HERITAGE COMMERCE CORP
Form 10-Q
November 06, 2013

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended September 30, 2013

OR

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

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

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

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

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

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

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

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

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

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

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

The Registrant had 26,345,329 shares of Common Stock outstanding on October 30, 2013.

HERITAGE COMMERCE CORP
QUARTERLY REPORT ON FORM 10-Q
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Cautionary Note Regarding Forward-Looking Statements

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

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

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

A prolonged slowdown in construction activity;

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

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

Changes in consumer spending, borrowings and saving habits;

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

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

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

- The ability to increase market share and control expenses; and

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

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

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Part I FINANCIAL INFORMATION

ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HERITAGE COMMERCE CORP

CONSOLIDATED BALANCE SHEETS (Unaudited)

	September 30, 2013	December 31, 2012
	(Dollars in thousands)	
Assets		
Cash and due from banks	$ 32,571	$ 16,520
Interest-bearing deposits in other financial institutions	9,327	357,045
Total cash and cash equivalents	41,898	373,565
Securities available-for-sale, at fair value	280,471	367,912
Securities held-to-maturity, at amortized cost (fair value of $80,505 at September 30, 2013 and $50,964 at December 31, 2012)	89,732	51,472
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	6,975	3,409
Loans, net of deferred fees	893,052	812,313
Allowance for loan losses	(19,342)	(19,027)
Loans, net	873,710	793,286
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	10,792	10,728
Company owned life insurance	49,598	48,358
Premises and equipment, net	7,390	7,469
Intangible assets	1,645	2,000
Accrued interest receivable and other assets	38,424	35,113
Total assets	$ 1,400,635	$ 1,693,312
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	$ 409,269	$ 727,684
Demand, interest-bearing	178,783	155,951
Savings and money market	312,991	272,047
Time deposits under $100	22,029	25,157
Time deposits $100 and over	195,321	190,502
Time deposits brokered	62,833	97,807
CDARS money market and time deposits	14,311	10,220
Total deposits	1,195,537	1,479,368
Subordinated debt		9,279
Accrued interest payable and other liabilities	34,613	34,924
Total liabilities	1,230,150	1,523,571
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at September 30, 2013 and December 31, 2012 (liquidation preference of $21,004 at September 30, 2013 and December 31, 2012)	19,519	19,519
Common stock, no par value; 60,000,000 shares authorized; 26,341,021 shares issued and outstanding at September 30, 2013 and 26,322,147 shares issued and outstanding at December 31, 2012	132,298	131,820
Retained earnings	22,949	15,721

Accumulated other comprehensive (loss) income		(4,281)		2,681
Total shareholders' equity		170,485		169,741
Total liabilities and shareholders' equity	$	1,400,635	$	1,693,312

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	**2012**	**2013**	**2012**
	(Dollars in thousands, except per share data)			
Interest income:				
Loans, including fees	$ 10,733	$ 10,146	$ 30,874	$ 30,754
Securities, taxable	2,247	2,681	7,107	8,753
Securities, non-taxable	436	5	1,042	5
Interest-bearing deposits in other financial institutions	42	30	140	95
Total interest income	13,458	12,862	39,163	39,607
Interest expense:				
Deposits	575	690	1,796	2,144
Subordinated debt	51	346	229	1,293
Short-term borrowings	1	2	1	3
Total interest expense	627	1,038	2,026	3,440
Net interest income before provision for loan losses	12,831	11,824	37,137	36,167
Provision (credit) for loan losses	(534)	1,200	(804)	2,115
Net interest income after provision for loan losses	13,365	10,624	37,941	34,052
Noninterest income:				
Service charges and fees on deposit accounts	645	575	1,840	1,766
Increase in cash surrender value of life insurance	414	434	1,240	1,292
Servicing income	331	429	1,081	1,336
Gain on sales of SBA loans	103	221	373	633
Gain on sales of securities		1,105	38	1,164
Other	245	184	744	570
Total noninterest income	1,738	2,948	5,316	6,761
Noninterest expense:				
Salaries and employee benefits	5,772	5,336	17,647	16,380
Occupancy and equipment	986	1,041	3,082	3,004
Professional fees	602	587	1,984	2,268
Software subscriptions	381	275	966	878
Low income housing investment losses	320	264	930	795
Data processing	259	252	838	744
Insurance expense	255	198	763	645
FDIC deposit insurance premiums	200	248	666	675
Correspondent bank charges	170	156	513	455
Foreclosed assets, net	8	9	(242)	229
Subordinated debt redemption charges		601	167	601
Other	1,427	1,180	4,236	3,783
Total noninterest expense	10,380	10,147	31,550	30,457
Income before income taxes	4,723	3,425	11,707	10,356
Income tax expense	1,510	939	3,521	3,116

Net income		3,213		2,486		8,186		7,240
Dividends and discount accretion on preferred stock								(1,206)
Net income available to common shareholders	$	3,213	$	2,486	$	8,186	$	6,034
Earnings per common share:								
Basic	$	0.10	$	0.08	$	0.26	$	0.19
Diluted	$	0.10	$	0.08	$	0.26	$	0.19
Dividends per share	$	0.03	$		$	0.03	$	

