HERITAGE COMMERCE CORP
Form 10-K/A
February 22, 2008

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

FORM 10-K/A

(Amendment No. 2)

(MARK ONE)

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

For the fiscal year ended December 31, 2006

OR

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

FOR THE TRANSITION PERIOD FROM TO

Commission file number 000-23877

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

California	**77-0469558**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification 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)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on which Registered**
Common Stock, no par value	The NASDAQ Stock Market

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes o No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K/A, or any amendment to this Form 10-K/A. x

Indicate by check mark whether the Registrant is an 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.

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x

The aggregate market value of the stock held by non-affiliates of the Registrant, based upon the closing price of its common stock as of June 30, 2006 ($24.69 per share), as reported on the Nasdaq Global Select Market, was approximately $258 million.

As of February 12, 2007, there were 11,658,109 shares of the Registrant s common stock (no par value) outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

DOCUMENTS INCORPORATED	**PARTS OF FORM 10-K INTO WHICH INCORPORATED**
Definitive proxy statement for the Company s 2007 Annual Meeting of Shareholders to be filed within 120 days of the end of the fiscal year ended December 31, 2006.	Part III

HERITAGE COMMERCE CORP
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PART I

EXPLANATORY NOTE

Heritage Commerce Corp is filing this Amendment No. 2 to its Annual Report on Form 10-K for the year ended December 31, 2006, to reflect the restatement of Heritage Commerce Corp s Consolidated Balance Sheets and Consolidated Statements of Cash Flows, as discussed in Note 17 of the Notes to the Consolidated Financial Statements contained in Part II, Item 8, Financial Statements and Supplementary Data. Except for Part II, Item 8, and related changes to conform Item 6, Selected Financial Data, and Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, of Part II and certain other information contained herein related to the restated financial statements, no other information in the Form 10-K or Form 10-K/A, Amendment No. 1, for the year ended December 31, 2006 is being amended by this Amendment No. 2. This Amendment No. 2 continues to speak as of the date of the original filing of the Form 10-K and Heritage Commerce Corp has not updated the disclosure in the Amendment to speak as of any later date.

ITEM 1 - BUSINESS

Discussions of certain matters in this Report on this Amendment No. 2 to Form 10-K 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, predict, 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. The factors include, but are not limited to 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, the occurrence of events such as the terrorist acts of September 11, 2001, 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 for further discussion of factors that could cause actual results 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.

GENERAL

Heritage Commerce Corp (the Company) is registered with the Board of Governors of the Federal Reserve System (FRB) as a Bank Holding Company under the Bank Holding Company Act (BHCA). The Company was

organized in 1997 to be the holding company for Heritage Bank of Commerce (HBC). Subsequent to 1997, the Company became the holding company for Heritage Bank East Bay (HBEB), Heritage Bank South Valley (HBSV), and Bank of Los Altos (BLA). On January 1, 2003, HBEB, HBSV, and BLA were merged into Heritage Bank of Commerce. The former HBEB, HBSV, and BLA now operate as branch offices of HBC and continue to serve their local markets.

The Company s only other direct subsidiaries are Heritage Capital Trust I (formed 2000), Heritage Statutory Trust I (formed 2000), Heritage Statutory Trust II (formed 2001) and Heritage Statutory Trust III (formed 2002) (collectively, Subsidiary Trusts), which were formed solely to facilitate the issuance of capital trust pass-through securities to enhance regulatory capital and liquidity. Pursuant to FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46), the Subsidiary Trusts are not reflected on a consolidated basis in the financial statements of the Company.

The Company s principal source of income is dividends from HBC. The expenditures of the Company, including (but not limited to) the payment of dividends to shareholders, if and when declared by the Board of Directors, the cost of servicing debt, legal fees, audit fees, and shareholder costs will generally be paid from dividends paid to the Company by HBC.

At December 31, 2006, the Company had consolidated assets of $1.04 billion, deposits of $847 million and shareholders equity of $123 million. The Company s liabilities include $24 million in debt obligations due to the Subsidiary Trusts related to capital trust pass-through securities issued by those entities.

The Internet address of the Company s website is http://www.heritagecommercecorp.com. The Company makes available free of charge through the Company s website, the Company s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports. The Company makes these reports available on its website on the same day they appear on the SEC s website.

Heritage Bank of Commerce

Heritage Bank of Commerce (HBC) is a California state-chartered bank headquartered in San Jose, California. It was incorporated in November 1993 and opened for business in January 1994. HBC is a multi-community independent bank that offers a full range of banking services to small to medium sized businesses and their owners, managers and employees residing in Santa Clara, Alameda and Contra Costa counties in California. We operate nine full service branch offices throughout this geographic footprint. The locations of HBC s current offices are:

San Jose:	Administrative Office
	Main Branch
	150 Almaden Boulevard
Los Gatos:	Branch Office
	15575 Los Gatos Boulevard
Fremont:	Branch Office
	3077 Stevenson Boulevard
Danville:	Branch Office
	310 Hartz Avenue
Morgan Hill:	Branch Office
	18625 Sutter Boulevard
Gilroy:	Branch Office
	7598 Monterey Street
Los Altos:	Branch Office
	369 S. San Antonio Road
Los Altos:	Branch Office
	4546 El Camino Real
Mountain View:	Branch Office
	175 E. El Camino Real

HBC s gross loan balances at the end of 2006 totaled $709 million, excluding loans held for sale. HBC s lending activities are diversified and include commercial, real estate, construction loans, and consumer loans. HBC 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 provide for floating interest rates, with monthly payments of both principal and interest. HBC s commercial loans are centered in locally-oriented commercial activities in markets where HBC has a physical presence through its branch offices and loan production offices.

HBC 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. HBC 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. HBC offers both fixed and floating rate loans. Maturities on such loans are generally restricted to between five and ten years (with amortization ranging from fifteen to twenty-five years and a balloon payment due at maturity); however, Small Business Administration (SBA) loans and certain other real estate loans that may be sold in the secondary market may be granted for longer maturities.

HBC s real estate land and construction loans are primarily short term interim loans to finance the construction of commercial and single family residential properties. HBC 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.

HBC makes consumer loans for the purpose of financing automobiles, various types of consumer goods, and other personal purposes. Additionally, HBC makes home equity lines of credit available to its clientele. Consumer loans

generally provide for the monthly payment of principal and interest. Most of HBC s consumer loans are secured by the personal property being purchased or, in the instances of home equity loans or lines, real property.

We also actively engage in SBA lending. We have been designated as an SBA preferred Lender since 1999 and HBC is a participant in the SBA s innovative Community Express program. HBC regularly makes SBA-guaranteed loans; the guaranteed portion of these loans may be sold in the secondary market depending on market conditions. As of December 31, 2006, the percentage of our total loans guaranteed by the SBA was 5%.

As of December 31, 2006, the percentage of our total loans for each of the principal areas in which we directed our lending activities were as follows: (i) commercial 40%, (ii) real estate secured loans 34%, (iii) construction loans 20%, and (iv) consumer (including home equity) 6%. While no specific industry concentration is considered significant, our lending operations are located in market areas dependent on technology and real estate industries and their supporting companies.

In addition to loans, we offer a wide range of deposit products for retail and business banking markets including checking accounts, interest-bearing transaction accounts, savings accounts, time deposits and retirement accounts. We attract deposits from throughout our market area with a customer-oriented product mix, competitive pricing, and convenient locations. At December 31, 2006 we had 13,000 deposit accounts totaling approximately $847 million, compared to 14,000 deposit accounts totaling approximately $940 million as of December 31, 2005.

We offer a multitude of other products and services to complement our lending and deposit services. These include cashier s checks, traveler s checks, bank-by-mail, ATM, night depository, safe deposit boxes, direct deposit, automated payroll services, electronic funds transfers, on-line banking, and other customary banking services. We currently operate ATM s at four different locations. In addition, we have established a convenient customer service group accessible by toll-free telephone to answer questions and promote a high level of customer service. HBC does not have a trust department.

Recent Developments

Merger Agreement with Diablo Valley Bank.

On February 8, 2007, the Company, HBC and Diablo Valley Bank (Diablo) entered into an Agreement and Plan of Merger (the Merger Agreement), pursuant to which, among other things, Diablo will merge with and into HBC, with HBC surviving the merger (the Merger) in a cash and stock transaction valued at approximately $70 million. The Merger Agreement has been unanimously approved by the Boards of Directors of the Company, HBC and Diablo. The Merger is subject to approval by the Diablo shareholders.

Under the terms of the Merger Agreement, the Company will pay a fixed number of 1,732,298 shares of the Company s common stock and an aggregate of $15 million in cash for all of the issued and outstanding shares of Diablo common stock. Each Diablo common shareholder will be entitled to receive at the shareholder s election (subject to certain prorating procedures) cash or the Company s common stock. The per share consideration for each share of Diablo common stock will be calculated by reference to the Company s average closing price over a 20 trading day period ending 5 days before the effective date of the Merger (Average Closing Price). Based on the closing price of the Company s common

stock of $27.25 on February 8, 2007, the per share consideration would be $24.87. The per share consideration will float within a band of $23.00 to $25.00 if the Average Closing Price is between $24.55 and $27.44. If the Average Closing Price is above $27.44, the per share consideration will be increased to reflect one-third of the increase in the Average Closing Price above $27.44. If the Average Closing Price is below $24.55, the aggregate amount of cash paid in the Merger will be increased to an amount necessary to maintain a minimum per share consideration of $23.00. If the Average Closing Price falls below $23.50, the

Company has the right to terminate the Merger Agreement. All Diablo stock options will be terminated at the effective time of the Merger and option holders will receive cash in the amount of the per share consideration minus the exercise price of the option (in the aggregate approximately $8 million). Diablo s issued and outstanding Series A Preferred Stock will be redeemed in full at $32 per share by Diablo prior to the effective time of the Merger (approximately $6.5 million).

The Merger Agreement contains customary representations and warranties of the Company, HBC and Diablo. Consummation of the Merger is subject to certain conditions, including, among others, (i) approval by the Diablo common shareholders, (ii) receipt of certain regulatory approvals, (iii) the filing of a registration statement on Form S-4 to register the Company s common stock to be issued in the Merger with the Securities and Exchange Commission (SEC) and receipt of the SEC s order that such registration statement is effective, (iv) listing of the Company s common stock to be issued in the Merger with NASDAQ, (v) satisfaction of tangible net worth and customer deposit tests, (vi) redemption of Diablo s Series A Preferred Stock, and (vii) the accuracy of representations and warranties of Diablo, the Company and HBC.

Certain shareholders of Diablo have entered into Shareholder Agreements with the Company pursuant to which they have agreed to vote their Diablo shares in favor of the Merger. The Diablo Board of Directors has agreed to recommend to its shareholders the approval of the Merger. The Merger Agreement provides for the payment of a Termination Fee in the amount of $3,380,000, payable to the Company, if the Merger Agreement is terminated by the Company or Diablo under specified circumstances.

On the effective date of the Merger, two members of the Diablo Board of Directors, John J. Hounslow and Mark E. Lefanowicz will be added to the Company and HBC s Board of Directors.

In connection with the Merger Agreement, the Company and/or HBC entered into the following agreements which will become effective upon June 20, 2007, the effective date of the Merger: (i) a three year employment agreement with James Mayer (the President of Diablo) for annual salaries of $220,000, $240,000 and $250,000 and the grant (subject to approval of the Company s Compensation Committee and Board of Directors) of stock options for 20,000 shares of the Company s common stock pursuant to its 2004 Stock Option Plan, (ii) a consulting agreement with John J. Hounslow (the Chairman of the Board of Diablo) pursuant to which Mr. Hounslow will receive $400,000, and (iii) non-compete agreements with Mr. Mayer and Mr. Hounslow (for which Mr. Hounslow will receive $200,000). Mr. Mayer and Mr. Hounslow have agreed to forego certain severance payments due to them as a result of the Merger in exchange for the Agreements with the Company and HBC.

The transaction is expected to close during the second or third quarter of 2007.

Personnel Changes

On May 5, 2006, Kenneth A. Corsello resigned as the Company s Executive Vice President and Chief Credit Officer.

On May 12, 2006, Richard E. Hagarty was promoted to Executive Vice President and Chief Credit Officer of Heritage Bank of Commerce.

On July 27, 2006, the Company s Board of Directors elected Jack W. Conner as Chairman of the Board, succeeding William Del Biaggio, Jr., who will remain on the Board of Directors as a director and Founding Chairman and will continue serving the Bank as an Executive Vice President.

Correspondent Banks

Correspondent bank deposit accounts are maintained to enable the Company to transact types of activity that it would otherwise be unable to perform or would not be cost effective due to the size of the Company or volume of activity. The Company has utilized several correspondent banks to process a variety of transactions.

COMPETITION

The banking and financial services business in California generally, and in the Company s market areas specifically, is highly competitive. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the consolidation among financial service providers. The Company competes for loans, deposits and customers for financial services with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market funds, credit unions, and other non-bank financial service providers. Many of these competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services than the Company. In order to compete with the other financial service providers, the Company principally relies upon local promotional activities, personal relationships established by officers, directors, and employees with its customers, and specialized services tailored to meet its customers needs. In those instances where the Company is unable to accommodate a customer s needs, the Company seeks to arrange for such loans on a participation basis with other financial institutions or to have those services provided in whole or in part by its correspondent banks. See Item 1 - *BUSINESS - Supervision and Regulation.*

SUPERVISION AND REGULATION

Introduction

Banking is a complex, highly regulated industry. The primary goals of the regulatory scheme are to maintain a safe and sound banking system, protect depositors and the Federal Deposit Insurance Corporation s insurance fund, and facilitate the conduct of sound monetary policy. In furtherance of these goals, Congress and the states have created several largely autonomous regulatory agencies and enacted numerous laws that govern banks, bank holding companies and the financial services industry. Consequently, the growth and earnings performance of the Company and HBC can be affected not only by management decisions and general economic conditions, but also by the requirements of applicable state and federal statues, regulations and the policies of various governmental regulatory authorities, including the Board of Governors of the Federal Reserve System, (FRB), and the California Department of Financial Institutions, (DFI).

The system of supervision and regulation applicable to financial services businesses governs most aspects of the business of the Company and HBC, including: (i) the scope of permissible business; (ii) investments; (iii) reserves that must be maintained against deposits; (iv) capital levels that must be maintained; (v) the nature and amount of collateral that may be taken to secure loans; (vi) the establishment of new branches; (vii) mergers and consolidations with other financial institutions; and (viii) the payment of dividends.

From time to time laws or regulations are enacted which have the effect of increasing the cost of doing business, limiting or expanding the scope of permissible activities, or changing the competitive balance between banks and other financial and non-financial institutions. Proposals to change the laws and regulations governing the operations of banks and bank holding companies are frequently made in Congress, in the California legislature and by various bank and other regulatory agencies. Future changes in the laws, regulations or polices that impact the Company and HBC cannot necessarily be predicted, but they may have a material effect on the business and earnings of the Company and HBC.

The Company

General. As a bank holding company, the Company is registered under the Bank Holding Company Act of 1956, as amended, or the BHCA, and is subject to regulation by the FRB. According to FRB policy, the Company is expected to act as a source of financial strength for HBC, to commit resources to support it in circumstances where the Company might not otherwise do so. Under the BHCA, the Company is subject to periodic examination by the FRB. The Company is also required to file periodic reports of its operations and any additional information regarding its activities and those of its subsidiaries, as may be required by the FRB.

The Company is also a bank holding company within the meaning of Section 3700 of the California Financial Code. Consequently, the Company and HBC are subject to examination by, and may be required to file reports with, the DFI. Regulations have not yet been proposed or adopted or steps otherwise taken to implement the DFI s powers under this statute.

Bank Holding Company Liquidity. The Company is a legal entity, separate and distinct from HBC. The Company has the ability to raise capital on its own behalf or borrow from external sources. The Company may also obtain additional funds from dividends paid by, and fees charged for services provided to, HBC. However, regulatory constraints on HBC may restrict or totally preclude the payment of dividends by HBC to the Company.

The Company is entitled to receive dividends, when and as declared by HBC s Board of Directors. Those dividends may come from funds legally available for those dividends, as specified and limited by the California Financial Code. Under the California Financial Code, funds available for cash dividends by a California-chartered bank are restricted to the lesser of: (i) the bank s retained earnings; or (ii) the bank s net income for its last three fiscal years (less any distributions to shareholders made during such period). With the prior approval of the DFI, cash dividends may also be paid out of the greater of: (a) the bank s retained earnings; (b) net income for the bank s last preceding fiscal year; or (c) net income of the bank s current fiscal year.

If the DFI determines that the shareholders equity of the bank paying the dividend is not adequate or that the payment of the dividend would be unsafe or unsound for the bank, the DFI may order the bank not to pay the dividend. Since HBC is an FDIC insured institution, it is also possible, depending upon its financial condition and other factors, that the FDIC could assert that the payment of dividends or other payments might, under some circumstances, constitute an unsafe or unsound practice and thereby prohibit such payments.

