            | 1,387             | 0%         |    | 2,422   | 0%   |
| Total loans                            |                       | 953,931    | 100%                  |            | 712,528           | 100%       |    | 724,884 | 100% |
| Deferred loan costs                    |                       | 727        |                       |            | 1,172             |            |    | 870     |      |
| Allowance for loan<br>losses           |                       | (11,472)   |                       |            | (9,379)           |            |    | (9,279) |      |
| Loans, net                             | \$                    | 943,186    |                       | \$         | 704,321           |            | \$ | 716,475 |      |

Total loans (excluding loans held of sale) were \$954 million at September 30, 2007, compared to \$713 million at September 30, 2006. The Company's allowance for loan losses was \$11.5 million, or 1.20% of total loans, at September 30, 2007, as compared to \$9.3 million, or 1.31% of total loans, at September 30, 2006. As of September 30, 2007 and 2006, the Company had \$2.9 million and \$3.0 million, respectively, in nonperforming loans.

The Company's loan portfolio is concentrated in commercial loans, primarily manufacturing, wholesale, services, and real estate, with the balance in land development and construction, home equity and consumer loans. The increase in the Company's loan portfolio in the third quarter of 2007 from 2006 is primarily due to the merger with DVB adding \$204 million to the Company's loan portfolio at June 20, 2007. The Company does not have any concentrations by industry or group of industries in its loan portfolio; however, approximately 60% of its loans were secured by real property as of September 30, 2007 and 2006. While no specific industry concentration is considered significant, the Company's lending operations are located in areas that are dependent on the technology and real estate industries and their supporting companies.

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

The Company is an active participant in the Small Business Administration ("SBA") and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes loans that are partially guaranteed by either the SBA or the U.S. Department of Agriculture (collectively referred to as "SBA loans"). In prior years and to the designing of the third quarter of 2007, the Company sold the guaranteed portion of these loans in the secondary market depending on market conditions. Once it is determined that they will be sold, these loans were classified as held for sale and carried at the lower of cost or market. On the sale of the guaranteed portion of an SBA loan, the Company retained the servicing rights for the entire loan. Beginning in the third quarter of 2007, the Company changed its strategy regarding its SBA loan business. The Company is now retaining most new SBA production in lieu of selling the loans. The Company had \$6.1 million in SBA loans held for sale as of June 30, 2007, of which \$2.5 million were sold in the third quarter of 2007 and the balance reclassified to the loan portfolio because the loans either no longer qualified for sale or did not have an acceptable premium for sale. As a result, the Company's noninterest income was lower in the third quarter of 2007, compared to the third quarter of 2006.

As of September 30, 2007, real estate mortgage loans consisted of approximately \$324 million of adjustable and fixed rate loans secured by commercial property, and \$1 million of loans secured by first mortgages on 1-4 family residential properties. Home equity lines of credit are secured by junior deeds of trust on 1-4 family residential properties totaling \$40 million. Properties securing the real estate mortgage loans are primarily located in the Company's market area. While no specific industry concentration is considered significant, the Company's lending operations are located in market areas that are dependent on the technology and real estate industries and their supporting companies. There continues to be a concern expressed by Federal Regulatory Agencies as to the stability of the local and overall Bay Area real estate market, which is essentially the geographic area encompassing the majority of the Company's real estate loans. While many local and national economists question the sustainability of real estate values in the next few years, Silicon Valley, as well as the overall Bay Area has not seen the same retraction in values as other areas of the state and the nation. While it is taking longer to sell real estate, the median housing price and the value of commercial properties are staying relatively stable in our service area, according to various publications that the Company continually monitors to stay abreast of the market changes.

The Company's real estate term loans consist primarily of loans made based on the borrower's cash flow and are secured by deeds of trust on commercial and residential property to provide a secondary source of repayment. The Company generally restricts real estate term loans to no more than 80% of the property's appraised value or the purchase price of the property, depending on the type of property and its utilization. The Company offers both fixed and floating rate loans. Maturities on such loans are generally between five and ten years (with amortization ranging from fifteen to twenty-five years and a balloon payment due at maturity); however, SBA and certain other real estate loans that are easily sold in the secondary market may be granted for longer maturities.

The Company's real estate land and construction loans are primarily short term interim loans to finance the construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or permanent mortgage financing prior to making the construction loan.

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

With certain exceptions, state chartered banks are permitted to make extensions of credit to any one borrowing entity up to 15% of the bank's capital and reserves for unsecured loans and up to 25% of the bank's capital and reserves for secured loans. For the Company, these lending limits were \$28 million and \$47 million at September 30, 2007.

### *Loan Maturities*

The following table presents the maturity distribution of the Company's loans as of September 30, 2007. The table shows the distribution of such loans between those loans with fixed interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the western edition of The Wall Street Journal. As of September 30, 2007, approximately 72% of the Company's loan portfolio consisted of floating interest rate loans.