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Net income	$ 3,213	$ 2,486	$ 8,186	$ 7,240
Other comprehensive income (loss):				
Change in net unrealized holding gains (losses) on available-for-sale securities and I/O strips	675	3,045	(12,033)	6,814
Deferred income taxes	(284)	(1,279)	5,053	(2,862)
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(14)	870	(42)	870
Deferred income taxes	6	(365)	18	(365)
Reclassification adjustment for gains realized in income		(1,105)	(38)	(1,164)
Deferred income taxes		464	16	489
Change in unrealized gains (losses) on securities and I/O strips, net of deferred income taxes	383	1,630	(7,026)	3,782
Change in net pension and other benefit plan liability adjustment	44	38	109	134
Deferred income taxes	(18)	(16)	(45)	(56)
Change in pension and other benefit plan liability, net of deferred income taxes	26	22	64	78
Other comprehensive income (loss)	409	1,652	(6,962)	3,860
Total comprehensive income	$ 3,622	$ 4,138	$ 1,224	$ 11,100

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

Nine Months Ended September 30, 2013 and 2012

	Preferred Stock			Common Stock			Accumulated Other Comprehensive	Total
	Shares	Amount	Discount	Shares	Amount	Retained Earnings	Income/ (Loss)	Shareholders' Equity
	(Dollars in thousands, except share data)							
Balance, January 1, 2012	61,004	$ 59,365	$ (833)	26,295,001	$ 131,172	$ 7,172	$ 955	$ 197,831
Net income						7,240		7,240
Other comprehensive income							3,860	3,860
Repurchase of Series A preferred stock	(40,000)	(40,000)						(40,000)
Series A preferred stock capitalized offering costs		154				(154)		
Issuance (forfeitures) of restricted stock awards, net				21,500				
Amortization of restricted stock awards, net of forfeitures and taxes					86			86
Cash dividends accrued on Series A preferred stock						(373)		(373)
Accretion of discount on Series A preferred stock			833			(833)		
Stock option expense, net of fortfeitures and taxes					340			340
Stock options exercised				3,683	17			17
Balance, September 30, 2012	21,004	$ 19,519	$	26,320,184	$ 131,615	$ 13,052	$ 4,815	$ 169,001
Balance, January 1, 2013	21,004	$ 19,519	$	26,322,147	$ 131,820	$ 15,721	$ 2,681	$ 169,741
Net income						8,186		8,186
Other comprehensive loss							(6,962)	(6,962)
Issuance of restricted stock awards				10,000				
Repurchase of warrant					(140)			(140)
Amortization of restricted stock awards, net of forfeitures and taxes					153			153
Stock option expense, net of forfeitures and taxes					430			430
Cash dividend declared on common stock, $0.03 per share						(958)		(958)
Stock options exercised				8,874	35			35
Balance, September 30, 2013	21,004	$ 19,519	$	26,341,021	$ 132,298	$ 22,949	$ (4,281)	$ 170,485

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 8,186	$ 7,240
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	1,894	1,781
Gain on sales of securities available-for-sale	(38)	(1,164)
Gain on sales of SBA loans	(373)	(633)
Proceeds from sale of SBA loans originated for sale	5,128	8,792
Net change in SBA loans originated for sale	(8,341)	(8,882)
Write-downs on other loans held-for-sale		87
Provision (credit) for loan losses	(804)	2,115
Increase in cash surrender value of life insurance	(1,240)	(1,292)
Depreciation and amortization	539	569
Amortization of intangible assets	355	368
Gains on sale of foreclosed assets, net	(231)	(135)
Stock option expense, net	430	340
Amortization of restricted stock awards, net	153	86
Effect of changes in:		
Accrued interest receivable and other assets	999	1,871
Accrued interest payable and other liabilities	1,395	481
Net cash provided by operating activities	8,052	11,624
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(8,334)	(148,107)
Purchase of securities held-to-maturity	(43,324)	(6,821)
Maturities/paydowns/calls of securities available-for-sale	55,206	82,766
Maturities/paydowns/calls of securities held-to-maturity	3,310	
Proceeds from sale of securities available-for-sale	26,944	26,357
Net change in loans	(79,633)	(40,360)
Change in Federal Home Loan Bank and Federal Reserve Bank stock	(64)	(976)
Purchase of premises and equipment	(460)	(216)
Proceeds from sale of foreclosed assets	809	574
Proceeds from sale of other loans transferred to held-for-sale		220
Purchases of company owned life insurance		(249)
Net cash used in investing activities	(45,546)	(86,812)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	(283,831)	88,605
Repurchase of warrant	(140)	
Repayment of preferred stock		(40,000)
Redemption of subordinated debt	(9,279)	(14,423)
Payment of cash dividends Series A preferred stock		(373)
Payment of cash dividends common stock	(958)	
Exercise of stock options	35	17
Net cash provided by (used in) financing activities	(294,173)	33,826
Net decrease in cash and cash equivalents	(331,667)	(41,362)
Cash and cash equivalents, beginning of period	373,565	72,872
Cash and cash equivalents, end of period	$ 41,898	$ 31,510

Supplemental disclosures of cash flow information:				
Interest paid	$	2,110	$	3,927
Income taxes paid		3,365		2,230
Supplemental schedule of non-cash investing activity:				
Due to broker for securities purchased	$	1,901	$	9,353
Loans transferred to foreclosed assets		33		1,973
Transfer securities from available-for-sale to held-to-maturity				15,498
Transfer of loans held-for-sale to loan portfolio		20		87

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company" or "HCC") and its wholly owned subsidiary, Heritage Bank of Commerce (the "Bank" or "HBC"), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes that were included in the Company's Form 10-K for the year ended December 31, 2012. The Company also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III, which were Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities. During the third quarter of 2012 the Company dissolved the Heritage Statutory Trust I and the Heritage Capital Trust I. During the third quarter of 2013 the Company dissolved the Heritage Statutory Trust II and the Heritage Commerce Corp Statutory Trust III.