Transactions With Affiliates. The Company and any subsidiaries it may purchase or organize are deemed to be affiliates of HBC within the meaning of Sections 23A and 23B of the Federal Reserve Act and the FRB s Regulation W. Under Sections 23A and 23B and Regulation W, loans by HBC to affiliates, investments by them in affiliates stock, and taking affiliates stock as collateral for loans to any borrower is limited to 10% of HBC s capital, in the case of any one affiliate, and is limited to 20% of HBC s capital, in the case of all affiliates. In addition, transactions between HBC and other affiliates must be on terms and conditions that are consistent with safe and sound banking practices; in particular, a bank and its subsidiaries generally may not purchase from an affiliate a low-quality asset, as defined in the Federal Reserve Act. These restrictions also prevent a bank holding company and its other affiliates from borrowing from a banking subsidiary of the bank holding company, unless the loans are secured by marketable collateral of designated amounts. The Company and HBC are also subject to certain restrictions with respect to engaging in the underwriting, public sale and distribution of securities.

Limitations on Business and Investment Activities. Under the BHCA, a bank holding company must obtain the FRB s approval before: (i) directly or indirectly acquiring more than 5% ownership or control of any voting shares of another bank or bank holding company; (ii) acquiring all or substantially all of the assets of another bank; (iii) or merging or consolidating with another bank holding company.

The FRB may allow a bank holding company to acquire banks located in any state of the United States without regard to whether the acquisition is prohibited by the law of the state in which the target bank is located. In approving interstate acquisitions, however, the FRB must give effect

to applicable state laws limiting the aggregate amount of deposits that may be held by the acquiring bank holding company and its insured depository institutions in the state in which the target bank is located, provided that those limits do not discriminate against out-of-state depository institutions or their holding companies, and state laws which require that the target bank have been in existence for a minimum period of time, not to exceed five years, before being acquired by an out-of-state bank holding company.

In addition to owning or managing banks, bank holding companies may own subsidiaries engaged in certain businesses that the FRB has determined to be so closely related to banking as to be a proper incident thereto. The

Company, therefore, is permitted to engage in a variety of banking-related businesses. Some of the activities that the FRB has determined, pursuant to its Regulation Y, to be related to banking are: (i) making or acquiring loans or other extensions of credit for its own account or for the account of others; (ii) servicing loans and other extensions of credit; (iii) performing functions or activities that may be performed by a trust company in the manner authorized by federal or state law under certain circumstances; (iv) leasing personal and real property or acting as agent, broker, or adviser in leasing such property in accordance with various restrictions imposed by FRB regulations; (v) acting as investment or financial advisor; (vi) providing management consulting advice under certain circumstances; (vii) providing support services, including courier services and printing and selling MICR-encoded items; (viii) acting as a principal, agent, or broker for insurance under certain circumstances; (ix) making equity and debt investments in corporations or projects designed primarily to promote community welfare or jobs for residents; (x) providing financial, banking, or economic data processing and data transmission services; (xi) owning, controlling, or operating a savings association under certain circumstances; (xii) selling money orders, travelers checks and U.S. Savings Bonds; (xiii) providing securities brokerage services, related securities credit activities pursuant to Regulation T, and other incidental activities; and (xiv) underwriting dealing in obligations of the U.S., general obligations of states and their political subdivisions, and other obligations authorized for state member banks under federal law.

Additionally, under the Gramm-Leach-Bliley Act of 1999 qualifying bank holding companies making an appropriate election to the FRB may engage in a full range of financial activities, including insurance, securities and merchant banking. The Company has not elected to qualify for these financial activities.

Federal law prohibits a bank holding company and any subsidiary banks from engaging in certain tie-in arrangements in connection with the extension of credit. Thus, for example, HBC may not extend credit, lease or sell property, or furnish any services, or fix or vary the consideration for any of the foregoing on the condition that: (i) the customer must obtain or provide some additional credit, property or services from or to HBC other than a loan, discount, deposit or trust services; (ii) the customer must obtain or provide some additional credit, property or service from or to the Company or any subsidiaries; or (iii) the customer must not obtain some other credit, property or services from competitors, except reasonable requirements to assure soundness of credit extended.

The FRB also possesses enforcement powers over bank holding companies and their non-bank subsidiaries to prevent or remedy actions that represent unsafe or unsound practices or violations of applicable statutes and regulations.

Capital Adequacy. Bank holding companies must maintain minimum levels of capital under the FRB s risk-based capital adequacy guidelines. If capital falls below minimum guideline levels, a bank holding company, among other things, may be denied approval to acquire or establish additional banks or non-bank businesses.

The FRB s risk-based capital adequacy guidelines, discussed in more detail below in the section entitled SUPERVISION AND REGULATION HBC Regulatory Capital Guidelines, assign various risk percentages to different categories of assets, and capital is measured as a percentage of risk assets. Under the terms of the guidelines, bank holding companies are expected to meet capital adequacy guidelines based both on total risk assets and on total assets, without regard to risk weights.

The risk-based guidelines are minimum requirements. Higher capital levels will be required if warranted by the particular circumstances or risk profiles of individual organizations. For example, the FRB s capital guidelines contemplate that additional capital may be required to take adequate account of, among other things, interest rate risk, or the risks posed by concentrations of credit, nontraditional activities or securities trading activities. Moreover, any banking organization experiencing or anticipating significant growth or expansion into new activities, particularly under the expanded powers under the Gramm-Leach-Bliley Act, would be expected to maintain capital ratios, including tangible capital positions, well above the minimum levels.

Limitations on Dividend Payments. The California General Corporation Law prohibits the Company from paying dividends on the Common Stock unless: (i) its retained earnings, immediately prior to the dividend payment, equals or exceeds the amount of the dividend or (ii) immediately after giving effect to the dividend the sum of the

Company s assets (exclusive of goodwill and deferred charges) would be at least equal to 125% of its liabilities (not including deferred taxes, deferred income and other deferred liabilities) and the current assets of the Company would be at least equal to its current liabilities, or, if the average of its earnings before taxes on income and before interest expense for the two preceding fiscal years was less than the average of its interest expense for the two preceding fiscal years, at least equal to 125% of its current liabilities. Additionally, the FRB s policy regarding dividends provides that a bank holding company should not pay cash dividends exceeding its net income or which can only be funded in ways that weaken the bank holding company s financial health, such as by borrowing.

The Gramm-Leach-Bliley Act of1999. On November 12, 1999, the Gramm-Leach-Bliley Act of 1999 (the Financial Services Modernization Act) was signed into law. The Financial Services Modernization Act is intended to modernize the banking industry by removing barriers to affiliation among banks, insurance companies, the securities industry and other financial service providers. It provides financial organizations with the flexibility to structure such affiliations through a holding company structure or through a financial subsidiary of a bank, subject to certain limitations. The Financial Services Modernization Act establishes a new type of bank holding company, known as a financial holding company, that may engage in an expanded list of activities that are financial in nature, which include securities and insurance brokerage, securities underwriting, insurance underwriting and merchant banking.

The Company currently meets all the requirements for financial holding company status. However, the Company does not expect to elect financial holding company status unless and until it intends to engage in any of the expanded activities under the Financial Services Modernization Act which require such status. Unless and until it elects such status, the Company will only be permitted to engage in non-banking activities that were permissible for bank holding companies as of the date of the enactment of the Financial Services Modernization Act.

The Financial Services Modernization Act also sets forth a system of functional regulation that makes the FRB the umbrella supervisor for holding companies, while providing for the supervision of the holding company s subsidiaries by other federal and state agencies. A bank holding company may not become a financial holding company if any of its subsidiary financial institutions are not well-capitalized or well-managed. Further, each bank subsidiary of the holding company must have received at least a satisfactory Community Reinvestment Financial Services Modernization Act (CRA) rating. The Financial Services Modernization Act also expands the types of financial activities a national bank may conduct through a financial subsidiary, addresses state regulation of insurance, generally prohibits unitary thrift holding companies organized after May 4, 1999 from participating in new financial activities, provides privacy protection for nonpublic customer information of financial institutions, modernizes the Federal Home Loan Bank system and makes miscellaneous regulatory improvements. The FRB and the Secretary of the Treasury must coordinate their supervision regarding approval of new financial activities to be conducted through a financial holding company or through a financial subsidiary of a bank. While the provisions of the Financial Services Modernization Act regarding activities that may be conducted through a financial subsidiary directly apply only to national banks, those provisions indirectly apply to state-chartered banks.

In addition, HBC is subject to other provisions of the Financial Services Modernization Act, including those relating to CRA, privacy and safe-guarding confidential customer information, regardless of whether the Company elects to become a financial holding company or to conduct activities through a financial subsidiary of HBC.

The Company and HBC do not believe that the Financial Services Modernization Act has had thus far, or will have in the near term, a material adverse effect on their operations. However, to the extent that it permits banks, securities firms, and insurance companies to affiliate, the financial services industry may experience further consolidation. The Financial Services Modernization Act is intended to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis. Nevertheless, this act may have the result of increasing the amount of competition that the Company and HBC face from larger institutions and other types of companies offering financial products, many of which may have substantially more financial resources than the Company and HBC.

The Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 (SOX), became effective on July 30, 2002, and represents the most far reaching corporate and accounting reform legislation since the enactment of the Securities Act of 1933 and the Exchange Act of 1934. SOX is intended to provide a permanent framework that improves the quality of independent audits and accounting services, improves the quality of financial reporting, strengthens the independence of accounting firms and increases the responsibility of management for corporate disclosures and financial statements.

Sox s provisions are significant to all companies that have a class of securities registered under Section 12 of the Exchange Act, or are otherwise reporting to the SEC (or the appropriate federal banking agency) pursuant to Section 15(d) of the Exchange Act, including the Company (collectively, public companies). In addition to SEC rulemaking to implement SOX, The Nasdaq National Market has adopted corporate governance rules intended to allow shareholders to more easily and effectively monitor the performance of companies and directors. The principal provisions of SOX, many of which have been interpreted through regulations released in 2003, provide for and include, among other things: (i) the creation of an independent accounting oversight board; (ii) auditor independence provisions that restrict non-audit services that accountants may provide to their audit clients; (iii) additional corporate governance and responsibility measures, including the requirement that the chief executive officer and chief financial officer of a public company certify financial statements; (iv) the forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer s securities by chief executive officer and chief finanical officer in the twelve month period following initial publication of any financial statements that later require restatement due to material noncompliance of financial accounting reporting requirements as a result of misconduct; (v) an increase in the oversight of, and enhancement of certain requirements relating to, audit committees of public companies and how they interact with the Company s independent auditors; (vi) requirements that audit committee members must be independent and are barred from accepting consulting, advisory or other compensatory fees from the issuer; (vii) requirements that companies disclose whether at least one member of the audit committee is a financial expert (as such term is defined by the SEC) and if not discuss, why the audit committee does not have a financial expert; (viii) expanded disclosure requirements for corporate insiders, including accelerated reporting of stock transactions by insiders and a prohibition on insider trading during pension blackout periods; (ix) a prohibition on personal loans to directors and officers, except certain loans made by insured financial institutions on non-preferential terms and in compliance with other bank regulatory requirements; (x) disclosure of a code of ethics and filing a Form 8-K for a change or waiver of such code; (xi) a range of enhanced penalties for fraud and other violations; and (xii) expanded disclosure and certification relating to an issuer s disclosure controls and procedures and internal controls over financial reporting.

As a result of SOX and its implementing regulations, the Company continues to incur substantial cost to interpret and ensure compliance with the law and its regulations. The Company cannot be certain of the effect, if any, of the foregoing legislation on the business of the Company. Future changes in the laws, regulation, or policies that impact the Company cannot necessarily be predicted and may have a material effect on the business and earnings of the Company.

Heritage Bank of Commerce

General. HBC, as a California-chartered bank which is a member of the Federal Reserve System, is subject to regulation, supervision, and regular examination by the DFI and the FRB. HBC s deposits are insured by the FDIC up to the maximum extent provided by law. The regulations of these agencies govern most aspects of HBC s business and establish a comprehensive framework governing its operations. California law exempts all banks from usury limitations on interest rates.

Regulatory Capital Guidelines. The federal banking agencies have established minimum capital standards known as risk-based capital guidelines. These guidelines are intended to provide a measure of capital that reflects the degree of

risk associated with a bank s operations. The risk-based capital guidelines include both a definition of capital and a framework for calculating the amount of capital that must be maintained against a bank s assets and off-balance sheet items. The amount of capital required to be maintained is based upon the credit risks associated with the various

types of a bank s assets and off-balance sheet items. A bank s assets and off-balance sheet items are classified under several risk categories, with each category assigned a particular risk weighting from 0% to 100%. The following table sets forth the regulatory capital guidelines and the actual capitalization levels for HBC and the Company as of December 31, 2006:

	Adequately Capitalized	Well Capitalized	HBC	Company (consolidated)
	(greater than or equal to)			
Total risk-based capital	8.00%	10.00%	18.12%	18.39%
Tier 1 risk-based capital ratio	4.00%	6.00%	16.98%	17.25%
Tier 1 leverage capital ratio	4.00%	5.00%	13.35%	13.57%

As of December 31, 2006, management believes that the Company s capital levels met all minimum regulatory requirements and that HBC was considered well capitalized under the regulatory framework for prompt corrective action.

To enhance regulatory capital and to provide liquidity, the Company, through unconsolidated subsidiary grantor trusts, issued $23.7 million of trust preferred securities. These securities are currently included in our Tier I capital for purposes of determining the Company s Tier I and total risk-based capital ratios. The FRB has promulgated a modification of the capital regulations affecting trust preferred securities. Under this modification, effective March 31, 2009, the Company will be required to use a more restrictive formula to determine the amount of trust preferred securities that can be included in regulatory Tier I capital. At that time, the Company will be allowed to include in Tier I capital an amount of trust preferred securities equal to no more than 25% of the sum of all core capital elements, which is generally defined as shareholders equity, less goodwill and any related deferred income tax liability. The regulations currently in effect through December 31, 2008, limit the amount of trust preferred securities that can be included in Tier I capital to 25% of the sum of core capital elements without a deduction for goodwill. Management has determined that the Company s Tier I capital ratios would remain above the well-capitalized level had the modification of the capital regulations been in effect at December 31, 2006. Management expects that the Company s Tier I capital ratios will be at or above the existing well capitalized levels on March 31, 2009, the first date on which the modified capital regulations must be applied.

Prompt Corrective Action. The federal banking agencies possess broad powers to take prompt corrective action to resolve the problems of insured banks. Each federal banking agency has issued regulations defining five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Under the regulations, a bank shall be deemed to be:

• well capitalized if it has a total risk-based capital ratio of 10.0% or more, has a Tier 1 risk-based capital ratio of 6.0% or more, has a leverage capital ratio of 5.0% or more, and is not subject to specified requirements to meet and maintain a specific capital level for any capital measure;

• adequately capitalized if it has a total risk-based capital ratio of 8.0% or more, a Tier 1 risk-based capital ratio of 4.0% or more, and a leverage capital ratio of 4.0% or more (3.0% under certain circumstances) and does not meet the definition of well capitalized ;

- undercapitalized if it has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio that is less than 4.0%, or a leverage capital ratio that is less than 4.0% (3.0% under certain

circumstances);

- significantly undercapitalized if it has a total risk-based capital ratio that is less than 6.0%, a Tier 1 risk-based capital ratio that is less than 3.0% or a leverage capital ratio that is less than 3.0%; and

- critically undercapitalized if it has a ratio of tangible equity to total assets that is equal to or less than 2.0%.

Banks are prohibited from paying dividends or management fees to controlling persons or entities if, after making the payment the bank would be undercapitalized, that is, the bank fails to meet the required minimum level for any relevant capital measure. Asset growth and branching restrictions apply to undercapitalized banks. Banks classified as undercapitalized are required to submit acceptable capital plans guaranteed by its holding company, if any. Broad regulatory authority was granted with respect to significantly undercapitalized banks, including forced mergers, growth restrictions, ordering new elections for directors, forcing divestiture by its holding company, if any, requiring management changes, and prohibiting the payment of bonuses to senior management. Even more severe restrictions are applicable to critically undercapitalized banks, those with capital at or less than 2%. Restrictions for these banks include the appointment of a receiver or conservator. All of the federal banking agencies have promulgated substantially similar regulations to implement this system of prompt corrective action.

A bank, based upon its capital levels, that is classified as well capitalized, adequately capitalized or undercapitalized may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for a hearing, determines that an unsafe or unsound condition, or an unsafe or unsound practice, warrants such treatment. At each successive lower capital category, an insured bank is subject to more restrictions. The federal banking agencies, however, may not treat an institution as critically undercapitalized unless its capital ratios actually warrant such treatment.

In addition to measures taken under the prompt corrective action provisions, insured banks may be subject to potential enforcement actions by the federal banking agencies for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation or any condition imposed in writing by the agency or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, the issuance of a cease-and-desist order that can be judicially enforced, the termination of insurance of deposits (in the case of a depository institution), the imposition of civil money penalties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the issuance of removal and prohibition orders against institution-affiliated parties. The enforcement of such actions through injunctions or restraining orders may be based upon a judicial determination that the agency would be harmed if such equitable relief was not granted.