### **Loan Maturities**

| <b>Due in<br/>One Year<br/>or Less</b> | <b>Over One<br/>Year But<br/>Less than<br/>Five Years</b> | <b>Over<br/>Five Years</b> | <b>Total</b> |
|--|---|----------------------------|--------------|
|--|---|----------------------------|--------------|

**(Dollars in thousands)**

|                                     |            |            |            |            |
|-------------------------------------|------------|------------|------------|------------|
| Commercial                          | \$ 315,843 | \$ 51,544  | \$ 11,380  | \$ 378,777 |
| Real estate - mortgage              | 62,190     | 171,122    | 92,015     | 325,327    |
| Real estate - land and construction | 196,562    | 9,363      | -          | 205,925    |
| Home equity                         | 33,148     | 130        | 6,493      | 39,771     |
| Consumer                            | 2,456      | 1,675      | -          | 4,131      |
| Total loans                         | \$ 610,199 | \$ 233,844 | \$ 109,888 | \$ 953,931 |
| Loans with variable interest rates  | \$ 591,216 | \$ 90,029  | \$ 1,557   | \$ 682,802 |
| Loans with fixed interest rates     | 18,983     | 143,815    | 108,331    | 271,129    |
| Total loans                         | \$ 610,199 | \$ 233,844 | \$ 109,888 | \$ 953,931 |



**Loan Servicing**

As of September 30, 2007 and 2006, \$190 million and \$181 million, respectively, in SBA loans were serviced by the Company for others.

Activity for loan servicing rights was as follows:

|                             | <b>For the Three Months<br/>Ended<br/>September 30,</b> |             | <b>For the Nine Months<br/>Ended<br/>September 30,</b> |             |
|-----------------------------|---|-------------|--|-------------|
|                             | <b>2007</b>   | <b>2006</b> | <b>2007</b>  | <b>2006</b> |
|                             | <b>(Dollars in thousands)</b>                           |             |  |             |
| Beginning of period balance | \$ 2,138  | \$ 2,161    | \$ 2,154   | \$ 2,171    |
| Additions                   | 42  | 314         | 575  | 912         |
| Amortization                | (234)   | (365)       | (783)  | (973)       |
| End of period balance       | \$ 1,946  | \$ 2,110    | \$ 1,946   | \$ 2,110    |

Loan servicing rights and I/O strips are included in accrued interest receivable and other assets on the balance sheet and are reported net of amortization. There was no valuation allowance for servicing rights as of September 30, 2007 and 2006, as the fair market value of the assets was greater than the carrying value.

Activity for I/O strip receivables was as follows:

|                                   | <b>For the Three Months<br/>Ended<br/>September 30,</b> |             | <b>For the Nine Months<br/>Ended<br/>September 30,</b> |             |
|-----------------------------------|---|-------------|--|-------------|
|                                   | <b>2007</b>   | <b>2006</b> | <b>2007</b>  | <b>2006</b> |
|                                   | <b>(Dollars in thousands)</b>                           |             |  |             |
| Beginning of period balance       | \$ 3,750  | \$ 4,792    | \$ 4,537   | \$ 4,679    |
| Additions                         | -   | 8           | 27   | 788         |
| Amortization                      | (182)   | (395)       | (833)  | (1,001)     |
| Unrealized holding gain<br>(loss) | 74  | (224)       | (89)   | (285)       |
| End of period balance             | \$ 3,642  | \$ 4,181    | \$ 3,642   | \$ 4,181    |

**Nonperforming Assets**

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

To help minimize credit quality concerns, we have established a sound approach to credit that includes well-defined goals and objectives and well-documented credit policies and procedures. The policies and procedures identify market segments, set goals for portfolio growth or contraction, and establish limits on industry and geographic credit concentrations. In addition, these policies establish the Company's underwriting standards and the methods of monitoring ongoing credit quality. The Company's internal credit risk controls are centered in underwriting practices, credit granting procedures, training, risk management techniques, and familiarity with loan and lease customers as

well as the relative diversity and geographic concentration of our loan portfolio.

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

Nonperforming assets are comprised of the following: Loans for which the Company is no longer accruing interest; loans 90 days or more past due and still accruing interest (although they are generally placed on nonaccrual when they become 90 days past due unless they are both well secured and in the process of collection); loans restructured where the terms of repayment have been renegotiated, resulting in a deferral of interest or principal; and other real estate owned ("OREO"). 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, reverses any uncollected interest that had been accrued as income, and begins recognizing interest income only as cash interest payments are received as long as the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are continuously pursued. Loans may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. OREO consists of properties acquired by foreclosure or similar means that management is offering or will offer for sale.