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

In management's opinion, all adjustments necessary for a fair presentation of these consolidated financial statements have been included and are of a normal and recurring nature. All intercompany transactions and balances have been eliminated.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ significantly from these estimates.

The results for the three and nine months ended September 30, 2013 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2013.

Reclassifications

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

Adoption of New Accounting Standards

In February 2013, the FASB issued an accounting standards update with the primary objective of improving the reporting of reclassifications out of accumulated other comprehensive income ("AOCI"). For significant reclassifications that are required to be presented in their entirety in net income in the same reporting period by U.S. GAAP, the update requires an entity to report the effect of these

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

1) Basis of Presentation (Continued)

reclassifications out of AOCI on the respective line items of net income either on the face of the statement that reports net income or in the financial statement notes. For AOCI items that are not reclassified to net income in their entirety, presentation in the financial statement notes is required. This update is effective for public companies for fiscal years and interim periods within those years beginning after December 15, 2012, or the first quarter of 2013 for calendar year-end companies, and is required to be applied prospectively. The effect of adopting this standard did not have a material effect on the Company's operating results or financial condition, but the additional disclosures are included in Note 3.

2) Earnings Per Share

Basic earnings per common share is computed by dividing net income, less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is convertible into 5,601,000 shares of common stock when transferred in accordance with its terms. The Series C Preferred Stock participate in the earnings of the Company and, therefore, the shares issued on the conversion of the Series C Preferred Stock are considered outstanding under the two-class method of computing basic earnings per common share during periods of earnings. Diluted earnings per share reflect potential dilution from outstanding stock options and common stock warrant, using the treasury stock method. The common stock warrant was antidilutive for the nine months ended September 30, 2013 and for the three months and nine months ended September 30, 2012. The Company repurchased the warrant for $140,000 in the second quarter of 2013. A reconciliation of these factors used in computing basic and diluted earnings per common share is as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Net income available to common shareholders	$ 3,213	$ 2,486	$ 8,186	$ 6,034
Less: net income allocated to Series C Preferred Stock	563	436	1,436	1,059
Net income allocated to common shareholders	$ 2,650	$ 2,050	$ 6,750	$ 4,975
Weighted average common shares outstanding for basic earnings per common share	26,340,080	26,312,263	26,335,222	26,297,359
Dilutive effect of stock options oustanding, using the the treasury stock method	46,969	30,776	46,742	27,096
Shares used in computing diluted earnings per common share	26,387,049	26,343,039	26,381,965	26,324,455
Basic earnings per share	$ 0.10	$ 0.08	$ 0.26	$ 0.19
Diluted earnings per share	$ 0.10	$ 0.08	$ 0.26	$ 0.19

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

3) Accumulated Other Comprehensive Income ("AOCI")

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

	For the Three Months Ended September 30, 2013 and 2012			
	Unrealized Gains (Losses) on Available-for-Sale Securities and I/O Strips(1)	Unamortized Unrealized Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity(1)	Defined Benefit Pension Plan Items(1)	Total(1)
	(Dollars in thousands)			
Beginning balance July 1, 2013, net of taxes	$ 494	$ 481	$ (5,665)	$ (4,690)
Other comprehensive income (loss) before reclassification, net of taxes	391		(16)	375
Amounts reclassified from other comprehensive income (loss), net of taxes		(8)	42	34
Net current period other comprensive income (loss), net of taxes	391	(8)	26	409
Ending balance September 30, 2013, net of taxes	$ 885	$ 473	$ (5,639)	$ (4,281)
Beginning balance July 1, 2012, net of taxes	$ 8,362	$	$ (5,199)	$ 3,163
Other comprehensive income (loss) before reclassification, net of taxes	1,766		(19)	1,747
Amounts reclassified from other comprehensive income (loss), net of taxes	(641)	505	41	(95)
Net current period other comprensive income, net of taxes	1,125	505	22	1,652
Ending balance September 30, 2012, net of taxes	$ 9,487	$ 505	$ (5,177)	$ 4,815

(1) Amounts in parenthesis indicate debits.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

3) Accumulated Other Comprehensive Income ("AOCI") (Continued)

	For the Nine Months Ended September 30, 2013 and 2012			
	Unrealized Gains (Losses) on Available-for-Sale Securities and I/O Strips(1)	Unamortized Unrealized Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity(1)	Defined Benefit Pension Plan Items(1)	Total(1)
	(Dollars in thousands)			
Beginning balance January 1, 2013, net of taxes	$ 7,887	$ 497	$ (5,703)	$ 2,681
Other comprehensive (loss) before reclassification, net of taxes	(6,980)		(63)	(7,043)
Amounts reclassified from other comprehensive income (loss), net of taxes	(22)	(24)	127	81
Net current period other comprensive income (loss), net of taxes	(7,002)	(24)	64	(6,962)
Ending balance September 30, 2013, net of taxes	$ 885	$ 473	$ (5,639)	$ (4,281)
Beginning balance January 1, 2012, net of taxes	$ 6,210	$	$ (5,255)	$ 955
Other comprehensive income (loss) before reclassification, net of taxes	3,952		(44)	3,908
Amounts reclassified from other comprehensive income (loss), net of taxes	(675)	505	122	(48)
Net current period other comprensive income, net of taxes	3,277	505	78	3,860
Ending balance September 30, 2012, net of taxes	$ 9,487	$ 505	$ (5,177)	$ 4,815