The DFI, as the primary regulator for state-chartered banks, also has a broad range of enforcement measures, from cease and desist powers and the imposition of monetary penalties to the ability to take possession of a bank, including causing its liquidation.

FDIC Insurance and Insurance Assessments. Banks and thrifts have historically paid varying amounts of premiums for federal deposit insurance depending upon a risk-based system which evaluated the institution s regulatory and capital adequacy ratings. The FDIC operated two separate insurance funds, the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF).

As a result of the Federal Deposit Insurance Reform Act of 2005 (the FDI Reform Act) and regulations adopted by the FDIC effective as of November 2, 2006: (i) the BIF and the SAIF have been merged into the Deposit Insurance Fund (the DIF); (ii) the $100,000 insurance level has been indexed to reflect inflation (the first adjustment for inflation will be effective January 1, 2011 and thereafter adjustments will occur every 5 years); (iii) deposit insurance coverage for retirement accounts has been increased to $250,000, and will also be subject to adjustment every five years; (iv) banks that historically have capitalized the BIF are entitled to a one-time credit which can be used to off-

set premiums otherwise due (this addresses the fact that institutions that have grown rapidly have not had to pay deposit premiums); (v) a cap on the level of the DIF has been imposed and dividends will be paid when the DIF grows beyond a specified threshold; and (vi) the previous risk-based system for assessing premiums has been revised.

Prior to January 1, 2007, the FDIC utilized a risk-based assessment system to set semi-annual insurance premium assessments which categorized banks into risk categories based on two criteria, (1) three capital levels and (2) three supervisory ratings, creating a nine-cell matrix for risk-based assessments. The new assessment system consolidates the previous nine risk categories into four and names them Risk Categories I, II, III and IV. The four new categories will continue to be defined based upon supervisory and capital evaluations. In practice, the subgroup evaluations will generally be based on an institution s composite CAMELS rating assigned to it by the institution s federal supervisor at the end of its examination. The CAMELS rating system is based upon an evaluation of the five critical elements of an institution s operations: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to risk. This rating system is designed to take into account and reflect all significant financial and operational factors financial institution examiners assess in their evaluation of an institution s performance. The consolidation creates four new Risk Categories as shown in following table:

	Supervisory Subgroup		
Captial Group	**A**	**B**	**C**
1. Well Capitalized	I		
2. Adequately Capitalized		II	III
3. Undercapitalized		III	IV

Within Risk Category I, the new assessment system combines supervisory ratings with other risk measures to differentiate risk. For most institutions, the new assessment system combines CAMELS component ratings with financial ratios to determine an institution s assessment rate. For large institutions that have long-term debt issuer ratings, the new assessment system differentiates risk by combining CAMELS component ratings with those ratings. For large institutions within Risk Category I, initial assessment rate determinations may be modified within limits upon review of additional relevant information. The new assessment system assesses those within Risk Category I that pose the least risk a minimum assessment rate and those that pose the greatest risk a maximum assessment rate that is two basis points higher. An institution that poses an intermediate risk within Risk Category I will be charged a rate between the minimum and maximum that will vary incrementally by institution.

Effective January 1, 2007, the actual assessment rates under this new assessment system are summarized below, expressed in terms of cents per $100 in insured deposits:

Risk Category				
I*				
Minimum	**Maximum**	**II**	**III**	**IV**
5	7	10	28	43

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* Rates for institutions that do not pay the minimum or maximum rate vary between these rates.

The FDIC may terminate its insurance of deposits if it finds that HBC has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC.

Money Laundering and Currency Controls. Various federal statutory and regulatory provisions are designed to enhance record-keeping and reporting of currency and foreign transactions. Pursuant to the Bank Secrecy Act, financial institutions must report high levels of currency transactions or face the imposition of civil monetary penalties for reporting violations. The Money Laundering Control Act imposes sanctions, including revocation of federal deposit insurance, for institutions convicted of money laundering.

The International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (IMLAFATA), a part of the Patriot Act, authorizes the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to banks and other financial institutions to enhance record-keeping and reporting requirements for certain financial transactions that are of primary money laundering concern. Among its other provisions, IMLAFATA requires each financial institution to: (i) establish an anti-money laundering program; (ii) establish due diligence policies, procedures and controls with respect to its private banking accounts and correspondent banking accounts involving individuals and certain foreign banks; and (iii) avoid establishing, maintaining, administering, or managing correspondent accounts in the Untied States for, or on behalf of, a foreign bank that does not have a physical presence in any country. In addition, IMLAFATA contains a provision encouraging cooperation among financial institutions, regulatory authorities and law enforcement authorities with respect to individuals, entities and organizations engaged in, or reasonably suspected of engaging in, terrorist acts or money laundering activities.

The Treasury Department s regulations implementing IMLAFATA mandate that federally-insured banks and other financial institutions establish customer identification programs designed to verify the identity of persons opening new accounts, maintain the records used for verification, and determine whether the person appears on any list of known or suspected terrorists or terrorist organizations.

Community Reinvestment Act (CRA). The CRA is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. The CRA specifically directs the federal bank regulatory agencies, in examining insured depository institutions, to assess their record of helping to meet the credit needs of their entire community, including low-and moderate-income neighborhoods, consistent with safe and sound banking practices. The CRA further requires the agencies to take a financial institution s record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, consummating mergers or acquisitions, or holding company formations.

The federal banking agencies have adopted regulations which measure a bank s compliance with its CRA obligations on a performance-based evaluation system. This system bases CRA ratings on an institution s actual lending service and investment performance rather than the extent to which the institution conducts needs assessments, documents community outreach or complies with other procedural requirements. The ratings range from outstanding to a low of substantial noncompliance. HBC had a CRA rating of Satisfactory as of its most recent regulatory examination.

Environmental Regulation. Federal, state and local laws and regulations regarding the discharge of harmful materials into the environment may have an impact on HBC. Since HBC is not involved in any business that manufactures, uses or transports chemicals, waste, pollutants or toxins that might have a material adverse effect on the environment, HBC s primary exposure to environmental laws is through its lending activities and through properties or businesses HBC may own, lease or acquire. Based on a general survey of HBC s loan portfolio, conversations with local appraisers and the type of lending currently and historically done by HBC, management is not aware of any potential liability for hazardous waste contamination that would be reasonably likely to have a material adverse effect on the Company as of December 31, 2006.

Safeguarding of Customer Information and Privacy. The FRB and other bank regulatory agencies have adopted guidelines for safeguarding confidential, personal customer information. These guidelines require financial institutions to create, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, protect against any anticipated threats or hazards to the security or integrity of such information and protect against unauthorized access to or use of such information that could result in substantial

harm or inconvenience to any customer. HBC has adopted a customer information security program to comply with such requirements.

Financial institutions are also required to implement policies and procedures regarding the disclosure of nonpublic personal information about consumers to non-affiliated third parties. In general, financial institutions must provide

explanations to consumers on policies and procedures regarding the disclosure of such nonpublic personal information, and, except as otherwise required by law, prohibits disclosing such information except as provided in HBC s policies and procedures. HBC has implemented privacy policies addressing these restrictions which are distributed regularly to all existing and new customers of HBC.

USA Patriot Act of 2001. On October 26, 2001, President Bush signed the USA Patriot Act of 2001 (the Patriot Act). Enacted in response to the terrorist attacks in New York, Pennsylvania and Washington, D.C. on September 11, 2001, the Patriot Act is intended to strengthen the ability of U.S. law enforcement agencies and intelligence communities to work cohesively to combat terrorism on a variety of fronts. The impact of the Patriot Act on financial institutions of all kinds has been significant and wide ranging. The Patriot Act substantially enhanced existing anti-money laundering and financial transparency laws, and required appropriate regulatory authorities to adopt rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. Under the Patriot Act, financial institutions are subject to prohibitions regarding specified financial transactions and account relationships, as well as enhanced due diligence and know your customer standards in their dealings with foreign financial institutions and foreign customers. For example, the enhanced due diligence policies, procedures, and controls generally require financial institutions to take reasonable steps:

- to conduct enhanced scrutiny of account relationships to guard against money laundering and report any suspicious transactions;

- to ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, each account as needed to guard against money laundering and report any suspicious transactions;

- to ascertain for any foreign bank, the shares of which are not publicly traded, the identity of the owners of the foreign bank, and the nature and extent of the ownership interest of each such owner; and

- to ascertain whether any foreign bank provides correspondent accounts to other foreign banks and, if so, the identity of those foreign banks and related due diligence information.

The Patriot Act also requires all financial institutions to establish anti money laundering programs, which must include, at minimum:

- the development of internal policies, procedures, and controls;

- the designation of a compliance officer;

- an ongoing employee training program; and
- an independent audit function to test the programs.

HBC has incorporated the requirements of the Patriot Act into its operating procedures, and while these requirements have resulted in an additional time burden the financial impact on HBC is difficult to quantify.

Other Aspects of Banking Law. HBC is also subject to federal statutory and regulatory provisions covering, among other things, security procedures, insider and affiliated party transactions, management interlocks, electronic funds transfers, funds availability, and truth-in-savings. There are also a variety of federal statutes which regulate acquisitions of control and the formation of bank holding companies.

EMPLOYEES

At December 31, 2006, the Company had 196 full-time equivalent employees. The Company s employees are not represented by any union or collective bargaining agreement and the Company believes its employee relations are satisfactory.

ITEM 1A RISK FACTORS

In addition to the other information in this Annual Report Amendment No. 2 on Form 10-K/A, shareholders or prospective investors should carefully consider the following risk factors:

Our profitability is dependent upon the economic conditions of the markets in which we operate. We operate primarily in Santa Clara County, Contra Costa County and Alameda County and, as a result, our financial condition, results of operations and cash flows are subject to changes in the economic conditions in those areas. Our success depends upon the business activity, population, income levels, deposits and real estate activity in these markets. Although our customers business and financial interests may extend well beyond these market areas, adverse economic conditions that affect these market areas could reduce our growth rate, affect the ability of our customers to repay their loans to us and generally affect our financial condition and results of operations. While no specific industry concentration is considered significant, our lending operations are located in market areas dependent on technology and real estate industries and their supporting companies. Thus, the Company s borrowers could be adversely impacted by a downturn in these sectors of the economy which could reduce the demand for loans and adversely impact the borrower s ability to repay their loans. Because of our geographic concentration, we are less able than other regional or national financial institutions to diversify our credit risks across multiple markets.

Our growth must be effectively managed and our growth strategy involves risks that may impact our net income. As part of our general growth strategy, we may expand into additional communities or attempt to strengthen our position in our current markets to take advantage of expanding market share by opening new offices. To the extent that we undertake additional office openings, we are likely to experience the effects of higher operating expenses relative to operating income from the new operations for a period of time, which may have an adverse effect on our levels of reported net income, return on average equity and return on average assets. Our current growth strategies involve internal growth from our current offices and the addition of new branch offices over time, so that the additional overhead expenses associated with these openings is absorbed prior to opening other new offices.

We must compete with other banks and financial institutions in all lines of business. The banking and financial services business in our market is highly competitive. Our competitors include large regional banks, local community banks, savings institutions, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market mutual funds, credit unions and other non-bank financial service providers. Many of these competitors are not subject to the same regulatory restrictions we are and are able to provide customers with an alternative to traditional banking services. In addition, there is an increased importance on remaining current on technological changes because such technological advances may diminish the importance of depository institutions and financial intermediaries in the transfer of funds between parties. Increased competition in our market and market changes, such

as interest rate changes, force management to better control costs in order to absorb any resultant narrowing of our net interest margin, i.e., the spread between the interest rates earned on investments and loans and the interest rates paid on deposits and other interest-bearing liabilities. Without effective management and cost controls, net income may be adversely impacted by changing conditions and competition.

Interest rates and other conditions impact our results of operations. The earnings of most financial institutions depend largely on the relationship between the cost of funds, primarily deposits and borrowings, and the yield on earning assets such as loans and investment securities. This relationship, known as the interest rate spread, is subject to fluctuation and is affected by economic, regulatory and competitive factors that influence interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities, and the level of non-performing assets. Many of these factors are beyond our control. Fluctuations in interest rates affect the demand of customers for our products

and services, and we are subject to interest rate risk to the degree that our interest-bearing liabilities re-price or mature more slowly or more rapidly or on a different basis than our interest-earning assets. Given the current volume, mix, and re-pricing characteristics of our interest-bearing liabilities and interest-earning assets, our interest rate spread is expected to increase slightly in a rising rate environment, and decrease slightly in a declining interest rate scenario. However, there are scenarios where fluctuations in interest rates in either direction could have a negative effect on net income. For example, if funding rates rise faster than asset yields in a rising rate environment (i.e., if basis compression occurs), or if we do not actively manage certain loan index rates in a declining rate environment, we would be negatively impacted.

We must effectively manage our credit risk. There are risks inherent in making any loan, including risks inherent in dealing with individual borrowers, risks of nonpayment, risks resulting from uncertainties as to the future value of collateral and risks resulting from changes in economic and industry conditions. We attempt to minimize our credit risk through prudent loan application approval procedures, careful monitoring of the concentration of our loans within specific industries and periodic independent reviews of outstanding loans by external parties. However, we cannot assure such approval and monitoring procedures will eliminate these credit risks.

Our allowance for loan losses must be managed to provide a sufficient amount to absorb potential losses in our loan portfolio. We maintain our allowance for loan losses at a level considered adequate by management to absorb potential loan losses. The amount of future loan losses is susceptible to changes in economic, operating and other conditions within our market, which may be beyond our control, and such losses may exceed current estimates. At December 31, 2006, our allowance for loan losses as a percentage of total loans was 1.31%. Although management believes that the allowance for loan losses is adequate to absorb losses on any existing loans that may become uncollectible, we cannot predict loan losses with certainty, and we cannot assure that our allowance for loan losses will prove sufficient to cover actual loan losses in the future. Loan losses in excess of our allowance may adversely affect our business, financial condition and results of operations. Additional information regarding our allowance for loan losses and the methodology we use to determine an appropriate level of the allowance are located in the Management s Discussion and Analysis section included under Item 7 of Part II of this Amendment No. 2 on Form 10-K/A.

Government regulation can result in limitations on our operations. We operate in a highly regulated environment and are subject to supervision and regulation by a number of governmental regulatory agencies, including the Board of Governors of the Federal Reserve System, the California Department of Financial Institutions and the Federal Deposit Insurance Corporation. Regulations adopted by these agencies, which are generally intended to provide protection for depositors and customers rather than for the benefit of shareholders, govern a comprehensive range of matters relating to ownership and control of our shares, our acquisition of other companies and businesses, permissible activities for us to engage in, maintenance of adequate capital levels and other aspects of our operations. These bank regulators possess broad authority to prevent or remedy unsafe or unsound practices or violations of law. The laws and regulations applicable to the banking industry could change at any time and we cannot predict the effects of these changes on our business and profitability. Increased regulation could increase our cost of compliance and adversely affect profitability.

Technology is continually changing and we must effectively implement new technologies. The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables us to reduce costs. Our future success will depend in part upon our ability to address the needs of our customers by using

technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in our operations as we continue to grow and expand our market areas. In order to anticipate and develop new technology, we employ a qualified staff of internal information system specialists and consider this area a core part of our business. We do not develop our own software products, but have been able to respond to technological changes in a timely manner through association with leading technology vendors. We must continue to make substantial investments in technology which may affect our net income.

System failure or breaches of our network security could subject us to increased operating costs as well as litigation and other liabilities. The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to protect our computer equipment against damage from physical theft, fire, power loss, telecommunications failure or a similar catastrophic event, as well as from security breaches, denial of service attacks, viruses, worms and other disruptive problems caused by hackers. Any damage or failure that causes an interruption in our operations could have a material adverse effect on our financial condition and results of operations. Computer break-ins, phishing and other disruptions could also jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure, which may result in significant liability to us and may cause existing and potential customers to refrain from doing business with us. We employ internal auditors to conduct extensive auditing and testing for any weaknesses in our systems, controls, firewalls and encryption to reduce the likelihood of any security failures or breaches. Although we, with the help of third-party service providers and internal auditors, intend to continue to implement security technology and establish operational procedures to prevent such damage, there can be no assurance that these security measures will be successful. In addition, advances in computer capabilities, new discoveries in the field of cryptography or other developments could result in a compromise or breach of the algorithms we and our third-party service providers use to encrypt and protect customer transaction data. A failure of such security measures could have a material adverse affect on our financial condition and results of operations.