The following table provides information with respect to components of the Company's non-performing assets at the dates indicated:

### Nonperforming Assets

|  | September 30,<br>2007  |       | September 30,<br>2006 |       | December<br>31,<br>2006 |
|--|------------------------|-------|-----------------------|-------|-------------------------|
|  | (Dollars in thousands) |       |                       |       |                         |
| Nonaccrual loans   | \$                     | 2,862 | \$                    | 2,083 | \$ 3,866                |
| Loans 90 days past due and still accruing                                  |                        | 18    |                       | 879   | 451                     |
| Total nonperforming loans  |                        | 2,880 |                       | 2,962 | 4,317                   |
| Other real estate owned  |                        | 487   |                       | -     | -                       |
| Total nonperforming assets   | \$                     | 3,367 | \$                    | 2,962 | \$ 4,317                |
| Nonperforming assets as a percentage of loans plus other real estate owned |                        | 0.35% |                       | 0.42% | 0.60%                   |

The balance of nonperforming assets was \$3.4 million, or 0.25% of total assets, at September 30, 2007. Nonperforming assets decreased by \$1.0 million, or 22%, compared to December 31, 2006. The decrease in 2007 was primarily due to nonperforming loans pay-offs during the third quarter of 2007.

### Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses in our loan portfolio. The allowance is based on two basic principles of accounting: (1) Statement of Financial Accounting Standards ("Statement") No. 5 "Accounting for Contingencies," which requires that losses be accrued when they are probable of occurring and estimable and (2) Statement No. 114, "Accounting by Creditors for Impairment of a Loan," which requires that losses be accrued based on the differences between the impaired loan balance and value of collateral, if the loan is collateral dependent, or present value of future cash flows or values that are observable in the secondary market.

Management conducts a critical evaluation of the loan portfolio monthly. This evaluation includes periodic loan by loan review for certain loans to evaluate impairment, as well as detailed reviews of other loans (either individually or in pools) based on an assessment of the following factors: past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, collateral values, loan volumes and concentrations, size and complexity of the loans, recent loss experience in particular segments of the portfolio, bank regulatory examination and independent loan review results, and current economic conditions in the Company's marketplace, in particular the state of the technology industry and the real estate market. This process attempts to assess the risk of loss inherent in the portfolio by segregating loans into two categories for purposes of determining an appropriate level of the allowance: Loans graded "Pass" through "Special Mention" and those graded "Substandard."

Loans are charged against the allowance when management believes that the uncollectibility of the loan balance is confirmed. The Company's methodology for assessing the appropriateness of the allowance consists of several key elements, which include the formula allowance and specific allowances.

Specific allowances are established for impaired loans. Management considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the loan agreement. When a loan is considered to be impaired, the amount of impairment is measured based on the fair

value of the collateral if the loan is collateral dependent or on the present value of expected future cash flows.

The formula portion of the allowance is calculated by applying loss factors to pools of outstanding loans. Loss factors are based on the Company's historical loss experience, adjusted for significant factors that, in management's judgment, affect the collectibility of the portfolio as of the evaluation date. The adjustment factors for the formula allowance may include existing general economic and business conditions affecting the key lending areas of the Company, in particular the real estate market, credit quality trends, collateral values, loan volumes and concentrations, the technology industry and specific industry conditions within portfolio segments, recent loss experience in particular segments of the portfolio, duration of the current business cycle, and bank regulatory examination results. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty.

Loans that demonstrate a weakness, for which there is a possibility of loss if the weakness is not corrected, are categorized as "classified." Classified loans include all loans considered as substandard, doubtful, and loss and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate). The principal balance of classified loans, which consists of all loans internally graded as substandard, was \$24 million and \$20 million, respectively, at September 30, 2007 and 2006. Classified loans were \$25 million at December 31, 2006.

In adjusting the historical loss factors applied to the respective segments of the loan portfolio, management considered the following factors:

- Levels and trends in delinquencies, non-accruals, charge offs and recoveries
  - Trends in volume and loan terms
  - Lending policy or procedural changes
- Experience, ability, and depth of lending management and staff
  - National and local economic trends and conditions
  - Concentrations of credit

There can be no assurance that the adverse impact of any of these conditions on the Company will not be in excess of the current level of estimated losses.