(1) Amounts in parenthesis indicate debits.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

3) Accumulated Other Comprehensive Income ("AOCI") (Continued)

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Three Months Ended September 30, 2013	2012	Affected Line Item Where Net Income is Presented
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	$	$ 1,105	Realized gains on sale of securities
		(464)	Income tax expense
		641	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	14	(870)	Interest income on taxable securities
	(6)	365	Income tax expense
	8	(505)	Net of tax
Amortization of defined benefit pension plan items(2)			
Prior service cost		(7)	
Actuarial losses	(73)	(63)	
	(73)	(70)	Income before income tax
	31	29	Income tax expense
	(42)	(41)	Net of tax
Total reclassification for the period	$ (34)	$ 95	

(1) Amounts in parenthesis indicate debits.

(2) This AOCI component is included in the computation of net periodic benefit cost (see Note 7 Benefit Plans).

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

3) Accumulated Other Comprehensive Income ("AOCI") (Continued)

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Nine Months Ended September 30, 2013	2012	Affected Line Item Where Net Income is Presented
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	$ 38	$ 1,164	Realized gains on sale of securities
	(16)	(489)	Income tax expense
	22	675	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	42	(870)	Interest income on taxable securities
	(18)	365	Income tax expense
	24	(505)	Net of tax
Amortization of defined benefit pension plan items(2)			
Prior service cost		(21)	
Actuarial losses	(219)	(189)	
	(219)	(210)	Income before income tax
	92	88	Income tax expense
	(127)	(122)	Net of tax
Total reclassification for the period	$ (81)	$ 48	

(1) Amounts in parenthesis indicate debits.

(2) This AOCI component is included in the computation of net periodic benefit cost (see Note 7 Benefit Plans).

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

4) Securities

The amortized cost and estimated fair value of securities at September 30, 2013 and December 31, 2012 were as follows:

September 30, 2013	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	$ 210,728	$ 4,193	$ (2,407)	$ 212,514
Corporate bonds	49,040	446	(1,739)	47,747
Trust preferred securities	20,829	75	(694)	20,210
Total	$ 280,597	$ 4,714	$ (4,840)	$ 280,471
Securities held-to-maturity:				
Agency mortgage-backed securities	$ 13,229	$	$ (316)	$ 12,913
Municipals tax exempt	76,503	82	(8,993)	67,592
Total	$ 89,732	$ 82	$ (9,309)	$ 80,505

December 31, 2012	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	$ 281,598	$ 9,668	$ (22)	$ 291,244
Corporate bonds	53,739	1,849		55,588
Trust preferred securities	20,769	375	(64)	21,080
Total	$ 356,106	$ 11,892	$ (86)	$ 367,912
Securities held-to-maturity:				
Agency mortgage-backed securities	$ 16,659	$ 2	$ (177)	$ 16,484
Municipals tax exempt	34,813	80	(413)	34,480
Total	$ 51,472	$ 82	$ (590)	$ 50,964

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

4) Securities (Continued)

Securities with unrealized losses at September 30, 2013 and December 31, 2012, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

September 30, 2013	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Losses	12 Months or More Fair Value	12 Months or More Unrealized Losses	Total Fair Value	Total Unrealized Losses
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	$ 62,034	$ (2,254)	$ 2,731	$ (153)	$ 64,765	$ (2,407)
Corporate bonds	35,744	(1,739)			35,744	(1,739)
Trust preferred securities	14,306	(694)			14,306	(694)
Total	$ 112,084	$ (4,687)	$ 2,731	$ (153)	$ 114,815	$ (4,840)
Securities held-to-maturity:						
Agency mortgage-backed securities	$ 4,380	$ (145)	$ 8,213	$ (172)	$ 12,593	$ (317)
Municipals Tax Exempt	59,680	(8,992)			59,680	(8,992)
Total	$ 64,060	$ (9,137)	$ 8,213	$ (172)	$ 72,273	$ (9,309)

December 31, 2012	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Losses	12 Months or More Fair Value	12 Months or More Unrealized Losses	Total Fair Value	Total Unrealized Losses
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	$ 6,226	$ (22)	$	$	$ 6,226	$ (22)
Trust preferred securities	5,705	(64)			5,705	(64)
Total	$ 11,931	$ (86)	$	$	$ 11,931	$ (86)
Securities held-to-maturity:						
Agency mortgage-backed securities	$ 15,789	$ (177)	$	$	$ 15,789	$ (177)
Municipals Tax Exempt	21,985	(413)			21,985	(413)
Total	$ 37,774	$ (590)	$	$	$ 37,774	$ (590)

There were no holdings of securities of any one issuer, other than the U.S. Government and its sponsored entities, in an amount greater than 10% of shareholders' equity. At September 30, 2013, the Company held 380 securities (160 available for sale and 220 held to maturity), of which 237 had fair values below amortized cost. Unrealized losses were due to higher interest rates. At September 30, 2013, there were

$2.7 million of agency mortgage-backed securities available-for-sale, and $8.2 million of agency mortgage-backed securities held-to-maturity carried with an unrealized loss for over 12 months. The total unrealized loss for securities over 12 months was $325,000 at September 30, 2013. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The Company does not consider these securities to be other than temporarily impaired at September 30, 2013.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

4) Securities (Continued)

At December 31, 2012, the Company held 269 securities (168 available-for-sale and 101 held-to-maturity), of which 70 had fair values below amortized cost. No securities had been carried with an unrealized loss for over 12 months. The Company does not consider these securities to be other-than-temporarily impaired at December 31, 2012.