Our loan portfolio has a large concentration of real estate loans, which involve risks specific to real estate value. Real estate lending (including commercial and construction) is a large portion of our loan portfolio; however, it is within recently established regulatory guidelines based on a percentage of Tier 2 Capital. These categories constitute $382.9 million, or approximately 54% of our total loan portfolio as of December 31, 2006. The market value of real estate can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Although a significant portion of such loans is secured by real estate as a secondary form of collateral, adverse developments affecting real estate values in one or more of our markets could increase the credit risk associated with our loan portfolio. Additionally, commercial real estate lending typically involves larger loan principal amounts and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. Economic events or governmental regulations outside of the control of the borrower or lender could negatively impact the future cash flow and market values of the affected properties. If the loans that are collateralized by real estate become troubled during a time when market conditions are declining or have declined, we may not be able to realize the amount of security that we anticipated at the time of originating the loan, which could cause us to increase our provision for loan losses and adversely affect our operating results and financial condition.

Our construction and development loans are based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate and we may be exposed to more losses on these projects than on other loans. At December 31, 2006, residential construction loans, including land acquisition and development, totaled $143.8 million or 20%, of our total loan portfolio. This was comprised of 13% owner-occupied and 87% speculative construction and land loans. Construction, land acquisition and development lending involve additional risks because funds are advanced upon the security of the project, which is of uncertain value prior to its completion. Because of the uncertainties inherent in estimating construction costs, as well as the market value of the completed project and the effects of governmental regulation on real property, it is relatively difficult to evaluate accurately the total funds required to complete a project and the related loan-to-value ratio. As a result, speculative construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the completion of the project and the ability of the borrower to

sell the property, rather than the ability of the borrower or guarantor to repay principal and interest. If our appraisal of the value of the completed project proves to be overstated, we may have inadequate security for the repayment of the loan upon completion of construction of the project. If we are forced to foreclose on a project prior to or at completion due to a default, there can be no assurance that we will be able to recover all of the unpaid balance of, and accrued interest on, the loan as well as related foreclosure and holding costs. In addition, we may be required to fund additional amounts to complete the project and may have to hold the property for an unspecified period of time.

ITEM 1B UNRESOLVED STAFF COMMENTS

None

ITEM 2 PROPERTIES

The main and executive offices of the Company and HBC are located at 150 Almaden Boulevard in San Jose, California 95113, with branch offices located at 15575 Los Gatos Boulevard in Los Gatos, California 95032, at 3077 Stevenson Boulevard in Fremont, California 94538, at 310 Hartz Avenue in Danville, California 94526, at 18625 Sutter Boulevard in Morgan Hill, California 95037, at 7598 Monterey Street in Gilroy, California 95020, at 4546 El Camino Real in Los Altos, California 94022, at 369 S. San Antonio Road in Los Altos, California 94022, and at 175 E. El Camino Real in Mountain View, California 94040.

Main Office

The main offices of Heritage Bank of Commerce are located at 150 Almaden Boulevard in San Jose, California on the first three floors in a fifteen-story Class-A type office building. The first two floors, which consist of approximately 22,417 square feet of office space, were subleased from a non-affiliated third party under a non-cancelable operating lease dated February 12, 1996, as amended. The third floor, which consists of approximately 12,824 square feet of office space, was acquired directly under an office lease dated April 13, 2000, as amended. The current monthly rent payment for the third floor is $27,828 and is subject to annual increases of no more than 3% until August 1, 2009, when it will become fixed at $53,861 until the lease expires on May 31, 2015. The current monthly rent payment for the first two floors is $42,592 until the sublease expires on February 28, 2010; however, after the sublease expires, the first two floors will become part of the direct lease for the third floor, subject to all of the terms and conditions therein, except that the monthly rent will be based on the then prevailing market rate to be determined no later than January 15, 2010. The Company has reserved the right to extend the term of the direct lease for two additional periods of five years each.

In January of 1997, the Company leased approximately 1,255 square feet of office space (referred to as the Kiosk) located next to the primary operating area at 150 Almaden Boulevard in San Jose, California to be used for meetings, staff training and marketing events. The current monthly rent payment for this space is $2,723 and is subject to annual increases of no more than 3% until August 1, 2009, when the monthly rent payment will then become fixed at $5,271 until the lease expires on May 31, 2015. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

Branch Offices

In November of 1997, the Company leased approximately 6,590 square feet of space for a branch office in a stand alone office building located at 3077 Stevenson Boulevard in Fremont, California. The current monthly rent payment for this space is $18,715 and is subject to annual increases of approximately 4% until the lease expires on February 29, 2008. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In March of 1999, the Company leased approximately 7,260 square feet of space for a branch office in a one-story multi-tenant office building located at 18625 Sutter Boulevard in Morgan Hill, California. The current monthly rent payment for this space is $11,944 and is subject to adjustment every 36 months, based on the Consumer Price Index of the Labor of Statistics as defined in the lease agreement, until the lease expires on October 31, 2014.

In September of 1999, the Company subleased approximately 2,700 square feet of space for a branch office in a one-story multi-tenant retail center located at 310 Hartz Avenue in Danville, California. The current monthly rent payment for this space is $9,245, and is subject to annual increases of 4% until the lease expires on December 31, 2007.

In December of 2003, the Company leased approximately 1,920 square feet of office space in a one-story stand-alone building located in an office complex at 15575 Los Gatos Boulevard in Los Gatos, California. The current monthly rent payment for this space is $4,930 and is subject to annual increases of 3%, until the lease expires on November 30, 2008. The Company has reserve the right to extend the term of the lease for two additional periods of years each.

In May of 2006, the Company leased approximately 2,505 square feet of space for a branch office on the first floor in a three-story multi-tenant multi-use building located at 7598 Monterey Street in Gilroy, California. The current monthly rent payment for this space is $4,509, and is subject to annual increases of 2% until the lease expires on September 30, 2016. However, as provided for in the lease, the monthly rent payment has been waived until January of 2009 in exchange for a tenant improvement allowance equal to the amount that would have been paid during the free rent period. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In February of 1995, the Company leased approximately 7,889 square feet of space for a branch office in a two-story multi-tenant shopping center located at 4546 El Camino Real in Los Altos, California. In October of 2001, the lease was amended to return 795 square feet to the Landlord, leaving 7,094 square feet remaining under the lease. The current monthly rent payment for this space is $16,068 and is subject to annual increases, based on the Consumer Price Index of the Bureau of Labor Statistics as defined in the lease agreement, until the lease expires on September 30, 2008.

In January of 1998, the Company leased approximately 4,840 square feet of space for a branch office in a multi-tenant shopping center located at 175 E. El Camino Real in Mountain View, California. The current monthly rent payment for this space is $13,553 and is subject to annual increases based on the Consumer Price Index of the Bureau of Labor Statistics, as defined in the lease agreement. The lease expires on May 30, 2008; however, the Company has reserved the right to extend the term of the lease for two additional periods of five years each.

In September of 1998, the Company leased approximately 3,471 square feet of space for a branch office in a one-story stand-alone office building located at 369 S. San Antonio Road in Los Altos, California. The current monthly rent payment for this space is $16,626 and is subject to annual increases of 4% until the lease expires on September 30, 2008. The Company has reserved the right to extend the term of the lease for two additional periods of five years each.

Loan Production Offices

In August of 2005, the Company renewed its lease for a loan production office located at 740 Front Street in Santa Cruz, California 95060. The lease covers approximately 1,022 square feet of office space and expires on July 31, 2010. The current monthly rent payment for this space is $1,947 and is subject to annual increases of 3% until the lease expires.

In March of 2006, the Company renewed its lease for a loan production office located at 23 E. Beach Street in Watsonville, California 95076. The lease covers approximately 287 square feet of office space and expires on March 31, 2007. The current monthly rent payment for this space is $330.

In March of 2006, the Company renewed its lease for a loan production office located at 264 Clovis Avenue in Clovis, California 93612. The lease covers approximately 140 square feet of office space and expires on March 31, 2007. The current monthly rent payment for this space is

$500.

In January of 2007, the Company leased approximately 225 square feet of office space for a loan production office located at 8788 Elk Grove Boulevard in Elk Grove, California 95624. The current monthly rent payment for this space is $675 until the lease expires on January 31, 2008. The Company has reserved the right to extend the term of the lease for three additional periods of one year each.

In January of 2007, the Company leased approximately 333 square feet of office space for a loan production office

located at 2619 Forest Avenue in Chico, California 95928. The current monthly rent payment for this space is $416 until the lease expires on January 31, 2008. The Company has reserved the right to extend the term of the lease for one additional period of one year.

For additional information on operating leases and rent expense, refer to Footnote 9 to the Consolidated Financial Statements following Item 15 *Exhibits and Financial Statement Schedules*.

ITEM 3 - 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 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There was no submission of matters to a vote of security holders during the fourth quarter of the year ended December 31, 2006.

PART II

ITEM 5 - MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Market Information

The Company s Common Stock is listed on the NASDAQ General Select Market under the symbol HTBK. Management is aware of the following securities dealers which make a market in the Company s Common Stock. Citigroup Global Markets Holdings Inc., FTN Midwest Research Securities Corp., Keefe, Brunette & Woods, Inc., Knight Equity Markets, L.P., Merrill Lynch, Morgan Stanley & Company, Inc., RBC Dain Rauscher Inc., UBS Capital Markets, Goldman Sachs & Co., Citadel Derivatives Markets, Howe Barnes Hoefer & Arnett, and E-Trade Capital Markets. These market makers have committed to make a market for the Company s Common Stock, although they may discontinue making a market at any time. No assurance can be given that an active trading market will be sustained for the Common Stock at any time in the future.

The information in the following table for 2006 and 2005 indicates the high and low closing prices for the Common Stock, based upon information provided by the NASDAQ General Select Market.

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Quarter	High	Low	Dividends Paid Per Share
Year ended December 31, 2006:			
Fourth quarter	$ 27.25	$ 22.61	$ 0.05
Third quarter	$ 24.95	$ 22.55	$ 0.05
Second quarter	$ 25.16	$ 22.30	$ 0.05
First quarter	$ 25.00	$ 21.08	$ 0.05
Year ended December 31, 2005:			
Fourth quarter	$ 22.89	$ 19.45	$
Third quarter	$ 21.94	$ 18.38	$
Second quarter	$ 19.24	$ 17.55	$
First quarter	$ 19.39	$ 17.65	$

As of February 12, 2007, there were approximately 2,500 holders of record of Common Stock. There are no other classes of common equity outstanding.

Dividends

As a bank holding company that currently has no significant assets other than its equity interest in HBC, the Company s ability to declare dividends depends primarily upon dividends it receives from HBC. HBC s dividend practices in turn depend upon legal restrictions, HBC s earnings, financial position, current and anticipated capital requirements, and other factors deemed relevant by HBC s Board of Directors at that time.

The Company declared a $0.06 per share quarterly cash dividend on February 6, 2007. The dividend will be paid on March 15, 2007, to shareholders of record on February 22, 2007.

The Company paid cash dividends totaling $2.36 million, or $0.20 per share in 2006 representing 14% of 2006 earnings. The Company s general dividend policy is to pay cash dividends within the range of typical peer payout ratios, provided that such payments do not adversely affect the Company s financial condition and are not overly restrictive to our growth capacity. However, no assurance can be given that earnings and/or growth expectations in any given year will justify the payment of such a dividend.

During any period in which the Company has deferred payment of interest otherwise due and payable on its subordinated debt securities, it may not make any dividends or distributions with respect to its capital stock (see Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Capital Resources). The ability of HBC s Board of Directors to declare cash dividends is also subject to statutory and regulatory restrictions which limit the amount available for cash dividends depending upon the earnings, financial condition and cash needs of HBC, as well as general business conditions. Under California banking law, HBC may declare dividends in an amount not exceeding the lesser of its retained earnings or its net income for the last three years (reduced by dividends paid during such period) or, with the prior approval of the California Commissioner of Financial Institutions, in an amount not exceeding the greatest of (i) the retained earnings of HBC, (ii) the net income of HBC for its last fiscal year, or (iii) the net income of HBC for its current fiscal year. The payment of any cash dividends by HBC will depend not only upon HBC s earnings during a specified period, but also on HBC meeting certain regulatory capital requirements.

The Company s ability to pay dividends is also limited by state corporation law. The California General Corporation Law prohibits the Company from paying dividends on the Common Stock unless: (i) its retained earnings, immediately prior to the dividend payment, equals or exceeds the amount of the dividend or (ii) immediately after giving effect to the dividend the sum of the Company s assets (exclusive of goodwill and deferred charges) would be at least equal to 125% of its liabilities (not including deferred taxes, deferred income and other deferred liabilities)

and the current assets of the Company would be at least equal to its current liabilities, or, if the average of its earnings before taxes on income and before interest expense for the two preceding fiscal years was less than the average of its interest expense for the two preceding fiscal years, at least equal to 125% of its current liabilities.

Additionally, the FRB s policy regarding dividends provides that a bank holding company should not pay cash dividends exceeding its net income or which can only be funded in ways that weaken the bank holding company s financial health, such as by borrowing.

The FDIC and the DFI have authority to prohibit a bank from engaging in business practices that are considered to be unsafe or unsound. Depending upon the financial condition of a bank and upon other factors, the FDIC or DFI could assert that payments of dividends or other payments by a bank might be such an unsafe or unsound practice. The FRB has similar authority with respect to a bank holding company.

For regulatory restrictions on payment of dividends by the Company, see Item 1- *BUSINESS - Regulation and Supervision - Limitations on Dividends Payments.*

Performance Graph

The following graph compares the stock performance of the Company from December 31, 2001 to December 31, 2006, to the performance of several specific industry indices. The performance of the S&P 500 index, Nasdaq Stock Index and Nasdaq Bank Stocks were used as comparisons to the Company s stock performance. Management believes that a performance comparison to these indices provides meaningful information and has therefore included those comparisons in the following graph.

	Period Ending					
Index	**12/31/01**	**12/31/02**	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**
Heritage Commerce Corp *	100.00	102.29	135.23	194.74	200.76	221.31
S&P 500 *	100.00	76.63	96.85	105.56	108.73	123.54
NASDAQ - Total US*	100.00	68.47	102.72	111.54	113.07	123.84
NASDAQ Bank Index*	100.00	104.42	135.67	150.58	144.06	159.92

** Source: SNL Financial Bank Information Group* (434) 977-1600

Stock Repurchase Program

In February 2006, the Company s Board of Directors authorized the purchase of up to $10 million of its common stock, which represents approximately 455,000 shares, or 4%, of its outstanding shares at current market price. The share repurchase authorization is valid through June 30, 2007. The Company intends to continue to finance the repurchase of shares using its available cash. 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 (including compliance with the Company s black out trading policies).

The following table provides information concerning the Company s repurchase of its common stock in 2006.

		As of December 31, 2006
Total Shares Purchased		330,300
Average Per Share Price	$	23.88
Number of Shares as Part of Announced Plan or Program		330,300
Maximum Amount Remaining for Purchase Under Plan or Program	$	2,092,000

ITEM 6 - SELECTED FINANCIAL DATA

The following table presents a summary of selected financial information that should be read in conjunction with the Company s consolidated financial statements and notes thereto included under Item 8 - FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

SELECTED FINANCIAL DATA

(Dollars in thousands, except per share amounts and ratios)	2006	2005	2004	2003	2002
	AS OF YEARS ENDED DECEMBER 31,				
INCOME STATEMENT DATA:					
Interest income	$ 72,957	$ 63,756	$ 50,685	$ 46,447	$ 51,015
Interest expense	22,525	15,907	9,648	10,003	15,237
Net interest income before provision for loan losses	50,432	47,849	41,037	36,444	35,778
Provision for loan losses	(503)	313	666	2,900	2,663
Net interest income after provision for loan losses	50,935	47,536	40,371	33,544	33,115
Noninterest income	9,840	9,423	10,544	10,812	9,684
Noninterest expense	34,268	35,233	39,238	33,084	32,161
Income before income taxes	26,507	21,726	11,677	11,272	10,638
Income tax expense	9,237	7,280	3,199	3,496	3,484
Net income	$ 17,270	$ 14,446	$ 8,478	$ 7,776	$ 7,154
PER SHARE DATA:					
Basic net income (1)	$ 1.47	$ 1.22	$ 0.73	$ 0.69	$ 0.65
Diluted net income (2)	$ 1.44	$ 1.19	$ 0.71	$ 0.67	$ 0.63
Book value (3)	$ 10.54	$ 9.45	$ 8.45	$ 7.86	$ 7.30
Weighted average number of shares outstanding - basic	11,725,671	11,795,635	11,559,155	11,221,232	11,063,965
Weighted average number of shares outstanding - diluted	11,956,433	12,107,230	11,986,856	11,572,588	11,324,650
Shares outstanding at period end	11,656,943	11,807,649	11,669,837	11,381,037	11,214,414
BALANCE SHEET DATA:					
Securities	$ 172,298	$ 198,495	$ 232,809	$ 153,473	$ 126,443
Net loans (5)(6)	$ 699,957	$ 669,901	$ 708,611	$ 636,221	$ 653,807
Allowance for loan losses	$ 9,279	$ 10,224	$ 12,497	$ 13,451	$ 13,227
Total assets	$ 1,037,138	$ 1,130,509	$ 1,108,173	$ 1,005,982	$ 960,066
Total deposits	$ 846,593	$ 939,759	$ 918,535	$ 835,410	$ 841,936
Other borrowed funds	$ 21,800	$ 32,700	$ 47,800	$ 43,600	$ 0
Notes payable to subsidiary grantor trusts	$ 23,702	$ 23,702	$ 23,702	$ 23,702	$ 23,000
Total shareholders equity	$ 122,820	$ 111,617	$ 98,579	$ 89,485	$ 81,862
SELECTED PERFORMANCE RATIOS:					
Return on average assets (4)	1.57%	1.27%	0.80%	0.81%	0.77%
Return on average equity	14.62%	13.73%	9.04%	9.04%	9.15%
Net interest margin	5.06%	4.58%	4.22%	4.15%	4.19%
Efficiency ratio	56.86%	61.52%	76.07%	70.01%	70.74%
Average net loans as a percentage of average deposits	77.61%	73.55%	77.11%	77.21%	76.49%
Average total shareholders equity as a percentage of average total assets	10.75%	9.25%	8.80%	8.95%	8.41%
SELECTED ASSET QUALITY RATIOS:					
Net loan charge-offs to average loans	0.06%	0.28%	0.19%	0.41%	0.09%
Allowance for loan losses to total loans (5)(6)	1.31%	1.51%	1.73%	2.03%	1.96%
CAPITAL RATIOS:					
Tier 1 risk-based	17.3%	14.2%	13.0%	13.3%	12.1%
Total risk-based	18.4%	15.3%	14.3%	14.5%	13.3%
Leverage	13.6%	11.6%	10.9%	11.1%	10.7%

Notes:

(1) Represents net income divided by the average number of shares of common stock outstanding for the respective period.