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

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

### Allowance for Loan Losses

|  | For the Nine Months Ended<br>September 30, |           | For the Year<br>Ended<br>December 31, |
|--|--|-----------|---------------------------------------|
|  | 2007                                       | 2006      | 2006                                  |
|  | (Dollars in thousands)                     |           |                                       |
| Balance, beginning of period / year    | \$ 9,279                                   | \$ 10,224 | \$ 10,224                             |
| Net recoveries (charge-offs)           | 804  | (242)     | (442)                                 |
| Provision for loan losses              | (736)                                      | (603)     | (503)                                 |
| Allowance acquired in bank acquisition | 2,125                                      | -         | -                                     |
| Balance, end of period/ year           | \$ 11,472                                  | \$ 9,379  | \$ 9,279                              |

### RATIOS:

|   |        |       |       |
|---|--------|-------|-------|
| Net (recoveries) charge-offs to average loans outstanding * | -0.14% | 0.05% | 0.06% |
| Allowance for loan losses to total loans *                  | 1.20%  | 1.31% | 1.28% |
| Allowance for loan losses to nonperforming loans            | 398%   | 317%  | 215%  |

\* Average loans and total loans excluding loans held for sale

Historical net loan charge-offs/recoveries are not necessarily indicative of the amount of net charge-offs/recoveries that the Company will realize in the future.

### Deposits

The composition and cost of the Company's deposit base are important components in analyzing the Company's net interest margin and balance sheet liquidity characteristics, both of which are discussed in greater detail in other sections herein. Our net interest margin is improved to the extent that growth in deposits can be concentrated in historically lower-cost deposits such as non-interest-bearing demand, NOW accounts, savings accounts and money market deposit accounts. The Company's liquidity is impacted by the volatility of deposits or other funding instruments, or, in other words, by the propensity of that money to leave the institution for rate-related or other reasons. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning

time deposits with balances that equal or exceed \$100,000, as customers with balances of that magnitude are typically more rate-sensitive than customers with smaller balances.

The following table summarizes the distribution of deposits:

### Deposits

|                               | September 30, 2007     |            | September 30, 2006 |            | December 31, 2006 |            |
|-------------------------------|------------------------|------------|--------------------|------------|-------------------|------------|
|                               | Balance                | % to Total | Balance            | % to Total | Balance           | % to Total |
|                               | (Dollars in thousands) |            |                    |            |                   |            |
| Demand, noninterest bearing   | \$ 263,244             | 24%        | \$ 226,297         | 26%        | \$ 231,841        | 27%        |
| Demand, interest bearing      | 146,410                | 13%        | 133,636            | 15%        | 133,413           | 16%        |
| Savings and money market      | 468,263                | 42%        | 349,436            | 40%        | 307,266           | 36%        |
| Time deposits, under \$100    | 32,341                 | 3%         | 31,522             | 4%         | 31,097            | 4%         |
| Time deposits, \$100 and over | 138,327                | 13%        | 101,198            | 11%        | 111,017           | 13%        |
| Brokered deposits             | 52,179                 | 5%         | 34,009             | 4%         | 31,959            | 4%         |
| Total deposits                | \$ 1,100,764           | 100%       | \$ 876,098         | 100%       | \$ 846,593        | 100%       |

Total deposits were \$1,101 million at September 30, 2007 and \$876 million at September 30, 2006. The increases primarily reflect the merger with DVB. At September 30, 2007, compared to September 30, 2006, noninterest bearing demand deposits increased \$37 million, or 16%; interest bearing demand deposits increased \$13 million, or 10%; savings and money market deposits increased \$119 million, or 34%; time deposits increased \$38 million, or 29%; and brokered deposits increased \$18 million, or 53%.

At September 30, 2007 and 2006, less than 1%, of deposits were from public sources and approximately 9% and 13% of deposits were from real estate exchange company, title company and escrow accounts respectively.

The Company obtains deposits from a cross-section of the communities it serves. The Company's business is not seasonal in nature. The Company had brokered deposits totaling \$52 million, and \$34 million at September 30, 2007 and 2006, respectively. These brokered deposits generally mature within one to three years. The Company is not dependent upon funds from sources outside the United States.

The following table indicates the maturity schedule of the Company's time deposits of \$100,000 or more as of September 30, 2007:

### Deposit Maturity Distribution

|                                       | <b>Balance</b>                | <b>% of Total</b> |
|---------------------------------------|-------------------------------|-------------------|
|                                       | <b>(Dollars in thousands)</b> |                   |
| Three months or less                  | \$ 79,390                     | 57%               |
| Over three months through six months  | 26,980                        | 20%               |
| Over six months through twelve months | 27,314                        | 20%               |
| Over twelve months                    | 4,643                         | 3%                |
| Total                                 | \$ 138,327                    | 100%              |

The Company focuses primarily on providing and servicing business deposit accounts that are frequently over \$100,000 in average balance per account. The account activity for some account types and client types necessitates appropriate liquidity management practices by the Company to ensure its ability to fund deposit withdrawals.