The proceeds from sales of securities and the resulting gains and losses are listed below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	**2012**	**2013**	**2012**
	(Dollars in thousands)			
Proceeds	$	$ 24,077	$ 26,944	$ 26,357
Gross gains		1,105	310	1,164
Gross losses			(272)	

The amortized cost and estimated fair values of securities as of September 30, 2013, by contractual maturity, are shown below. The expected maturities will differ from contractual maturities if borrowers have the right to call or pre-pay obligations with or without call or pre-payment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	**Estimated Fair Value**
	(Dollars in thousands)	
Due after one through five years	$ 2,028	$ 2,124
Due after five through ten years	47,012	45,623
Due after ten years	20,829	20,210
Agency mortgage-backed securities	210,728	212,514
Total	$ 280,597	$ 280,471

	Held-to-maturity	
	Amortized Cost	**Estimated Fair Value**
	(Dollars in thousands)	
Due after five through ten years	$ 2,751	$ 2,658
Due after ten years	73,752	64,935
Agency mortgage-backed securities	13,229	12,912
Total	$ 89,732	$ 80,505

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

5) Loans

Loans were as follows:

	September 30, 2013	December 31, 2012
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	$ 410,933	$ 375,469
Real estate:		
Commercial and residential	387,777	354,934
Land and construction	30,780	22,352
Home equity	50,100	43,865
Consumer	13,712	15,714
Loans	893,302	812,334
Deferred loan origination fees, net	(250)	(21)
Loans, net of deferred fees	893,052	812,313
Allowance for loan losses	(19,342)	(19,027)
Loans, net	$ 873,710	$ 793,286

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

	Three Months Ended September 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,811	$ 6,388	$ 143	$ 19,342
Charge-offs	(254)	(40)		(294)
Recoveries	820	7	1	828
Net (charge-offs)/recoveries	566	(33)	1	534
Provision (credit) for loan losses	(10)	(461)	(63)	(534)
Balance, end of period	$ 13,367	$ 5,894	$ 81	$ 19,342

	Three Months Ended September 30, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 13,378	$ 6,539	$ 106	$ 20,023
Charge-offs	(916)	(1,334)		(2,250)
Recoveries	149	2		151

Net (charge-offs)/recoveries		(767)		(1,332)				(2,099)
Provision (credit) for loan losses		661		525		14		1,200
Balance, end of period	$	13,272	$	5,732	$	120	$	19,124

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

5) Loans (Continued)

	Nine Months Ended September 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,866	$ 6,034	$ 127	$ 19,027
Charge-offs	(1,213)	(96)		(1,309)
Recoveries	2,158	269	1	2,428
Net (charge-offs)/recoveries	945	173	1	1,119
Provision (credit) for loan losses	(444)	(313)	(47)	(804)
Balance, end of period	$ 13,367	$ 5,894	$ 81	$ 19,342

	Nine Months Ended September 30, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 13,215	$ 7,338	$ 147	$ 20,700
Charge-offs	(3,106)	(1,480)		(4,586)
Recoveries	670	225		895
Net (charge-offs)/recoveries	(2,436)	(1,255)		(3,691)
Provision (credit) for loan losses	2,493	(351)	(27)	2,115
Balance, end of period	$ 13,272	$ 5,732	$ 120	$ 19,124

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

	September 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 2,426	$ 827	$ 25	$ 3,278
Collectively evaluated for impairment	10,941	5,067	56	16,064
Total allowance balance	$ 13,367	$ 5,894	$ 81	$ 19,342
Loans:				
Individually evaluated for impairment	$ 5,736	$ 9,259	$ 132	$ 15,127

Collectively evaluated for impairment	405,197	459,398	13,580	878,175
Total loan balance	$ 410,933	$ 468,657	$ 13,712	$ 893,302

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

5) Loans (Continued)

	December 31, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 1,963	$ 760	$ 17	$ 2,740
Collectively evaluated for impairment	10,903	5,274	110	16,287
Total allowance balance	$ 12,866	$ 6,034	$ 127	$ 19,027
Loans:				
Individually evaluated for impairment	$ 10,161	$ 9,336	$ 147	$ 19,644
Collectively evaluated for impairment	365,308	411,815	15,567	792,690
Total loan balance	$ 375,469	$ 421,151	$ 15,714	$ 812,334

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of September 30, 2013 and December 31, 2012. The recorded investment included in the following table represents loan principal net of any partial charge-offs recognized on the loans. The unpaid principal balance represents the recorded balance prior to any partial charge-offs.