(2) Represents net income divided by the average number of shares of common stock and common stock-equivalents outstanding for the respective period.

(3) Represents shareholders equity divided by the number of shares of common stock outstanding at the end of the period indicated.

(4) Average balances used in this table and throughout this Annual Report are based on daily averages.

(5) Net loans have been restated for December 31, 2006, 2005 and 2004 as discussed in Note 17 to the consolidated financial statements.

(6) The Company has adjusted net loans for December 31, 2003 and 2002 related to the restatement discussed in Note 17 to the consolidated financial statements.

ITEM 7 - MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of financial condition gives effect to the restatement discussed in Note 17 to the consolidated financial 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.

Performance Overview

Net income in 2006 was $17.3 million, an increase of $2.9 million, or 20%, over the $14.4 million in net earnings achieved in 2005. Net income in 2005 was $5.9 million higher than 2004 net earnings of $8.5 million. Net income per diluted share was $1.44 for 2006, as compared to $1.19 during 2005 and $0.71 in 2004. The Company s Return on Average Assets was 1.57% and Return on Average Equity was 14.62% in 2006, as compared to 1.27% and 13.73%, respectively for 2005, and 0.80% and 9.04%, respectively in 2004.

The following are major factors impacting the Company s results of operations in recent years:

- Net interest income grew by $2.6 million, or 5%, in 2006, and by $6.8 million, or 17%, in 2005. The growth in both periods was largely driven by an increased rate on earning assets.

- Noninterest income increased by 4% in 2006 but decreased 11% in 2005 from 2004.

- The efficiency ratio was reduced to 56.86% in 2006 from 61.52% in 2005 due to the continued efforts on

cost savings.

- The loan loss provision was $0.9 million lower in 2006 than in 2005, and $0.4 million lower in 2005 than in 2004. This is the result of a general improvement in credit quality.

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

- Total assets declined by $93.4 million, or 8%, to $1.04 billion at the end of 2006 from $1.13 billion at the end of 2005.

- Gross loan balances (including loans held for sale) decreased by $15.9 million, or 2%, in 2006, primarily due to the Company selling its Capital Group loan portfolio in the first quarter of 2006 of approximately $30 million, which consisted primarily of factoring type loans.

Deposits

Growth in deposits is an important metric management uses to measure market share. The Company s depositors are primarily located in its primary market area. Depending on loan demand and other funding requirements, the Company will occasionally obtain deposits from wholesale sources including deposit brokers. The Company had $32 million in brokered deposits at December 31, 2006. 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 located in our primary market. The economy in our primary service area continued to stabilize in 2006. Commercial loans increased from December 31, 2005 primarily from increased loan demand reflecting the improving economy in our primary service area. Commercial real estate mortgage loans increased from December 31, 2005 primary due to general improvements in commercial income property markets. 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 total net interest income and the net interest margin (net interest income divided by average earning assets).

Increases in short-term interest rates contributed to growth in net interest income since the interest rate earned on a majority of the Company s loan portfolio adjusts with the prime rate. Approximately 76% of the Company s loan portfolio is indexed to the prime rate. As the Federal Open Market Committee (FOMC) reduced short term interest rates from 2000 to 2003, the prime rate dropped sharply from 9.50% at December 31, 2000 to 4.00% in June 2003. The FOMC began to increase short term rates in July 2004 and the prime rate at December 31, 2006 was 8.25%. The improvement in net interest margin in 2006 and 2005 is largely attributable to the FOMC action. Because of its focus on commercial lending to closely held businesses, the Company will continue 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 slightly in a rising rate environment, and decrease slightly in a declining interest rate scenario.

The Company, through its asset and liability policies and practices, seeks to maximize net interest income without exposing the Company to an excessive level of interest rate risk. Interest rate risk is managed by monitoring the pricing, maturity and repricing options of all classes of interest bearing assets and liabilities. This is discussed in more detail in *Items 7- Management s Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Asset/Liability Management.*

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 homogenous loans. The average size of its 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. The Company s provision for loan losses has decreased each of the last two years because of a reduction in classified loans from $35.6 million in 2004 to $16.3 million in 2005, and a reduction of impaired loans from $15.6 million in 2005 to $9.0 million in 2006. A complete discussion of the management of credit risk appears in *Item 7- Management s Discussion and Analysis of Financial Condition and Results of Operations - Provision for Loan Losses and Allowance for Loan Losses*.

Noninterest Income

While net interest income remains the largest single component of total revenues, noninterest income has become a growing component. 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 in the secondary market with retained servicing rights.

Noninterest income associated with SBA activity has increased each year from 2003 through 2006. 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. Further, change in the secondary market for SBA loans could reduce gains on sale. 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. Loan servicing is discussed in *Item 7- Management s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies* and in the *Notes to Consolidated Financial Statements*.

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 nonexpense through review of the Company s efficiency ratio. The Company s efficiency was 56.86% in 2006 compared with 61.52% in 2005.

In the fourth quarter of 2005 the Company recognized additional expenses of $1.05 million, representing the present value of term insurance for participants in the Company s Supplemental Executive Retirement Plan, substantially all of whom have split dollar life insurance agreements with the Company. Typically, under the split dollar life insurance agreements, the insureds beneficiary receives 80% of the excess of the death

benefit over the cash surrender value of the policy. This accounting adjustment was undertaken after the Company s review of split dollar life insurance agreements and recognition that the Company has contractually agreed with each participant to provide life insurance on an ongoing basis without interruption. In order to replace this coverage, the Company would have to obtain term insurance for the remainder of the insureds expected lives, if the Company ever terminated its company owned life insurance. This charge reflected the term insurance cost for all insureds.

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 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 Statement 158 did not affect the Company s financial statements since the Company s supplemental retirement plan has no assets and the liability for benefits is measured as of December 31 and recorded on the Company s balance sheet.

Capital Management and Share Repurchases

Heritage Commerce Corp and Heritage Bank of Commerce meet the regulatory definition of well capitalized at December 31, 2006. 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. As a part of this process, the Company determined in the second quarter of 2004 that its capital levels were higher than necessary. To adjust capital to levels consistent with its view of current market conditions, the Company commenced a stock repurchase plan in June 2004. The repurchase program was completed at the end of third quarter 2005. On February 7, 2006, the Board of Directors authorized the repurchase of up to an additional $10 million of common stock through June 30, 2007.

In 2006, the Company initiated the payment of quarterly cash dividends. The Company paid cash dividends totaling $2.36 million, or $0.20 per share in 2006, representing 14% of 2006 earnings. The Company s general policy is to pay cash dividends within the range of typical peer payout ratios, provided that such payments do not adversely affect our financial condition and are not overly restrictive to our growth capacity. On February 6, 2007, the Company declared a $0.06 per share quarterly cash dividend. The dividend will be paid on March 15, 2007, to shareholders of record on February 22, 2007.

Results of Operations

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earnings assets less interest expense on interest-bearing liabilities. The second is non-interest income, which primarily consists of gains from the sale of loans, loan servicing fees, and customer service charges and fees but also includes non-customer sources such as Company-owned life insurance. The majority of the Company s non-interest expenses are operating costs that relate to providing a full range of banking services to our customers.

Net Interest Income and Net Interest Margin

In 2006, net interest income was $50.4 million, an increase of 5% compared to $47.8 million in 2005. The level of net interest income depends on several factors in combination, including growth in earning assets, yields on earning assets, the cost of interest-bearing liabilities, the relative volumes of earning assets and interest-bearing liabilities, and the mix of products which comprise the Company s earning assets, deposits, and other interest-bearing liabilities. To maintain its net interest margin, the Company must manage the relationship between interest earned and paid.

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

Distribution, Rate and Yield

	Year Ended December 31,								
	2006			2005			2004		
(Dollars in thousands)	Average Balance	Interest Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate
Assets:									
Loans, gross (1) (2)	$ 738,297	$ 61,859	8.38%	$ 762,328	$ 54,643	7.17%	$ 725,921	$ 43,593	6.01%
Securities	191,220	7,796	4.08%	226,043	7,247	3.21%	216,012	6,715	3.11%
Interest bearing deposits in other financial institutions	2,826	132	4.67%	3,234	97	3.00%	1,336	14	1.05%
Federal funds sold	63,739	3,170	4.97%	52,438	1,769	3.37%	28,964	363	1.25%
Total interest earning assets	996,082	72,957	7.32%	1,044,043	63,756	6.11%	972,233	50,685	5.21%
Cash and due from banks	34,810			38,670			47,911		
Premises and equipment, net	2,482			2,879			3,728		
Other assets	64,904			51,593			41,923		
Total assets	$ 1,098,278			$ 1,137,185			$ 1,065,795		
Liabilities and shareholders equity:									
Deposits:									
Demand, interest bearing	$ 145,471	$ 3,220	2.21%	$ 134,412	$ 1,749	1.30%	$ 112,439	$ 536	0.48%
Savings and money market	358,846	10,274	2.86%	363,570	6,058	1.67%	350,922	3,658	1.04%
Time deposits, under $100	31,967	1,037	3.24%	37,260	862	2.31%	38,717	575	1.49%
Time deposits, $100 and over	107,387	3,762	3.50%	115,104	2,867	2.49%	100,309	1,556	1.55%
Brokered time deposits, $100 and over	34,234	1,295	3.78%	35,764	1,313	3.67%	11,460	473	4.13%
Notes payable to subsidiary grantor trusts	23,702	2,310	9.75%	23,702	2,136	9.01%	23,702	1,958	8.26%
Securities sold under agreement to repurchase	25,429	627	2.47%	40,748	922	2.26%	43,140	892	2.07%
Total interest bearing liabilities	727,036	$ 22,525	3.10%	750,560	$ 15,907	2.12%	680,689	$ 9,648	1.42%
Demand, noninterest bearing	229,190			259,881			275,192		
Other liabilities	23,957			21,536			16,139		
Total liabilities	980,183			1,031,977			972,020		
Shareholders equity	118,095			105,208			93,775		
Total liabilities and shareholders equity	$ 1,098,278			$ 1,137,185			$ 1,065,795		
Net interest income / margin	.	$ 50,432	5.06%		$ 47,849	4.58%		$ 41,037	4.22%

(1) Yields and amounts earned on loans include loan fees of $0.6 million, $1.3 million, $1.5 million, for the years ended December 31, 2006, 2005, and 2004. Nonaccrual loans are included in the average balance calculations above.

(2) Interest income is reflected on an actual basis, not a fully taxable equivalent basis and does not include a fair value adjustment.

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

Volume and Rate Variances

	2006 vs. 2005 Increase (Decrease) Due to Change in:			2005 vs. 2004 Increase (Decrease) Due to Change in:		
(Dollars in thousands)	**Average Volume**	**Average Rate**	**Net Change**	**Average Volume**	**Average Rate**	**Net Change**
Income from the interest earning assets:						
Loans, gross	$ (2,024)	$ 9,240	$ 7,216	$ 2,594	$ 8,456	$ 11,050
Securities	(1,427)	1,976	549	313	219	532
Interest bearing deposits in other financial institutions	(19)	54	35	57	26	83
Federal funds sold	564	837	1,401	793	613	1,406
Total interest income on interest earning assets	$ (2,906)	$ 12,107	$ 9,201	$ 3,757	$ 9,314	$ 13,071
Expense from the interest liabilities:						
Demand, interest bearing	$ 249	$ 1,222	$ 1,471	$ 287	$ 926	$ 1,213
Savings and money market	(124)	4,340	4,216	198	2,202	2,400
Time deposits, under $100	(170)	345	175	(94)	381	287
Time deposits, $100 and over	(267)	1,162	895	420	891	1,311
Brokered time deposits, $100 and over	(57)	39	(18)	892	(52)	840
Notes payable to subsidiary grantor trusts		174	174		178	178
Securities sold under agreement to repurchase	(379)	84	(295)	(53)	83	30
Total interest expense on interest bearing liabilities	$ (748)	$ 7,366	$ 6,618	$ 1,650	$ 4,609	$ 6,259
Net interest income	$ (2,158)	$ 4,741	$ 2,583	$ 2,107	$ 4,705	$ 6,812

Net interest income for 2006 increased $2.58 million or 5% from 2005. The increase in 2006 was primarily due to increasing short-term interest rates. The Company s net interest margin expressed as a percentage of average earning assets, was 5.06% in 2006 relative to 4.58% in 2005, an increase of 48 basis points. A substantial portion of the Company s earning assets are variable-rate loans that re-price when the Company s prime lending rate is changed, versus a large base of core deposits that are generally slower to re-price. This causes the Company s balance sheet to be slightly asset-sensitive, which means that all else being equal, the Company s net interest margin will be lower during periods when short-term interest rates are falling and higher when rates are rising. This effect was visible in 2006, when the Company s net interest margin rose in correlation to increases in short-term market interest rates. Management anticipates that the Company s net interest margin could experience some compression if short-term interest rates do not continue to rise, nevertheless we feel that net interest income will continue to increase if

loans and core deposits grow as planned. However, no assurance can be given that this will, in fact, occur.

Net interest income for 2005 increased 17% from 2004. The increase in 2005 was due to the increase in average earning assets and increases in key market interest rates in 2005. Average interest earning assets increased 7% in 2005 from 2004. This increase was primarily attributable to growth in average loans and Federal funds sold. Average loans outstanding, including loans held for sale, increased $36.4 million during 2005, over the average during 2004. Average Federal funds sold in 2005 increased $23.5 million from 2004. The increase in average interest bearing assets is partially offset by the increase in average interest bearing liabilities. Average interest bearing liabilities increased 10% in 2005 from 2004. This increase was primarily attributable to growth in interest bearing demand deposits, savings and money-market accounts and time deposits. The Company s average rate paid on interest bearing liabilities increased to 2.12% in 2005 from 1.42% in 2004. Overall, the net interest margin increased 36 basis points to 4.58% in 2005 from 4.22% in 2004. Net interest income increased $6.8 million or 17%, for 2005 to $47.8 million from $41.0 million for 2004, primarily due to the increase in interest rates.

Provision for Loan Losses

Credit risk is inherent in the business of making loans. The Company sets aside an allowance or reserve 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. 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.

For 2006, the Company had a credit provision for loan losses of $0.5 million, compared to provision for loan losses of $0.3 million for 2005 and $0.7 million for 2004. The allowance for loan losses represented 1.31%, 1.51% and 1.73% of total loans at December 31, 2006, 2005 and 2004, respectively. See Allowance for Loan Losses on page 44 for additional information.

Noninterest Income

While net interest income remains the largest single component of consolidated net income, noninterest income has become a growing component. 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 in the secondary market with retained servicing rights. SBA loan activity includes the origination, sale, and servicing of loans guaranteed by the U.S. Department of Agriculture.

Noninterest income associated with SBA activity has increased each year from 2003 through 2006. 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. Further, change in the secondary market for SBA loans could reduce gains on sale. 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. Loan servicing is discussed in *Item 7 - Management s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies* and in the *Notes to Consolidated Financial Statements*.