### Return on Equity and Assets

The following table indicates the ratios for return on average tangible assets and average tangible equity, dividend payout, and average tangible equity to average tangible assets for 2007 and 2006:

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|  | <b>2007</b>               | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
| Return on average tangible assets                  | 1.00%                     | 1.61%       | 1.33%                    | 1.57%       |
| Return on average tangible equity                  | 10.55%                    | 14.43%      | 12.12%                   | 14.76%      |
| Dividend payout ratio                              | 24.75%                    | 13.60%      | 19.49%                   | 13.73%      |
| Average tangible equity to average tangible assets | 9.46%                     | 11.13%      | 11.00%                   | 10.61%      |

### Liquidity and Asset/Liability Management

Liquidity refers to the Company's ability to maintain cash flows sufficient to fund operations, and to meet obligations and other commitments in a timely and cost-effective fashion. At various times the Company requires funds to meet short-term cash requirements brought about by loan growth or deposit outflows, the purchase of assets, or liability repayments. To manage liquidity needs properly, cash inflows must be timed to coincide with anticipated outflows or sufficient liquidity resources must be available to meet varying demands. The Company manages liquidity in such a fashion as to be able to meet unexpected sudden changes in levels of its assets or deposit liabilities without maintaining excessive amounts of balance sheet liquidity. Excess balance sheet liquidity can negatively impact the interest margin.

An integral part of the Company's ability to manage its liquidity position appropriately is the Company's large base of core deposits, which are generated by offering traditional banking services in its service area and which have, historically, been a stable source of funds. In addition to core deposits, the Company has the ability to raise deposits through various deposit brokers if required for liquidity purposes. The Company's loan to deposit ratio increased to 87% at September 30, 2007 from 81% at September 30, 2006.

To meet liquidity needs, the Company maintains a portion of its funds in cash deposits at other banks, in Federal funds sold and in securities available-for-sale. The primary liquidity ratio is composed of net cash, non-pledged securities, and other marketable assets, divided by total deposits and short-term liabilities minus liabilities secured by investments or other marketable assets. As of September 30, 2007, the Company's primary liquidity ratio was 13.4%, comprised of \$59 million in securities available for sale of maturities of up to five years, less \$8 million of securities that were pledged to secure public and certain other deposits as required by law and contract, Federal funds sold of \$43 million, and \$52 million cash and due from banks, as a percentage of total unsecured deposits of \$1.1 billion.

As of September 30, 2006, the Company's primary liquidity ratio was 17.3%, comprised of \$79 million in securities available-for-sale of maturities of up to five years, less \$11 million of securities that were pledged to secure public and certain other deposits as required by law and contract, Federal funds sold of \$41 million and \$41 million in cash and due from banks, as a percentage of total unsecured deposits of \$865 million.



The following table summarizes the Company's borrowings under its Federal funds purchased and security repurchase arrangements for the periods indicated:

|  | <b>September 30,</b>          |             |
|--|-------------------------------|-------------|
|  | <b>2007</b>                   | <b>2006</b> |
|  | <b>(Dollars in thousands)</b> |             |
| Average balance year-to-date                 | \$ 16,266                     | \$ 26,653   |
| Average interest rate year-to-date           | 2.74%                         | 2.44%       |
| Maximum month-end balance during the quarter | \$ 10,900                     | \$ 21,800   |
| Average rate at September 30                 | 2.77%                         | 2.56%       |

### ***Capital Resources***

At September 30, 2007, the Company had total shareholders' equity of \$168 million, which included \$98 million in common stock, \$71 million in retained earnings, and \$1 million of accumulated other comprehensive loss.

The Company paid cash dividends totaling \$2.2 million, or \$.18 per share, in the first nine months of 2007. The Company's Board of Director approved a raise in the quarterly cash dividend to \$0.08 per share, a 33% increase from the prior dividend, on October 25, 2007. The Company anticipates paying future dividends within the range of typical peer payout ratios provided, however, that no assurance can be given that earnings and/or growth expectations in any given year will justify the payment of such a dividend.

On July 26, 2007, the Board of Directors authorized the repurchase of up to \$30 million of common stock through June 30, 2009. Shares may be repurchased in open market purchases or in privately negotiated transactions as permitted under applicable rules and regulations. The repurchase program may be modified, suspended or terminated by the Board of Directors at any time without notice. The extent to which the Company repurchases its shares and the timing of such repurchases will depend upon market conditions and other corporate considerations.

The Company uses a variety of measures to evaluate capital adequacy. Management reviews various capital measurements on a regular basis and takes appropriate action to ensure that such measurements are within established internal and external guidelines. The external guidelines, which are issued by the Federal Reserve Board and the FDIC, establish a risk-adjusted ratio relating capital to different categories of assets and off-balance sheet exposures. There are two categories of capital under the Federal Reserve Board and FDIC guidelines: Tier 1 and Tier 2 Capital. Our Tier 1 Capital currently includes common shareholders' equity and the proceeds from the issuance of trust preferred securities (trust preferred securities are counted only up to a maximum of 25% of Tier 1 capital), less goodwill and other intangible assets and the unrealized net gains/losses (net of deferred income taxes) on securities available for sale and I/O Strips. Our Tier 2 Capital includes the allowances for loan losses and the allowance for off balance sheet credit losses.