	September 30, 2013			December 31, 2012		
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
	(Dollars in thousands)					
With no related allowance recorded:						
Commercial	$ 682	$ 598	$	$ 7,829	$ 6,978	$
Real estate:						
Commercial and residential	3,452	3,452		2,755	2,741	
Land and construction	1,794	1,794		2,310	2,223	
Home Equity	2,059	2,059		2,141	2,141	
Total with no related allowance recorded	7,987	7,903		15,035	14,083	
With an allowance recorded:						
Commercial	5,207	5,138	2,426	3,678	3,182	1,963
Real estate:						
Commercial and residential	1,543	1,543	463	3,183	1,937	465
Land and construction	55	55	8			
Home Equity	356	356	356	295	295	295
Consumer	132	132	25	147	147	17
Total with an allowance recorded	7,293	7,224	3,278	7,303	5,561	2,740

Total	$	15,280	$	15,127	$	3,278	$	22,338	$	19,644	$	2,740

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

5) Loans (Continued)

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

	Three Months Ended September 30, 2013					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 5,539	$ 5,032	$ 1,989	$ 2,393	$ 133	$ 15,086
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

	Three Months Ended September 30, 2012					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 11,138	$ 3,329	$ 2,228	$ 546	$ 156	$ 17,397
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

	Nine Months Ended September 30, 2013					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 7,342	$ 5,061	$ 2,095	$ 2,414	$ 138	$ 17,050
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

	Nine Months Ended September 30, 2012					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					

Average of impaired loans during the period	$	11,294	$	3,051	$	2,615	$	281	$	83	$	17,324
Interest income during impairment	$		$	1	$	14	$		$		$	15
Cash-basis interest earned	$		$	1	$	14	$		$		$	15

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

5) Loans (Continued)

Nonperforming loans include both smaller dollar balance homogenous loans that are collectively evaluated for impairment and individually classified loans. Nonperforming loans were as follows at period-end:

	September 30, 2013	September 30, 2012	December 31, 2012
	(Dollars in thousands)		
Nonaccrual loans held-for-investment	$ 14,615	$ 17,396	$ 17,335
Restructured and loans over 90 days past due and still accruing	502	1,722	859
Total nonperforming loans	$ 15,117	$ 19,118	$ 18,194
Other restructured loans	$ 10	$ 704	$ 1,450
Impaired loans, excluding loans held-for-sale	$ 15,127	$ 19,822	$ 19,644

The following table presents the nonperforming loans by class as of September 30, 2013 and December 31, 2012:

	September 30, 2013			December 31, 2012		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	$ 5,224	$ 502	$ 5,726	$ 7,852	$ 859	$ 8,711
Real estate:						
Commercial and residential	4,995		4,995	4,676		4,676
Land and construction	1,849		1,849	2,223		2,223
Home equity	2,415		2,415	2,437		2,437
Consumer	132		132	147		147
Total	$ 14,615	$ 502	$ 15,117	$ 17,335	$ 859	$ 18,194

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

5) Loans (Continued)

The following table presents the aging of past due loans as of September 30, 2013 by class of loans:

	September 30, 2013					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 1,098	$ 716	$ 2,690	$ 4,504	$ 406,429	$ 410,933
Real estate:						
Commercial and residential	134		1,548	1,682	386,095	387,777
Land and construction			55	55	30,725	30,780
Home equity			447	447	49,653	50,100
Consumer			97	97	13,615	13,712
Total	$ 1,232	$ 716	$ 4,837	$ 6,785	$ 886,517	$ 893,302

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

	December 31, 2012					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 1,699	$ 355	$ 5,120	$ 7,174	$ 368,295	$ 375,469
Real estate:						
Commercial and residential	1,603		3,290	4,893	350,041	354,934
Land and construction			78	78	22,274	22,352
Home equity	742		2,045	2,787	41,078	43,865
Consumer					15,714	15,714
Total	$ 4,044	$ 355	$ 10,533	$ 14,932	$ 797,402	$ 812,334

Past due loans 30 days or greater totaled $6,785,000 and $14,932,000 at September 30, 2013 and December 31, 2012, respectively, of which $5,603,000 and $12,020,000 were on nonaccrual. At September 30, 2013, there were also $9,012,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2012, there were also $5,315,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

5) Loans (Continued)

Credit Quality Indicators

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

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

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

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

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

Loss. Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for loan losses. Therefore, there is no balance to report at September 30, 2013 or December 31, 2012.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

5) Loans (Continued)

The following table provides a summary of the loan portfolio by loan type and credit quality classification at September 30, 2013 and December 31, 2012:

	September 30, 2013			December 31, 2012		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)					
Commercial	$ 396,102	$ 14,831	$ 410,933	$ 355,440	$ 20,029	$ 375,469
Real estate:						
Commercial and residential	380,470	7,307	387,777	345,045	9,889	354,934
Land and construction	28,931	1,849	30,780	18,858	3,494	22,352
Home equity	47,364	2,736	50,100	41,187	2,678	43,865
Consumer	13,354	358	13,712	15,321	393	15,714
Total	$ 866,221	$ 27,081	$ 893,302	$ 775,851	$ 36,483	$ 812,334

Classified loans in the table above are gross of Small Business Administration ("SBA") guarantees.