The following table sets forth the various components of the Company s noninterest income:

Noninterest Income

	Year Ended December 31,			Increase (decrease) 2006 versus 2005		Increase (decrease) 2005 versus 2004	
(Dollars in thousands)	**2006**	**2005**	**2004**	**Amount**	**Percent**	**Amount**	**Percent**
Gain on sale of SBA loans	$ 3,337	$ 2,871	$ 3,052	$ 466	16%	$ (181)	-6%
Gain on sale of Capital Group loan portfolio	671			671	N/A		N/A
Servicing income	1,860	1,838	1,498	22	1%	340	23%
Increase in cash surrender value of life insurance	1,439	1,236	1,031	203	16%	205	20%
Service charges and fees on deposit accounts	1,335	1,468	1,799	(133)	-9%	(331)	-18%
Gain on sale of leased equipment		299		(299)	-100%	299	N/A
Equipment leasing		131	871	(131)	-100%	(740)	-85%
Gain on sales of securities available-for-sale			476		N/A	(476)	-100%
Mortgage brokerage fees			168		N/A	(168)	-100%
Other	1,198	1,580	1,649	(382)	-24%	(69)	-4%
Total	$ 9,840	$ 9,423	$ 10,544	$ 417	4%	$ (1,121)	-11%

The increase in noninterest income in 2006 as compared to 2005 was primarily attributable to a $1.14 million increase in gain on sale of loans. The Company, subject to market conditions, sells the guaranteed portion of its SBA loans and retains the servicing rights. The increase gain on sale of loans included a one time gain on sale of certain specialty loans that occurred during the first quarter of 2006, which resulted in a one time gain of $0.7 million.

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.

Also contributing to the improvements in noninterest income in 2006 was an increase in the cash surrender value of life insurance and a slight increase in servicing income which offset a slight decline in deposit service charges and fees. The increases in 2006 offset the $0.4 million generated last year from leasing activities, a business the Company exited in 2005.

In 2005, the increase in the cash surrender value of life insurance was primarily the result of additional policies purchased in 2005. The reduction in gain on sale of loans was related to the market conditions. The decrease in deposit service charges and fees on deposit accounts was primarily because higher interest rates applied to collected balances created a waiver of (or credit against) service charges for many business customers. The Company sold all leased equipment during the second quarter of 2005 and closed the residential mortgage department in June 2004.

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company s performance. The Company undertook several initiatives to reduce its noninterest expense and improve its efficiency. These initiatives included a reduction in staff and the consolidation of its operations under the common Heritage Bank brand and restructuring each department.

The following table sets forth the various components of the Company s noninterest expense:

Noninterest Expense

(Dollars in thousands)	Year Ended December 31, 2006	2005	2004	Increase (decrease) 2006 versus 2005 Amount	Percent	Increase (decrease) 2005 versus 2004 Amount	Percent
Salaries and employee benefits	$ 19,414	$ 19,845	$ 20,189	$ (431)	-2%	$ (344)	-2%
Occupancy	3,110	3,254	3,670	(144)	-4%	(416)	-11%
Professional fees	1,688	1,617	2,656	71	4%	(1,039)	-39%
Client services	1,000	1,404	1,044	(404)	-29%	360	34%
Advertising and promotion	1,064	985	1,090	79	8%	(105)	-10%
Low income housing investment losses and writedowns	995	957	878	38	4%	79	9%
Furniture and equipment	517	734	921	(217)	-30%	(187)	-20%
Data processing expense	806	661	722	145	22%	(61)	-8%
Retirement plan expense	352	619	306	(267)	-43%	313	102%
Amortization of leased equipment		334	1,016	(334)	-100%	(682)	-67%
Operational losses	9	37	2,219	(28)	-76%	(2,182)	-98%
Other	5,313	4,786	4,527	527	11%	259	6%
Total	$ 34,268	$ 35,233	$ 39,238	$ (965)	-3%	(4,005)	-10%

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

Noninterest Expense by Category

	2006		2005		2004	
(Dollars in thousands)	**Amount**	**Percent of Total**	**Amount**	**Percent of Total**	**Amount**	**Percent of Total**
Salaries and employee benefits	$ 19,414	57%	$ 19,845	56%	$ 20,189	51%
Occupancy	3,110	9%	3,254	9%	3,670	9%
Professional fees	1,688	5%	1,617	4%	2,656	7%
Client services	1,000	3%	1,404	4%	1,044	3%
Advertising and promotion	1,064	3%	985	3%	1,090	3%
Low income housing investment losses and writedowns	995	3%	957	3%	878	2%
Furniture and equipment	517	1%	734	2%	921	2%
Data processing expense	806	2%	661	2%	722	2%
Retirement plan expense	352	1%	619	2%	306	1%
Amortization of leased equipment		0%	334	1%	1,016	2%
Operational losses	9	0%	37	0%	2,219	6%
Other	5,313	16%	4,786	14%	4,527	12%
Total	$ 34,268	100%	$ 35,233	100%	$ 39,238	100%

Noninterest expense decreased $1.0 million, or 3% in 2006 as compared with 2005. Non-interest expense for 2005 decreased $4.0 million, or 10%, from 2004. Management monitors progress in its management of noninterest expense by improvements in the Company s efficiency ratio. The efficiency ratio represents operating expense divided by the sum of net interest and non-interest income, with the provision for loan losses and security gains and losses excluded from the equation. The Company s efficiency ratio was 56.86% in 2006 as compared to 61.52% in 2005.

Salaries and employee benefits, the single largest component of noninterest expense, decreased $0.4 million in 2006 from 2005. In 2005, salaries and employee benefits decreased $0.3 million from 2004. The decrease in 2006 from 2005 was primarily attributable to a decrease in loan officer commissions, executive severance and term life insurance expense, partially offset by an increase in stock option expense. The Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004) (Statement 123R) in 2006, which has resulted in an increase of stock option expense in noninterest expense of $780,000 in 2006. In 2005, stock option expense was not included in the salaries and employee benefits but rather disclosed in a footnote in the Company s financial statements on a pro forma basis. The decrease in 2005 from 2004 was primarily attributable to a decrease in the number of employees.

Occupancy expense decreased $0.1 million in 2006 from 2005. In 2005, occupancy expense decreased $0.4 million from 2004. The decrease in 2006 from 2005 was primarily a result of lower depreciation on leasehold improvements and reduction in repairs at bank branches. The decrease in 2005 from 2004 was also a result of lower depreciation on leasehold improvements. Occupancy expense in 2006 and partially in 2005 were reduced because, during the third quarter of 2005, the Company amended two of its existing lease contracts to reduce monthly rent and extend the terms of the leases. These costs were 9% of total operating expenses in 2006 and remained fairly constant compared to 2005 and 2004.

Professional fees increased $0.1 million in 2006 from 2005. In 2005, professional fees decreased $1.0 million from 2004. The increase in 2006 was primarily attributable to increased legal and audit expenses, partially offset by a decrease in consultant expenses. The decrease in 2005 from 2004 was primarily attributable to decreased legal, audit and consulting expenses. Professional fees in 2004 included audit and consulting expenses related to compliance with Sarbanes-Oxley and legal expenses related to the proxy solicitation for the 2004 annual meeting and other corporate governance matters.

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Client services decreased $0.4 million in 2006 from 2005 primarily due to the decrease in service fees charged to the Company from the third party vendors, such as for armored car services. In 2005, client services increased $0.4 million from 2004. The increase in 2005 from 2004 was primarily attributable to the increase in service fees charged to the Company from third party vendors who have certain deposit accounts.

Advertising and promotion costs increased $0.1 million in 2006 from 2005. The increase in 2006 from 2005 was due to an increase in business promotion. In 2005, advertising and promotion costs decreased $0.1 million from 2004. The decrease in 2005 from 2004 was primarily attributable to the discontinuation of certain sponsorships.

Low income housing investment losses and writedowns increased $0.04 million in 2006 from 2005. In 2005, low income housing investment losses and writedowns increased $0.1 million from 2004. The increase in 2006 was primarily attributable to the increased losses from three fully active limited partnerships. The Company obtains tax credits from these investments which reduce income tax expense. These investments are written down to zero over the period that tax credits are recognized, since no residual value is assumed.

Furniture and equipment expense decreased $0.2 million in 2006 from 2005. In 2005, furniture and equipment expense decreased $0.2 million from 2004. The decrease in 2006 was primarily due to lower depreciation on furniture and equipment. The decrease in 2005 was primarily due to fewer equipment repairs and lower depreciation on furniture and equipment.

Data processing expense increased $0.1 million in 2006 from 2005. In 2005, data processing expense decreased $0.1 million from 2004. The increase in 2006 from 2005 was primarily due to a higher volume of data processing. The decrease in 2005 was a result of cost saving by outsourcing the core data and item processing.

Retirement plan expense for directors decreased $0.3 million in 2006 from 2005. In 2005, retirement plan expense increased $0.3 million from 2004. The increase in 2005 was primarily due to more participants in 2005.

Amortization of leased equipment decreased $0.7 million in 2005 from 2004. All of the leased equipment was sold in the second half of 2005.

Operational losses in 2004 were primarily due to the write-off of electronic test equipment subject to an operating lease. The Company sold all leased equipment during the second quarter of 2005.

Other noninterest expenses remained fairly constant for 2006, 2005 and 2004.

Income Tax Expense

The Company computes its provision for income taxes on a monthly basis. As indicated in Note 7 in the Notes to the Consolidated Financial Statements, the amount of such provision is determined by applying the Company s statutory income tax rates to pre-tax book income as adjusted for permanent differences between pre-tax book income and actual taxable income. These permanent differences include but are not limited to tax-exempt interest income, increases in the cash surrender value of life insurance policies, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits.

The Company s federal and state income tax expense was $9.2 million in 2006, compared to $7.3 million and $3.2 million for 2005 and 2004 respectively. This represents 34.8% of income before taxes in 2006, 33.5% in 2005, and 27.4% in 2004. The effective tax rate is higher in 2006 than in 2005 and 2004 because pre-tax income increased at a greater rate than savings from tax advantaged investments.

Tax-exempt interest income is generated primarily by the Company s investments in state, county and municipal bonds, which provided $0.2 million in federal tax-exempt income in 2006 and 2005, and $0.3 million in 2004. Although not reflected in the investment portfolio, the Company also has total investments of $11.7 million in low-income

housing limited partnerships as of December 31, 2006. These investments have generated tax credits for the past few years, with about $1.0 million in credits available for the 2006 tax year and $1.0 million in tax credits realized in 2005. The investments are expected to generate an additional $7.2 million in aggregate tax credits from 2007 through 2016; however, the credits are dependent upon the occupancy level of the housing projects and income of the tenants and cannot be projected with certainty.

Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles, leading to timing differences between the Company s actual tax liability and the amount accrued for this liability based on book income. These temporary differences comprise the deferred portion of the Company s tax expense, which is accumulated on the Company s books as a deferred tax asset or deferred tax liability until such time as it reverses. At the end of 2006, the Company had a net deferred tax asset of $11.2 million.

Financial Condition

As of December 31, 2006, total assets were $1.04 billion, a decrease of 8% from $1.13 billion at year-end 2005. Total securities available-for-sale (at fair value) were $172.3 million, a decrease of 13% from $198.5 million at year-end 2005. The total loan portfolio (excluding loans held for sale) was $709.2 million, an increase of 4% from $680.1 million at year-end 2005. Total deposits were $846.6 million, a decrease of 10% from $939.8 million at year-end 2005. Securities sold under agreement to repurchase decreased $10.9 million, or 33%, to $21.8 million at December 31, 2006, from $32.7 million at year-end 2005.

Securities Portfolio

The following table reflects the fair market values for the total portfolio for each category of securities for the past three years.

Investment Portfolio

(Dollars in thousands)	December 31, 2006	2005	2004
Securities available-for-sale (at fair value)			
U.S. Treasury	$ 5,963	$ 6,920	$ 5,942
U.S. Government Agencies	59,396	82,041	90,308
Mortgage-Backed Securities	90,186	91,868	107,735
Municipals - Tax Exempt	8,142	8,268	9,206
Collateralized Mortgage Obligations	8,611	9,398	19,618
Total	$ 172,298	$ 198,495	$ 232,809

The following table summarizes the amounts and distribution of the Company s securities and the weighted average yields as of December 31, 2006:

	Maturity									
	Within One Year		After One and Within Five Years		After Five and Within TenYears		After Ten Years		Total	
(Dollars in thousands)	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**
Securities available-for-sale (at fair value):										
U.S. Treasury	$ 5,963	3.50%	$		$		$		$ 5,963	3.50%
U.S. Government Agencies	27,385	4.96%	32,011	4.79%					59,396	4.87%
Mortgage Backed Securities			2,028	3.46%	7,256	4.41%	80,902	4.44%	90,186	4.41%
Municipals - non-taxable	4,086	2.76%	4,056	3.14%					8,142	2.95%
Collateralized Mortgage Obligations					5,353	5.64%	3,258	2.82%	8,611	4.57%
Total	$ 37,434	4.49%	$ 38,095	4.54%	$ 12,609	4.93%	$ 84,160	4.38%	$ 172,298	4.48%

The investment 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 uses two portfolio classifications for its securities: Held-to-maturity , and Available-for-sale . Accounting rules also allow for a trading portfolio classification, but the Company has no securities that would be classified as such. The held-to-maturity portfolio can consist only of securities that the Company has both the intent and ability to hold until maturity, to be sold only in the event of concerns with an issuer s credit worthiness, a change in tax law that eliminates their tax exempt status, or other infrequent situations as permitted by generally accepted accounting principles. Since the Company does not have a trading portfolio, the available-for-sale portfolio is comprised of all securities not included as held-to-maturity . 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 investment portfolio. FASB Statement 115 requires available-for-sale securities to be marked to market with an offset to 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 investment portfolio is currently composed primarily of: (i) U.S. Treasury and 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) state, county and 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 $53.7 million and $64.4 million at December 31, 2006 and 2005, respectively.

Except for obligations of the U.S. government or U.S. government agencies, no securities of a single issuer exceeded 10% of shareholders equity at December 31, 2006. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or to otherwise mitigate interest rate risk.

In 2006, the investment portfolio declined by $26.2 million, or 13%, and decreased to 16.6% of total assets at the end of 2006 from 17.6% at the end of 2005. While the overall change is not significant, certain components of the investment portfolio changed. U.S. Treasury and U.S. Agency securities decreased to 38% of the portfolio at the end of 2006 from 45% at the end of 2005. The decrease was primarily due to maturities of U.S. Agency securities during 2006. Municipal securities, mortgage-backed securities and collateralized mortgage obligations remained fairly constant in the portfolio in 2006 compared to 2005.

U.S. Treasury and U.S. Agency securities increased to 45% of the portfolio at the end of 2005 from 41% at the end of 2004. Municipal securities and mortgage backed securities remained fairly constant in the portfolio at the end of 2005 and 2004. Collateralized mortgage obligations decreased to 5% of the portfolio in 2005 from 8% in 2004, primarily due to maturity. Higher interest rates at December 31, 2005 resulted in lower fair values for the period.

Loans

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

Gross loans (including loans held for sale) represented 72% of total assets at December 31, 2006, as compared to 67% of at December 31, 2005. The ratio of net loans to deposits increased to 83% at the end of 2006 from 71% at the end of 2005. Demand for loans remains relatively strong in many areas within the Company s markets and competition continues to intensify. To help ensure that we remain competitive, we make every effort to be flexible and creative in our approach to structuring loans.

The Selected Financial Data table in Item 6 above reflects the amount of loans outstanding at December 31st for each year from 2002 through 2006, net of deferred fees and origination costs and the allowance for loan losses. 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. The amounts shown in the table do not reflect any deferred loan fees or deferred origination costs, nor is the allowance deducted.

Loan Distribution

	December 31,									
(Dollars in thousands)	**2006**	**% to Total**	**2005**	**% to Total**	**2004**	**% to Total**	**2003**	**% to Total**	**2002**	**% to Total**
Commercial	$ 284,093	40%	$ 248,060	37%	$ 296,030	41%	$ 269,076	41%	$ 256,271	38%
Real estate - mortgage	239,041	34%	237,566	35%	250,984	35%	227,474	35%	210,121	32%
Real estate - land and construction	143,834	20%	149,851	22%	118,290	17%	101,082	16%	147,822	22%
Home equity	38,976	6%	41,772	6%	52,170	7%	49,434	8%	49,853	7%
Consumer	2,422	0%	1,721	0%	2,908	0%	1,743	0%	2,850	1%
Total loans	708,366	100%	678,970	100%	720,382	100%	648,809	100%	666,917	100%
Deferred loan costs, net	870		1,155		726		863		117	
Allowance for loan losses	(9,279)		(10,224)		(12,497)		(13,451)		(13,227)	
Loans, net	$ 699,957		$ 669,901		$ 708,611		$ 636,221		$ 653,807	

Total loans (excluding of loans held for sale) were $709.2 million at December 31, 2006, an increase of 4% from $680.1 million at December 31, 2005, and a decrease of 2% from $721.1 million at December 31, 2004. The Company s allowance for loan losses was $9.3 million, or 1.31% of total loans, for 2006 as compared to $10.2 million, or 1.51% of total loans, for 2005, and $12.5 million, or 1.73% of total loans, for 2004. As of December 31,

2006, 2005, and 2004, the Company had $4.3 million, $3.7 million, and $1.3 million, respectively, in nonperforming assets.