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of the Company:

|                            | <b>September 30,</b>          |             | <b>December 31,</b> |
|----------------------------|-------------------------------|-------------|---------------------|
|                            | <b>2007</b>                   | <b>2006</b> | <b>2006</b>         |
|                            | <b>(Dollars in thousands)</b> |             |                     |
| <b>Capital components:</b> |                               |             |                     |
| Tier 1 Capital             | \$ 144,579                    | \$ 142,967  | \$ 147,600          |
| Tier 2 Capital             | 12,365                        | 9,754       | 9,756               |

Edgar Filing: HERITAGE COMMERCE CORP - Form 10-Q

|                                     |    |           |    |           |    |           |
|-------------------------------------|----|-----------|----|-----------|----|-----------|
| Total risk-based capital            | \$ | 156,944   | \$ | 152,721   | \$ | 157,356   |
| Risk-weighted assets                | \$ | 1,135,878 | \$ | 839,097   | \$ | 855,715   |
| Average assets for capital purposes | \$ | 1,291,775 | \$ | 1,079,571 | \$ | 1,087,502 |

|                           |  |       |  |       | Minimum<br>Regulatory<br>Requirements |       |
|---------------------------|--|-------|--|-------|---------------------------------------|-------|
| Capital ratios            |  |       |  |       |                                       |       |
| Total risk-based capital  |  | 13.8% |  | 18.2% | 18.4%                                 | 8.00% |
| Tier 1 risk-based capital |  | 12.7% |  | 17.0% | 17.3%                                 | 4.00% |
| Leverage <sup>(1)</sup>   |  | 11.2% |  | 13.2% | 13.6%                                 | 4.00% |

Leverage ratio is equal to Tier 1 capital divided by (1) quarterly average assets (excluding goodwill and other intangible assets).

The table above presents the capital ratios of the Company computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements under the FDIC's prompt corrective action authority as of September 30, 2007.

At September 30, 2007 and 2006, and December 31, 2006, the Company's capital met all minimum regulatory requirements. As of September 30, 2007, management believes that HBC was considered "Well Capitalized" under the Prompt Corrective Action Provisions.

### **Market Risk**

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

### **Interest Rate Management**

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

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

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

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

The Company uses modeling software for asset/liability management to simulate the effects of potential interest rate changes on the Company's net interest margin, and to calculate the estimated fair values of the Company's financial instruments under different interest rate scenarios. The program imports current balances, interest rates, maturity dates

and repricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company's interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Company's investment, loan, deposit and borrowed funds portfolios.

The Company applies a market value ("MV") methodology to gauge its interest rate risk exposure as derived from its simulation model. Generally, MV is the discounted present value of the difference between incoming cash flows on interest earning assets and other investments and outgoing cash flows on interest bearing liabilities and other liabilities. The application of the methodology attempts to quantify interest rate risk as the change in the MV which would result from a theoretical 200 basis point (1 basis point equals 0.01%) change in market interest rates. Both a 200 basis point increase and a 200 basis point decrease in market rates are considered.

At September 30, 2007, it was estimated that the Company's MV would increase 17.2% in the event of a 200 basis point increase in market interest rates. The Company's MV at the same date would decrease 25.7% in the event of a 200 basis point decrease in market interest rates.

Presented below, as of September 30, 2007 and 2006, is an analysis of the Company's interest rate risk as measured by changes in MV for instantaneous and sustained parallel shifts of 200 basis points in market interest rates:

|                        | September 30, 2007              |                                      |  |                     | September 30, 2006              |                                      |  |                     |
|------------------------|---------------------------------|--------------------------------------|--|---------------------|---------------------------------|--------------------------------------|--|---------------------|
|                        | \$ Change<br>in Market<br>Value | %<br>Change<br>in<br>Market<br>Value | Market Value as a %<br>of<br>Present Value of<br>Assets<br>MV<br>Ratio | %<br>Change<br>(bp) | \$ Change<br>in Market<br>Value | %<br>Change<br>in<br>Market<br>Value | Market Value as a %<br>of<br>Present Value of<br>Assets<br>MV<br>Ratio | %<br>Change<br>(bp) |
| <b>Change in rates</b> |                                 |                                      |  |                     |                                 |                                      |  |                     |
| + 200 bp               | \$ 37,805                       | 17.2%                                | 19.39%   | 284                 | \$ 34,859                       | 21.0%                                | 19.10%   | 331                 |
| 0 bp                   | \$ -                            | -                                    | 16.54%   | -                   | \$ -                            | -                                    | 15.80%   | -                   |
| - 200 bp               | \$ (56,407)                     | -25.7%                               | 12.30%   | (424)               | \$ (50,121)                     | -30.2%                               | 11.00%   | (477)               |

Management believes that the MV methodology overcomes three shortcomings of the typical maturity gap methodology. First, it does not use arbitrary repricing intervals and accounts for all expected future cash flows. Second, because the MV method projects cash flows of each financial instrument under different interest rate environments, it can incorporate the effect of embedded options on an institution's interest rate risk exposure. Third, it allows interest rates on different instruments to change by varying amounts in response to a change in market interest rates, resulting in more accurate estimates of cash flows.