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

The recorded investment of troubled debt restructurings at September 30, 2013 was $2,045,000, which included $1,534,000 of nonaccrual loans and $511,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2012 was $4,107,000, which included $1,798,000 of nonaccrual loans and $2,309,000 of accruing loans. Approximately $722,000 and $1,152,000 in specific reserves were established with respect to these loans as of September 30, 2013 and December 31, 2012, respectively. As of September 30, 2013 and December 31, 2012, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

There were no new loans modified as troubled debt restructurings during the three month period ended September 30, 2013. The following table presents loans by class modified as troubled debt restructurings during the three month period ended September 30, 2012:

	During the Three Months Ended September 30, 2012		
Troubled Debt Restructurings:	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
	(Dollars in thousands)		
Consumer	2	$ 91	$ 91
Total	2	$ 91	$ 91

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

5) Loans (Continued)

The troubled debt restructurings described above increased the allowance for loan losses by $21,000 through the allocation of specific reserves, and resulted in no net charge-offs during the three month period ended September 30, 2012.

There were no new loans modified as troubled debt restructurings during the nine month period ended September 30, 2013. The following table presents loans by class modified as troubled debt restructurings during the nine month period ended September 30, 2012:

	During the Nine Months Ended September 30, 2012		
Troubled Debt Restructurings:	**Number of Contracts**	**Pre-modification Outstanding Recorded Investment**	**Post-modification Outstanding Recorded Investment**
	(Dollars in thousands)		
Commercial	3	$ 163	$ 163
Consumer	1	111	111
Total	4	$ 274	$ 274

The troubled debt restructurings described above increased the allowance for loan losses by $59,000 through the allocation of specific reserves, and resulted in no net charge-offs during the nine month period ended September 30, 2012.

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the three and nine month periods ended September 30, 2013 and 2012.

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

6) Income Taxes

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

Realization of the Company's deferred tax assets is primarily dependent upon the Company generating sufficient taxable income to obtain benefit from the reversal of net deductible temporary differences and utilization of tax credit carryforwards and the net operating loss carryforwards for Federal and California state income tax purposes. The amount of deferred tax assets considered realizable is subject to adjustment in future periods based on estimates of future taxable income. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

6) Income Taxes (Continued)

realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.

The Company had net deferred tax assets of $23,673,000, and $19,264,000, at September 30, 2013, and December 31, 2012, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at September 30, 2013 and December 31, 2012 will be fully realized in future years.

7) Benefit Plans

Supplemental Retirement Plan

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(Dollars in thousands)			
Components of net periodic benefit cost:				
Service cost	$ 303	$ 294	$ 909	$ 882
Interest cost	196	193	588	579
Amortization of prior service cost		7		21
Amortization of net actuarial loss	73	63	219	189
Net periodic benefit cost	$ 572	$ 557	$ 1,716	$ 1,671

Split-Dollar Life Insurance Benefit Plan

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

	September 30, 2013	December 31, 2012
	(Dollars in thousands)	
Change in projected benefit obligation		
Projected benefit obligation at beginning of year	$ 4,717	$ 4,525
Interest cost	133	185
Actuarial gain		7
Projected benefit obligation at end of period	$ 4,850	$ 4,717

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

8) Preferred Stock

Series A Preferred Stock

On November 21, 2008, the Company issued 40,000 shares of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") to the U.S. Treasury under the terms of the U.S. Treasury Capital Purchase Program for $40,000,000 with a liquidation preference of $1,000 per share. On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve Board, the Company repurchased all of the Series A Preferred Stock and paid all of the related accrued and unpaid dividends. HCC used available cash and proceeds from a $30,000,000 distribution approved by the California Department of Financial Institutions from HBC to HCC. The repurchase of the Series A Preferred Stock accelerated the accretion of the remaining issuance discount on the Series A Preferred Stock. Total dividends and discount accretion on Preferred Stock, including accelerated accretion of approximately $765,000, reduced net income available to common shareholders by $1,206,000 in the first quarter of 2012. On June 12, 2013, the Company completed the repurchase of the common stock warrant issued to the U.S. Department of the Treasury on November 21, 2008, which was exercisable into 462,963 shares of common stock at an exercise price of $12.96. The Company repurchased the warrant for $140,000.

Series C Preferred Stock

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into 5,601,000 shares of common stock at a conversion price of $3.75 per share upon a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of $1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

9) Fair Value

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

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

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

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

9) Fair Value (Continued)

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

Financial Assets and Liabilities Measured on a Recurring Basis

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

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

		Fair Value Measurements Using		
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(Dollars in thousands)		
Assets at September 30, 2013:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 212,514		$ 212,514	
Corporate bonds	47,747		47,747	
Trust preferred securities	20,210		20,210	
I/O strip receivables	1,647		1,647	
Assets at December 31, 2012:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 291,244		$ 291,244	
Corporate bonds	55,588		55,588	
Trust preferred securities	21,080		21,080	
I/O strip receivables	1,786		1,786	

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

Assets and Liabilities Measured on a Non-Recurring Basis

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

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. The appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

9) Fair Value (Continued)

routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

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

		Fair Value Measurements Using		
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Dollars in thousands)			
Assets at September 30, 2013:				
Impaired loans held-for-investment:				
Commercial	$ 3,012			$ 3,012
Real estate:				
Commercial and residential	2,984			2,984
Land and construction	1,363			1,363
Consumer	107			107
	$ 7,466			$ 7,466
Foreclosed assets:				
Commercial	$ 29			$ 29
Land and construction	602			602
	$ 631			$ 631
Assets at December 31, 2012:				
Impaired loans held-for-investment:				
Commercial	$ 3,645			$ 3,645
Real estate:				
Commercial and residential	3,674			3,674
Land and construction	1,723			1,723
Consumer	130			130
	$ 9,172			$ 9,172
Foreclosed assets:				
Commercial	$ 83			$ 83
Land and construction	1,187			1,187