The Company s loan portfolio concentrated in commercial, primarily manufacturing, wholesale, and services and real estate, with the balance in land development and construction and home equity and consumer loans. The loan portfolio mix over the past five years has remained relatively the same.

The change in the Company s loan portfolio in 2006 from 2005 is primarily due to the increase in the commercial loan portfolio and commercial real estate mortgage loan portfolio, partially offset by a decrease in the real estate land and construction loan portfolio. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 60% and 63% of its net loans were secured by real property as of December 31, 2006 and 2005. 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. In the fourth quarter of 2005, the Company entered into negotiations for the sale of its Capital Group loan portfolio consisting primarily of factoring type loans. In contemplation of the sale, $32 million, net of the respective allowance loan loss, was moved from commercial loans into loans held-for-sale. Primarily as a result of this reclassification, gross loans decreased 6% to $680.1 million at December 31, 2005, compared to $721.1 million at December 31, 2004. The sale of the Capital Group loan portfolio was completed in 2006, resulting in a gain of $0.7 million. In 2005, commercial real estate mortgages decreased as mortgage loans matured or were paid off. The increase in real estate land and construction loans is due to increased market demand for this type of financing.

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 provide for floating interest rates, with monthly payments of both principal and interest. The Company s commercial loans are centered in locally-oriented commercial activities in markets where the Company has a physical presence, and this segment of the portfolio has struggled for growth as these markets have become more competitive and business activity has moderated.

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 SBA-guaranteed loans; however, the guaranteed portion of these loans may be sold in the secondary market depending on market conditions. Once it is determined that they will be sold, these loans are classified as held for sale and carried at the lower of cost or market. In the event of the sale of the guaranteed portion of an SBA loan, the Company retains the servicing rights for the sold portion. As of December 31, 2006, 2005, and 2004, $188.8 million, $179.8 million and $166.8 million, respectively, in SBA and U.S. Department of Agriculture loans were serviced by the Company for others.

As of December 31, 2006, real estate mortgage loans of $239.0 million consist of adjustable and fixed rate loans secured by commercial property, and loans secured by first mortgages on 1-4 family residential properties of $0.9 million. Home equity lines of credit are secured by junior deeds of trust on 1-4 family residential properties totaling $39.0 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. Real estate values in portions of Santa Clara County and neighboring San Mateo County are among the highest in the country at present. The Company s borrowers could be adversely impacted by a downturn in these sectors of the economy, which could reduce the demand for loans and adversely impact the borrowers ability to repay their loans.

The Company 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 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 restricted 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 HBC, these lending limits were $22.9 million and $38.1 million at December 31, 2006.

Loan Maturities

The following table presents the maturity distribution of the Company s loans as of December 31, 2006. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the western edition of The Wall Street Journal. As of December 31, 2006, approximately 76% of the Company s loan portfolio consisted of floating interest rate loans.

Loan Maturities

(Dollars in thousands)	Due in One Year or Less	Over One Year But Less than Five Years	Over Five Years	Total
Commercial	$ 266,951	$ 13,567	$ 3,575	$ 284,093
Real estate - mortgage	97,935	81,260	59,846	239,041
Real estate - land and construction	143,763	71		143,834
Home equity	30,163		8,813	38,976
Consumer	2,306	116		2,422
Total loans	$ 541,118	$ 95,014	$ 72,234	$ 708,366
Loans with variable interest rates	$ 510,124	$ 23,108	$ 8,890	$ 542,122
Loans with fixed interest rates	30,994	71,906	63,344	166,244
Total loans	$ 541,118	$ 95,014	$ 72,234	$ 708,366

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.

Non-performing 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 non-accrual when they become 90 days past due unless they are both well secured and in the process of collcetion); 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 non-accrual 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

(Dollars in thousands)	December 31, 2006	2005	2004	2003	2002
Nonaccrual loans	$ 3,866	$ 3,672	$ 1,028	$ 3,972	$ 4,571
Loans 90 days past due and still accruing	451		302	608	
Total nonperforming loans	4,317	3,672	1,330	4,580	4,571
Other real estate owned					
Total nonperforming assets	$ 4,317	$ 3,672	$ 1,330	$ 4,580	$ 4,571
Nonperforming assets as a percentage of loans plus other real estate owned	0.61%	0.54%	0.18%	0.70%	0.69%

The balance of nonperforming assets at the end of 2006 represents an increase of $0.6 million, or 18%, from year-end 2005 levels. Nonperforming assets increased by $2.3 million, or 176%, in 2005 as compared to 2004. The ratio of non-performing assets to total gross loans plus OREO also increased to 0.60% at the end of 2006 from 0.53% at the end of 2005. The main changes during 2006 were in Land and Construction loans.

In 2005, the nonperforming loan changes were primarily in commercial and industrial loans which increased by $1.6 million.

While the current level of nonperforming assets is relatively low, we recognize that an increase in the dollar amount of non-accrual loans is possible in the normal course of business as we expand our lending activities. We also expect occasional foreclosures as a last resort in the resolution of some problem loans.

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 the level of 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 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 note 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 flow.

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 include all loans internally graded as substandard, doubtful, and loss, was $24.5 million, $16.3 million, and $35.6 million, respectively, at December 31, 2006, 2005, and 2004. At December 31, 2006 and 2005, all of the Company s classified loans were graded as substandard.

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 HBC 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 FRB and the DFI also review the allowance for loan losses as an integral part of the examination process. Based on information currently available to analyze loan loss delinquency and a history of actual charge-offs, 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 increased loan losses, which could adversely affect the Company s future growth and profitability. No assurance of the ultimate level of credit losses can be given with any certainty.

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

(Dollars in thousands)	2006	2005	2004	2003	2002
Balance, beginning of year	$ 10,224	$ 12,497	$ 13,451	$ 13,227	$ 11,154
Charge-offs:					
Commercial	(291)	(3,273)	(2,901)	(2,906)	(936)
Real estate - mortgage					
Real estate - land and construction					
Home equity	(540)				
Consumer					
Total charge-offs	(831)	(3,273)	(2,901)	(2,906)	(936)
Recoveries:					
Commercial	389	1,358	1,562	230	346
Real estate - mortgage					
Real estate - land and construction					
Home equity					
Consumer					
Total recoveries	389	1,358	1,562	230	346
Net charge-offs	(442)	(1,915)	(1,339)	(2,676)	(590)
Provision for loan losses	(503)	313	666	2,900	2,663
Reclassification of allowance for loan losses		(671)(1)			
Reclassification to other liabilities			(281)(2)		
Balance, end of year	$ 9,279	$ 10,224	$ 12,497	$ 13,451	$ 13,227
RATIOS:					
Net charge-offs to average loans *	0.06%	0.28%	0.19%	0.41%	0.09%
Allowance for loan losses to average loans *	1.32%	1.47%	1.80%	2.07%	2.07%
Allowance for loan losses to total loans *	1.31%	1.51%	1.73%	2.03%	1.96%
Allowance for loan losses to nonperforming loans	215%	278%	940%	294%	289%

* Average loans and total loans exclude loans held for sale

(1) The Company reclassified $0.7 million of the allowance allocated to $32 million of commercial asset based loans that were reclassified to loans held-for-sale as of December 31, 2005. Thus, the carrying value of these loans held-for-sale includes an allowance for loan losses of $0.7 million.

(2) The Company reclassified estimated losses on unused commitments of $0.3 million to other liabilities as of December 31, 2004.

The Company s allowance for loan losses has steadily decreased from 2003 through 2006. This trend has been attributable primarily to decreases in classified loan balances. The Company s allowance for loan losses decreased $0.9 million in 2006 as compared to 2005. The Company had a credit provision of $0.5 million in 2006, compared to a loss provision of $0.3 million in 2005.

Net loans charged-off reflect the realization of losses in the portfolio that were recognized previously though provisions for loan losses. Net charge-offs were $0.4 million, $1.9 million, and $1.3 million in 2006, 2005, and 2004, respectively. The decrease in net loan charge-offs in 2006 was primarily due to continued improvement in credit quality. The increase in net loan charge-offs in 2005 was primarily due to a $2.0 million charge-off from one commercial loan, partially offset by recoveries. Historical net loan charge-offs are not necessarily indicative of the amount of net charge-offs that the Company will realize in the future.

As of December 31, 2006, the Company s unallocated allowance was $1.4 million, compared to $1.1 million as of December 31, 2005. The unallocated component of the allowance is maintained to cover uncertainties that could affect management s estimate of probable losses and also reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating losses on specific problem loans and pools of other loans. The unallocated allowance increased from 2004 to 2005, as the Company updated its allowance methodology. If the same methodology used at year end 2005 was applied as of December 31, 2004, the unallocated allowance would be more comparable. The unallocated amount is reviewed periodically based on trends in credit losses, the results of credit reviews and overall economic trends.

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

Allocation of Loan Loss Allowance

	December 31,									
	2006		2005		2004		2003		2002	
(Dollars in thousands)	**Allowance**	**Percent of Loans in each category to total loans**	**Allowance**	**Percent of Loans in each category to total loans**	**Allowance**	**Percent of Loans in each category to total loans**	**Allowance**	**Percent of Loans in each category to total loans**	**Allowance**	**Percent of Loans in each category to total loans**
Commercial	$ 4,872	40%	$ 4,199	37%	$ 8,691	41%	$ 9,667	43%	$ 6,349	39%
Real estate - mortgage	1,507	34%	2,631	35%	1,498	35%	1,846	35%	2,041	31%
Real estate - land and construction	1,243	20%	1,914	22%	1,711	16%	1,714	15%	3,574	22%
Home equity	244	6%	300	6%	173	7%	157	7%	370	7%
Consumer	24	0%	33	0%	38	1%	37	0%	47	1%
Unallocated	1,389	0%	1,147	0%	386	0%	30	0%	846	0%
Total	$ 9,279	100%	$ 10,224	100%	$ 12,497	100%	$ 13,451	100%	$ 13,227	100%

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 and the percentage of distribution in each category of deposits for the periods indicated:

Deposits

	Years Ended December 31,					
	2006		2005		2004	
(Dollars in thousands)	Balance	% to Total	Balance	% to Total	Balance	% to Total
Demand, noninterest bearing	$ 231,841	27%	$ 248,009	26%	$ 277,451	30%
Demand, interest bearing	133,413	16%	157,330	17%	120,890	13%
Savings and money market	307,266	36%	353,798	38%	357,318	39%
Time deposits, under $100	31,097	4%	35,209	4%	38,295	4%
Time deposits, $100 and over	111,017	13%	109,373	12%	104,719	12%
Brokered deposits, $100 and over	31,959	4%	36,040	4%	19,862	2%
Total deposits	$ 846,593	100%	$ 939,759	100%	$ 918,535	100%

Total deposits were $846.6 million at December 31, 2006, a decrease of $93.2 million, or 10%, compared to $939.8 million at December 31, 2005. At December 31, 2006, noninterest bearing demand deposits decreased $16.2 million, or 7%, from December 31, 2005 primarily due to decreases in title and escrow companies accounts. Interest bearing demand deposits decreased $23.9 million, or 15%, primarily because the Company reduced certain high yield accounts; savings and money market deposits decreased $46.5 million, or 13%; time deposits decreased $2.5 million, or 2%; and brokered deposits decreased $4.1 million, or 11%.

As of December 31, 2006, the Company had a deposit mix of 36% in savings and money market accounts, 21% in time deposits, 16% in interest bearing demand accounts, and 27% in noninterest bearing demand deposits. On December 31, 2006, approximately $2.4 million, or less than 1%, of deposits were from public sources, and approximately $108.2 million, or 13%, of deposits were from real estate exchange company and title company accounts. As of December 31, 2005, the Company had a deposit mix of 38% in savings and money market accounts, 19% in time deposits, 17% in interest bearing demand accounts, and 26% in noninterest bearing demand deposits. On December 31, 2005, approximately $2.4 million, or less than 1%, of deposits were from public sources, and approximately $129.5 million, or 14%, of deposits were from real estate exchange company and title company accounts.

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 approximately $32.0 million, and $36.0 million at December 31, 2006 and 2005, respectively. These brokered deposits generally mature within one to three years. Brokered deposits are generally less desirable because of higher interest rates. 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 December 31, 2006:

Deposit Maturity Distribution

(Dollars in thousands)		Balance	% of Total
Three months or less	$	56,886	40%
Over three months through six months		33,809	23%
Over six months through twelve months		28,258	20%
Over twelve months		24,023	17%
Total	$	142,976	100%

The Company focuses primarily on providing and servicing business deposit accounts that are frequently over $100,000 in average balance per account. As a result, certain types of business clients that the Company serves typically carry average deposits in excess of $100,000. 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 assets and average equity, dividend payout, and average equity to average assets for 2006, 2005, and 2004:

	2006	2005	2004
Return on average assets	1.57%	1.27%	0.80%
Return on average equity	14.62%	13.73%	9.04%
Dividend payout ratio	13.65%		
Average equity to average assets ratio	10.75%	9.25%	8.80%

Off-Balance Sheet Arrangements

In the normal course of business, the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, yet are not reflected in any form within the Company s consolidated balance sheets. Total unused commitments to extend credit were $322.2 million at December 31, 2006, as compared to $334.1 million at December 31, 2005. Unused commitments represented 45% and 49% of outstanding gross loans at December 31, 2006 and 2005, respectively.

The effect on the Company s revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted, because there is no certainty that the lines of credit will ever be fully utilized. For more information regarding the Company s off-balance sheet arrangements, see Note 12 to the financial statements located elsewhere herein.

The following table presents the Company s commitments to fund as of December 31, 2006, 2005, and 2004:

(Dollars in thousands)		December 31, 2006		2005		2004
Commitments to extend credit	$	310,200	$	328,031	$	313,036
Standby letters of credit		12,020		6,104		5,256
	$	322,220	$	334,135	$	318,292

Allowance for Off-Balance Sheet Credit Losses

The allowance for unfunded commitments is based on management s estimate of the amount required to reflect the probable inherent losses on outstanding letters of credit and unused loan credit commitments. Adequacy of the allowance is determined using a systematic methodology similar to the one that analyzes the allowance for loan losses. Management must also estimate the likelihood that these commitments would be funded and become loans. This is done by evaluating the historical utilization of each type of unfunded commitment and estimating the likelihood that the current utilization rates on lines available at the balance sheet date could change in the future. The allowance for unfunded commitments is included in other liabilities on the balance sheet. See table below for activity in 2006 and 2005.

(Dollars in thousands)		For the Year Ended December 31, 2006		2005
Balance at beginning of period	$	203	$	281
Provision for credit losses		274		(78)
Balance at end of period	$	477	$	203

Contractual Obligations

The contractual obligations of the Company, summarized by type of obligation and contractual maturity, at December 31, 2006, are as follows:

(Dollars in thousands)	Less Than One Year	One to Three Years	Three to Five Years	After Five Years	Total
Securities sold under agreement to repurchase	$ 10,900	$ 10,900	$	$	$ 21,800
Notes payable to subsidiary grantor trusts				23,702	23,702
Operating leases	2,027	2,832	2,922	4,978	12,759
Time deposits	147,741	26,267	65		174,073
Total debt and operating leases	$ 160,668	$ 39,999	$ 2,987	$ 28,680	$ 232,334

In addition to those obligations listed above, in the normal course of business, the Company will make cash distributions for the payment of interest on interest bearing deposit accounts and debt obligations, payments for quarterly income tax estimates and contributions to certain employee benefit plans.

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 on-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 net loan to deposit ratio increased to 86% at end of 2006 from 73% at the end of 2005, due to a decrease in deposits during 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 December 31, 2006, the Company s primary liquidity ratio was 13.64%, comprised of $75.5 million in securities available for sale of maturities of up to five years, less $10.9 million of securities that were pledged to secure public and certain other deposits as required by law and contract, Federal funds sold of $15.1 million, and $34.3 million cash and due from banks, as a percentage of total unsecured deposits of $835.7 million.

As of December 31, 2005, the Company s primary liquidity ratio was 20.16%, comprised of $99.7 million in securities available for sale of maturities of up to five years, less $10.8 million of securities that were pledged to secure public and certain other deposits as required by law and contract, Federal funds sold of $62.9 million and $35.6 million in cash and due from banks, as a percentage of total unsecured deposits of $929.0 million.

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

	December 31,		
(Dollars in thousands)	**2006**	**2005**	**2004**
Average balance during the year	$ 25,429	$ 40,748	$ 43,109
Average interest rate during the year	2.46%	2.26%	2.07%
Maximum month-end balance	$ 32,700	$ 57,800	$ 48,600
Average rate at December 31,	2.56%	2.34%	2.21%

Capital Resources

At December 31, 2006, the Company had total shareholders equity of $122.8 million, which included $62.4 million in common stock and $62.5 million in retained earnings.