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

## **CRITICAL ACCOUNTING POLICIES**

### ***General***

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The financial information contained within our consolidated financial statements is, to a significant extent, based on approximate measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. In certain instances, we use a discount factor and prepayment assumptions to determine the present value of assets and liabilities. A change in the discount factor or prepayment speeds could increase or decrease the values of those assets and liabilities which would result in either a beneficial or adverse impact to our financial results. We use historical loss factors as one factor in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from the historical factors that we use. The Company adopted FASB Statement 123R on January 1, 2006, and elected the modified prospective method for expensing stock options, under which prior periods are not revised for comparative purposes. Other estimates that we use are related to the expected useful lives of our depreciable assets. In addition, GAAP itself may change from one previously acceptable method to another method, although the economics of our transactions would be the same.

### ***Allowance for Loan Losses***

The allowance for loan losses is an estimate of the losses in our loan portfolio. Our accounting for estimated loan losses is discussed under the heading "Allowance for Loan Losses".

### ***Loan Sales and Servicing***

The amounts of gains recorded on sales of loans and the initial recording of servicing assets and I/O strips are based on the estimated fair values of the respective components. In recording the initial value of the servicing assets and the fair value of the I/O strips receivable, the Company uses estimates which are made on management's expectations of future prepayment and discount rates.

***Stock Based Compensation***

We grant stock options to purchase our common stock to our employees and directors under the 2004 Plan. We also granted our chief executive officer restricted stock when he joined the Company. Additionally, we have outstanding options that were granted under an option plan from which we no longer make grants. The benefits provided under all of these plans are subject to the provisions of FASB Statement 123(Revised), "Share-Based Payment," which we adopted effective January 1, 2006. We elected to use the modified prospective application in adopting Statement 123R and therefore have not restated results for prior periods. The valuation provisions of Statement 123R apply to new awards and to awards that are outstanding on the adoption date and subsequently modified or cancelled. Our results of operations for 2007 and 2006 were impacted by the recognition of non cash expense related to the fair value of our share-based compensation awards as discussed in Note 3 to the consolidated financial statements.

The determination of fair value of stock-based payment awards on the date of grant using the Black-Scholes model is affected by our stock price, as well as the input of other subjective assumptions. These assumptions include, but are not limited to, the expected term of stock options and our expected stock price volatility over the term of the awards. Our stock options have characteristics significantly different from those of traded options, and changes in the assumptions can materially affect the fair value estimates.

Statement 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. If actual forfeitures vary from our estimates, we will recognize the difference in compensation expense in the period the actual forfeitures occur or when options vest.

### **ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As a financial institution, the Company's primary component of market risk is interest rate volatility. Fluctuations in interest rates will ultimately impact both the level of income and expense recorded on most of the Company's assets and liabilities, and the market value of all interest-earning assets, other than those which have a short term to maturity. Based upon the nature of the Company's operations, the Company is not subject to foreign exchange or commodity price risk. The Company has no market risk sensitive instruments held for trading purposes. As of September 30, 2007, the Company does not use interest rate derivatives to hedge its interest rate risk.

The information concerning quantitative and qualitative disclosure or market risk called for by Item 305 of Regulation S-K is included as part of the Item above. See page 29.

### **ITEM 4 – CONTROLS AND PROCEDURES**

#### **Disclosure Control and Procedures**

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of September 30, 2007. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded the Company's disclosure controls were effective as of September 30, 2007, the period covered by this report on Form 10Q.

During the nine months ended September 30, 2007, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to affect, our internal controls over financial reporting.

## **Part II — OTHER INFORMATION**

### **ITEM 1 – LEGAL PROCEEDINGS**

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

### **ITEM 1A – RISK FACTORS**

A description of the risk factors associated with our business is contained in Part I, Item 1A, "Risk Factors," of our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 filed with the Securities and Exchange Commission. These cautionary statements are to be used as a reference in connection with any forward-looking statements. The factors, risks and uncertainties identified in these cautionary statements are in addition to those contained in any other cautionary statements, written or oral, which may be made or otherwise addressed in connection with a forward-looking statement or contained in any of our subsequent filings with the Securities and Exchange Commission. There are no material changes in the "Risk Factors" previously disclosed in the Annual Report on Form 10-K for the year ended December 31, 2006.