The Company paid cash dividends totaling $2.4 million, or $0.20 per share in 2006. In the first quarter of 2007, the Company increased its quarterly dividend from $0.05 per share to $0.06 per share. 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 February 7, 2006, the Board of Directors authorized the repurchase of up to $10 million of common stock through June 30, 2007. 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 intangible assets, and add the unrealized net losses (after tax adjustments) on securities available for sale and accumulated net losses on cash flow hedges, which are carried at fair market value. Our Tier 2 Capital includes the amount of trust preferred securities not includible in Tier 1 Capital, and the allowances for loan losses and off balance sheet credit losses.

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

(Dollars in thousands)		**2006**		**December 31, 2005**		**2004**
Capital components:						
Tier 1 Capital	$	147,600	$	133,715	$	121,096
Tier 2 Capital		9,756		10,427		11,623
Total risk-based capital	$	157,356	$	144,142	$	132,719
Risk-weighted assets	$	855,715	$	941,567	$	929,241
Average assets (regulatory purposes)	$	1,087,502	$	1,157,704	$	1,112,526

				Minimum Regulatory Requirements
Capital ratios:				
Total risk-based capital	18.4%	15.3%	14.3%	8.00%
Tier 1 risk-based capital	17.3%	14.2%	13.0%	4.00%
Leverage (1)	13.6%	11.6%	10.9%	4.00%

(1) Tier 1 capital divided by average assets (excluding goodwill).

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 December 31, 2006. The risk-based and leverage capital ratios are defined in Item 1 - *Business - Supervision and Regulation - HBC* on page 8.

At December 31, 2006, 2005 and 2004, the Company s capital met all minimum regulatory requirements. As of December 31, 2006, 2005 and 2004, management believes that HBC was considered well capitalized under the regulatory framework for prompt corrective action.

Mandatory Redeemable Cumulative Trust Preferred Securities.

To enhance regulatory capital and to provide liquidity, the Company, through unconsolidated subsidiary grantor trusts, issued the following mandatorily redeemable cumulative trust preferred securities of subsidiary grantor trusts: In the first quarter of 2000, the Company issued $7 million aggregate principal amount of 10.875% subordinated debentures due on March 8, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2000, the Company issued $7 million aggregate principal amount of 10.60% subordinated debentures due on September 7, 2030 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2001, the Company issued $5 million aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on July 31, 2031 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. In the third quarter of 2002, the Company issued $4 million aggregate principal amount of Floating Rate Junior Subordinated Deferrable Interest Debentures due on September 26, 2032 to a subsidiary trust, which in turn issued a similar amount of trust preferred securities. Under applicable regulatory guidelines, the trust preferred securities currently qualify as Tier I capital. The subsidiary trusts are not consolidated in the Company s consolidated financial statements and the subordinated debt payable to the subsidiary grantor trusts is recorded as debt of the Company to the related trusts. See Footnote 6 the Consolidated Financial Statements.

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

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

The principal objective of interest rate risk management (often referred to as asset/liability management) is to manage the financial components of the Company in a manner that will optimize the risk/reward equation for earnings and capital in relation to changing interest rates. The Company s exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee (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 in order to simulate the effects of potential interest rate changes on the Company s net interest margin, and to calculate the estimated fair values of the Company s financial instruments under different interest rate scenarios. The program imports current balances, interest rates, maturity dates and repricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company s interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Company s investment, loan, deposit and borrowed funds portfolios. These rate projections can be shocked (an immediate and parallel change in all base rates, up or down), ramped (an incremental increase or decrease in rates over a specified time period), based on current trends and econometric models or economic conditions stable (unchanged from current actual levels).

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 December 31, 2006, it was estimated that the Company s MV would increase 17.16% in the event of a 200 basis point increase in market interest rates. The Company s MV at the same date would decrease 24.76% in the event of a 200 basis point decrease in market interest rates.

Presented below, as of December 31, 2006 and 2005, 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:

(Dollars in thousands)	2006				2005			
	$ Change in Market Value	% Change in Market Value	Market Value as a % of Present Value of Assets		$ Change in Market Value	% Change in Market Value	Market Value as a % of Present Value of Assets	
			MV Ratio	Change (bp)			MV Ratio	Change (bp)
Change in rates								
+ 200 bp	$ 31,607	17.16%	21.1%	309	$ 41,217	23.41%	19.6%	371
0 bp	$	0.00%	18.0%	0	$	0.00%	15.9%	0
- 200 bp	$ (45,606)	-24.76%	13.6%	(446)	$ (61,175)	-34.74%	10.4%	(551)

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 Statement 123R on January 1, 2006, and elected the modified prospective method, 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 beginning on page 44.

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 as discussed in Note 3 to the consolidated financial statements.

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 Payments, 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 fiscal 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 1 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 of when options vest.

Our accounting for stock options is disclosed primarily in Notes 1 and 8 to the consolidated financial statements.

ITEM 7A - 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 December 31, 2006, 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 Item above. See page 53.

ITEM 8 - FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements and reports of Independent Registered Public Accounting Firms are set forth on pages 61 through 99.

ITEM 9 CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

None

ITEM 9A 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 December 31, 2006. 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 December 31, 2006, the period covered by this report on Form 10-K/A.

Management s Annual Report on Internal Control over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. As defined in Rule 13a-15(f) under the Exchange Act, internal control over financial reporting is a process designed by, or under the supervision of, a company s principal executive and principal financial officers and effected by a company s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. It includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of a company;

- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of a company are being made only in accordance with authorizations of management and the board of directors of the company; and

- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of a company s assets that could have a material effect on its financial statements.

Because of the inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company s management has used the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) to evaluate the effectiveness of the Company s internal control over financial reporting. Management has selected the COSO framework for its evaluation as it is a control framework recognized by the SEC and the Public Company Accounting Oversight Board, that is free from bias, permits reasonably consistent qualitative and quantitative measurement of the Company s internal controls, is sufficiently complete so that relevant controls are not omitted and is relevant to an evaluation of internal controls over financial reporting.

Based on our assessment, management has concluded that our internal control over financial reporting, based on criteria established in Internal Control-Integrated Framework issued by COSO was effective as of December 31, 2006.

The Company s independent registered public accounting firm has issued an attestation report on the management s assessment of the Company s internal controls over financial reporting.

Inherent Limitations on Effectiveness of Controls

The Company s management, including the CEO and CFO, does not expect that our disclosure controls or our internal control over financial reporting will prevent or detect all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system s objectives will be met. The design of a control system must reflect the fact that there are resource constraints, and the benefits of

controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

ITEM 9B OTHER INFORMATION

None

PART III

ITEM 10 DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNACE

Information required by this item will be contained in our Definitive Proxy Statement for our 2007 Annual Meeting of Shareholders, to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2006. Such Information is incorporated herein by reference.

We have adopted a code of ethics that applies to our Chief Executive Officer, Chief Financial Officer, and to all of our other officers, directors, employees and agents. The code of ethics is available at the Corporate Governance section of the Investor Relations page on our website at www.heritagecommercecorp.com. We intend to disclose future amendments to, or waivers from, certain provisions of our code of ethics on the above website within four business days following the date of such amendment or waiver.

ITEM 11 - EXECUTIVE COMPENSATION

Information required by this item will be contained in our Definitive Proxy Statement for our 2007 Annual Meeting of Shareholders, to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2006. Such information is incorporated herein by reference.

ITEM 12 - SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information required by this item will be contained in our Definitive Proxy Statement for our 2007 Annual Meeting of Shareholders, to be filed pursuant to Regulation 14A with the Securities and Exchange Commission within 120 days of December 31, 2006. Such information is incorporated herein by reference.

ITEM 13 - CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information required by this item will be contained in our Definitive Proxy Statement for our 2007 Annual Meeting of Shareholders, to be filed pursuant to Regulation 14A, with the Securities and Exchange Commission within 120 days of December 31, 2006. Such information is incorporated herein by reference.

ITEM 14 PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information required by this item will be contained in our Definitive Proxy Statement for our 2007 Annual Meeting of Shareholders, to be filed pursuant to Regulation 14A, with the Securities and Exchange Commission within 120 days of December 31, 2006. Such information is incorporated herein by reference.

PART IV

ITEM 15 - EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) FINANCIAL STATEMENTS

The Financial Statements of the Company and the independent registered public accounting firms reports are set forth on pages 61 through 99.

(a)(2) FINANCIAL STATEMENT SCHEDULES

All schedules to the Financial Statements are omitted because of the absence of the conditions under which they are required or because the required information is included in the Financial Statements or accompanying notes.

(a)(3) EXHIBITS

The exhibit list required by this Item is incorporated by reference to the Exhibit Index included in this report.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report on Form 10-K/A to be signed on its behalf by the undersigned thereunto duly authorized.

	Heritage Commerce Corp	
	BY:	/s/ Walter T. Kaczmarek
DATE: February 22, 2008		Walter T. Kaczmarek
		Chief Executive Officer

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated:

Signature	Title	Date
/s/ FRANK BISCEGLIA Frank Bisceglia	Director	February 22, 2008
/s/ JAMES BLAIR James Blair	Director	February 22, 2008
/s/ JACK CONNER Jack Conner	Director and Chairman of the Board	February 22, 2008
/s/ WILLIAM DEL BIAGGIO, JR. William Del Biaggio, Jr	Director	February 22, 2008
/s/ WALTER T. KACZMAREK Walter T. Kaczmarek	Director and Chief Executive Officer and President (Principle Executive Officer)	February 22, 2008
/s/ LAWRENCE D. MCGOVERN Lawrence D. McGovern	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	February 22, 2008
/s/ ROBERT MOLES Robert Moles	Director	February 22, 2008
/s/ LON NORMANDIN Lon Normandin	Director	February 22, 2008

/s/ JACK PECKHAM Jack Peckham	Director	February 22, 2008
/s/ HUMPHREY POLANEN Humphrey Polanen	Director	February 22, 2008
/s/ CHARLES TOENISKOETTER Charles Toeniskoetter	Director	February 22, 2008
/s/ RANSON WEBSTER Ranson Webster	Director	February 22, 2008
/s/ JOHN J. HOUNSLOW John J. Hounslow	Director	February 22, 2008
/s/ MARK LEFANOWICZ Mark Lefanowicz	Director	February 22, 2008

HERITAGE COMMERCE CORP

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DECEMBER 31, 2006

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors

Heritage Commerce Corp

San Jose, California

We have audited the accompanying consolidated balance sheets of Heritage Commerce Corp as of December 31, 2006 and 2005, and the related consolidated income statements, statements of changes in shareholders equity and statements of cash flows for the years then ended. We also have audited management s assessment, included in *Management s Annual Report on Internal Control over Financial Reporting* in Item 9A of Form 10-K/A, that Heritage Commerce Corp maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Heritage Commerce Corp s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management s assessment, and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heritage Commerce Corp as of December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management s assessment that Heritage Commerce Corp maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects,

based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, Heritage Commerce Corp

maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

As discussed in Note 17, the accompanying consolidated balance sheets and statements of cash flows have been restated.

/s/ Crowe Chizek and Company LLP
Oak Brook, Illinois
March 15, 2007 (February 22, 2008 as to the effects of the restatement discussed in Note 17)

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Heritage Commerce Corp:

We have audited the accompanying consolidated statements of income, changes in shareholders equity, and cash flows of Heritage Commerce Corp and subsidiary (the Company) for the year ended December 31, 2004. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the results of operations and cash flows of Heritage Commerce Corp and subsidiary for the year ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 17, the accompanying consolidated statement of cash flows for the year ended December 31, 2004 has been restated.

/s/ Deloitte & Touche LLP

San Francisco, California
March 30, 2005 (February 22, 2008 as to the effects of the restatement discussed in Note 17)

HERITAGE COMMERCE CORP

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)	December 31, 2006 (As Restated See Note 17)	December 31, 2005 (As Restated See Note 17)
Assets		
Cash and due from banks	$ 34,285	$ 35,560
Federal funds sold	15,100	62,900
Total cash and cash equivalents	49,385	98,460
Securities available for sale, at fair value	172,298	198,495
Loans held for sale, at lower of cost or market	33,752	78,800
Loans, net of deferred costs	709,236	680,125
Allowance for loan losses	(9,279)	(10,224)
Loans, net	699,957	669,901
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	6,113	5,859
Company owned life insurance	36,174	34,735
Premises and equipment, net	2,539	2,541
Accrued interest receivable and other assets	36,920	41,718
Total assets	$ 1,037,138	$ 1,130,509
Liabilities and Shareholders Equity		
Liabilities:		
Deposits		
Demand, noninterest bearing	$ 231,841	$ 248,009
Demand, interest bearing	133,413	157,330
Savings and money market	307,266	353,798
Time deposits, under $100	31,097	35,209
Time deposits, $100 and over	111,017	109,373
Brokered deposits, $100 and over	31,959	36,040
Total deposits	846,593	939,759
Notes payable to subsidiary grantor trusts	23,702	23,702
Securities sold under agreement to repurchase	21,800	32,700
Accrued interest payable and other liabilities	22,223	22,731
Total liabilities	914,318	1,018,892
Shareholders equity:		
Preferred stock, no par value; 10,000,000 shares authorized; none outstanding	0	0
Common Stock, no par value; 30,000,000 shares authorized; shares outstanding: 11,656,943 in 2006 and 11,807,649 in 2005	62,363	67,602
Retained earnings	62,452	47,539
Unearned restricted stock award	0	(803)
Accumulated other comprehensive loss	(1,995)	(2,721)
Total shareholders equity	122,820	111,617
Total liabilities and shareholders equity	$ 1,037,138	$ 1,130,509

See notes to consolidated financial statements

HERITAGE COMMERCE CORP

CONSOLIDATED INCOME STATEMENTS

(Dollars in thousands, except per share data)	Years Ended December 31, 2006	2005	2004
Interest income:			
Loans, including fees	$ 61,859	$ 54,643	$ 43,593
Securities, taxable	7,614	7,042	6,418
Securities, non-taxable	182	205	297
Interest bearing deposits in other financial institutions	132	97	14
Federal funds sold	3,170	1,769	363
Total interest income	72,957	63,756	50,685
Interest expense:			
Deposits	19,588	12,849	6,798
Notes payable to subsidiary grantor trusts	2,310	2,136	1,958
Repurchase agreements and other	627	922	892
Total interest expense	22,525	15,907	9,648
Net interest income before provison for loan losses	50,432	47,849	41,037
Provision for loan losses	(503)	313	666
Net interest income after provision for loan losses	50,935	47,536	40,371
Noninterest income:			
Gain on sale of loans	4,008	2,871	3,052
Servicing income	1,860	1,838	1,498
Increase in cash surrender value of life insurance	1,439	1,236	1,031
Service charges and fees on deposit accounts	1,335	1,468	1,799
Gain on sale of leased equipment	0	299	0
Equipment leasing	0	131	871
Gain on sales of securities available-for-sale	0	0	476
Mortgage brokerage fees	0	0	168
Other	1,198	1,580	1,649
Total noninterest income	9,840	9,423	10,544
Noninterest expense:			
Salaries and employee benefits	19,414	19,845	20,189
Occupancy	3,110	3,254	3,670
Professional fees	1,688	1,617	2,656
Advertising and promotion	1,064	985	1,090
Client services	1,000	1,404	1,044
Low income housing investment losses and writedowns	995	957	878
Data processing	806	661	722
Furniture and equipment	517	734	921
Retirement plan expense	352	619	306
Operational losses	9	37	2,219
Amortization of leased equipment	0	334	1,016
Other	5,313	4,786	4,527
Total noninterest expense	34,268	35,233	39,238
Income before income taxes	26,507	21,726	11,677
Income tax expense	9,237	7,280	3,199
Net income	$ 17,270	$ 14,446	$ 8,478
Earnings per share:			

Basic	$ 1.47	$ 1.22	$ 0.73
Diluted	$ 1.44	$ 1.19	$ 0.71

See notes to consolidated financial statements

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

YEARS ENDED DECEMBER 31, 2006, 2005, AND 2004

(Dollars in thousands, except shares)	Common Stock Shares	Common Stock Amount	Unearned Restricted Stock Award	Unallocated ESOP Shares	Accumlated Other Comprehensive Income (Loss)	Retained Earnings	Total Shareholders, Equity	Comprehensive Income
Balance, January 1, 2004	11,381,037	$ 65,234	$	$ (443)	$ 79	$ 24,615	$ 89,485	
Net Income						8,478	8,478	$ 8,478
Net change in unrealized gain/loss on securities available-for-sale and Interest-Only strips, net of reclassification adjustment and deferred income taxes					(684)		(684)	(684)
Increase in pension liability, net of deferred income taxes					(1,125)		(1,125)	(1,125)
Total comprehensive income								$ 6,669
ESOP shares released		296		250			546	
Common stock repurchased	(263,728)	(4,214)					(4,214)	
Stock options exercised, including related tax benefits	552,528	6,093					6,093	
Balance, December 31, 2004	11,669,837	67,409		(193)	(1,730)	33,093	98,579	
Net Income						14,446	14,446	$ 14,446
Net change in unrealized gain/loss on securities available-for-sale and Interest-Only strips, net of reclassification adjustment and deferred income taxes					(664)		(664)	(664)
Increase in pension liability, net of deferred income taxes					(327)			