**ITEM 2 – UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

In February 2006, the Company's Board of Directors authorized the purchase of up to \$10 million of its common stock. The share repurchase authorization expired on June 30, 2007. On July 26, 2007, the Company's Board of Directors authorized the purchase of up to an additional \$30 million of its common stock over the next two years, which represents approximately 1.48 million shares, or 11% (based on the closing price of its shares on July 26, 2007).

The Company intends to finance the purchase using its available cash and line of credit. Shares may be repurchased by the Company in open market purchases or in privately negotiated transactions as permitted under applicable rules and regulations. The repurchase program may be modified, suspended or terminated by the Board of Directors at any time without notice. The extent to which the Company repurchases its shares and the timing of such repurchases will depend upon market conditions and other corporate considerations.



In the third quarter of 2007, repurchases of common stock are presented in the table below.

| Settlement Date | Total Number<br>of<br>Shares<br>Purchased | Price Paid<br>Per Share | Total Number of<br>Shares Purchased<br>as Part of Publicly<br>Announced Plans | Approximate<br>Dollar of Shares<br>That<br>May Yet Be<br>Purchased |
|-----------------|---|-------------------------|---|--|
|                 |   |                         |   | Under the Plan   |
| 8/16/2007       | 10,000                                    | \$ 21.24                | 10,000  | \$ 29,787,592  |
| 8/17/2007       | 12,000                                    | \$ 20.39                | 12,000  | \$ 29,542,967  |
| 8/20/2007       | 40,000                                    | \$ 21.00                | 40,000  | \$ 28,702,967  |
| 8/21/2007       | 10,000                                    | \$ 21.41                | 10,000  | \$ 28,488,826  |
| 8/22/2007       | 10,000                                    | \$ 23.11                | 10,000  | \$ 28,257,751  |
| 8/23/2007       | 10,000                                    | \$ 21.83                | 10,000  | \$ 28,039,414  |
| 8/24/2007       | 10,000                                    | \$ 21.45                | 10,000  | \$ 27,824,889  |
| 8/27/2007       | 10,000                                    | \$ 22.22                | 10,000  | \$ 27,602,650  |
| 8/28/2007       | 10,000                                    | \$ 21.91                | 10,000  | \$ 27,383,599  |
| 8/29/2007       | 10,000                                    | \$ 21.78                | 10,000  | \$ 27,165,845  |
| 8/30/2007       | 13,000                                    | \$ 22.04                | 13,000  | \$ 26,879,336  |
| 8/31/2007       | 13,000                                    | \$ 21.42                | 13,000  | \$ 26,600,902  |
| 9/4/2007        | 13,000                                    | \$ 21.29                | 13,000  | \$ 26,324,091  |
| 9/5/2007        | 13,000                                    | \$ 21.43                | 13,000  | \$ 26,045,445  |
| 9/6/2007        | 13,000                                    | \$ 21.11                | 13,000  | \$ 25,770,952  |
| 9/7/2007        | 15,000                                    | \$ 20.99                | 15,000  | \$ 25,456,106  |
| 9/10/2007       | 15,000                                    | \$ 21.25                | 15,000  | \$ 25,137,356  |
| 9/11/2007       | 10,000                                    | \$ 21.07                | 10,000  | \$ 24,926,618  |
| 9/12/2007       | 15,000                                    | \$ 21.05                | 15,000  | \$ 24,610,892  |
| 9/13/2007       | 5,000                                     | \$ 21.22                | 5,000   | \$ 24,504,778  |
| 9/14/2007       | 5,900                                     | \$ 21.42                | 5,900   | \$ 24,378,393  |
| 9/17/2007       | 5,200                                     | \$ 21.73                | 5,200   | \$ 24,265,374  |
| 9/18/2007       | 7,700                                     | \$ 21.55                | 7,700   | \$ 24,099,424  |
| 9/19/2007       | 3,700                                     | \$ 21.08                | 3,700   | \$ 24,021,440  |
|                 | 279,500                                   |                         | 279,500   |  |

### ITEM 3 – DEFAULTS UPON SENIOR SECURITIES

None

### ITEM 4 – SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

### ITEM 5 – OTHER INFORMATION

None



**ITEM 6 - EXHIBITS**

| <u>Exhibit</u> | <u>Description</u>  |
|----------------|---|
| 31.1           | Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2           | Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1           | Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350                        |
| 32.2           | Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350                        |

**SIGNATURES**

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

Heritage Commerce Corp  
(Registrant)

November 9, 2007  
Date

/s/ Walter T. Kaczmarek  
Walter T. Kaczmarek  
Chief Executive Officer

November 9, 2007  
Date

/s/ Lawrence D. McGovern  
Lawrence D. McGovern  
Chief Financial Officer

**EXHIBIT INDEX**

| <u>Exhibit</u> | <u>Description</u>  |
|----------------|---|
| 31.1           | Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2           | Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1           | Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350                        |
| 32.2           | Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350                        |