$ 1,270	$ 1,270

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

9) Fair Value (Continued)

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

	September 30, 2013	December 31, 2012
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	$ 10,744	$ 11,912
Book value of impaired loans held-for-investment carried at cost	4,383	7,732
Total impaired loans held-for-investment	$ 15,127	$ 19,644
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	$ 10,744	$ 11,912
Specific valuation allowance	(3,278)	(2,740)
Impaired loans held-for-investment carried at fair value, net	$ 7,466	$ 9,172

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were $15,127,000 at September 30, 2013, after partial charge-offs of $153,000 in the first nine months of 2013. In addition, these loans had a specific valuation allowance of $3,278,000 at September 30, 2013. Impaired loans held-for-investment totaling $10,744,000 at September 30, 2013 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining $4,383,000 of impaired loans were carried at cost at September 30, 2013, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during the first nine months of 2013 on impaired loans held-for-investment carried at fair value at September 30, 2013 resulted in an additional provision for loan losses of $1,072,000.

Foreclosed assets measured at fair value less costs to sell, had a carrying amount of $631,000, with no valuation allowance at September 30, 2013.

Impaired loans held-for-investment of $19,644,000 at December 31, 2012, after partial charge-offs of $2,694,000 in 2012, were analyzed for additional impairment primarily using the fair value of collateral. In addition, these loans had a specific valuation allowance of $2,740,000 at December 31, 2012. Impaired loans held-for-investment totaling $11,912,000 at December 31, 2012 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining $7,732,000 of impaired loans were carried at cost at December 31, 2012, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during 2012 on impaired loans held-for-investment carried at fair value at December 31, 2012 resulted in an additional provision for loan losses of $3,856,000.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

9) Fair Value (Continued)

At December 31, 2012, foreclosed assets had a carrying amount of $1,270,000, with no valuation allowance at December 31, 2012.

The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at the periods indicated:

	September 30, 2013			
	Fair Value	**Valuation Techniques**	**Unobservable Inputs**	**Range (Weighted Average)**
	(Dollars in thousands)			
Impaired loans held-for-investment:				
Commercial	$ 3,012	Market Approach	Discount adjustment for differences between comparable sales	2% to 3% (2%)
Real estate:				
Commercial and residential	2,984	Market Approach	Discount adjustment for differences between comparable sales	1% to 15% (1%)
Land and construction	1,363	Market Approach	Discount adjustment for differences between comparable sales	1% to 2% (2%)
Foreclosed assets:				
Land and construction	602	Market Approach	Discount adjustment for differences between comparable sales	1% to 16% (7%)

	December 31, 2012			
	Fair Value	**Valuation Techniques**	**Unobservable Inputs**	**Range (Weighted Average)**
	(Dollars in thousands)			
Impaired loans held-for-investment:				
Commercial	$ 3,645	Market Approach	Discount adjustment for differences between	0% to 4% (1%)

			comparable sales	
Real estate:				
Commercial and residential	3,674	Market Approach	Discount adjustment for differences between comparable sales	0% to 13% (1%)
Land and construction	1,723	Market Approach	Discount adjustment for differences between comparable sales	1% to 4% (2%)
Foreclosed assets:				
Land and construction	1,187	Market Approach	Discount adjustment for differences between comparable sales	0% to 23% (6%)

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

9) Fair Value (Continued)

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

The carrying amounts and estimated fair values of financial instruments at September 30, 2013 are as follows:

		Estimated Fair Value			
	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	(Dollars in thousands)				
Assets:					
Cash and cash equivalents	$ 41,898	$ 41,898	$	$	$ 41,898
Securities available-for-sale	280,471		280,471		280,471
Securities held-to-maturity	89,732		80,505		80,505
Loans (including loans held-for-sale), net	880,685		6,975	868,811	875,786
FHLB and FRB stock	10,792				N/A
Accrued interest receivable	4,302		1,883	2,419	4,302
Loan servicing rights and I/O strips receivables	2,212		4,236		4,236
Liabilities:					
Time deposits	$ 286,558	$	$ 286,988	$	$ 286,988
Other deposits	908,979		908,979		908,979
Accrued interest payable	193		193		193

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

9) Fair Value (Continued)

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2012:

		Estimated Fair Value			
	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	(Dollars in thousands)				
Assets:					
Cash and cash equivalents	$ 373,565	$ 373,565	$	$	$ 373,565
Securities available-for-sale	367,912		367,912		367,912
Securities held-to-maturity	51,472		50,964		50,964
Loans (including loans held-for-sale), net	796,695		3,409	793,911	797,320
FHLB and FRB stock	10,728				N/A
Accrued interest receivable	3,773		1,514	2,259	3,773
Loan servicing rights and I/O strips receivables	2,495		4,715		4,715
Liabilities:					
Time deposits	$ 318,664	$	$ 319,476	$	$ 319,476
Other deposits	1,160,704		1,160,704		1,160,704
Subordinated debt	9,279			5,400	5,400
Accrued interest payable	277		277		277

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

Cash and Cash Equivalents

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

Loans

The carrying amounts of loans held-for-sale approximate fair value resulting in a Level 2 classification.

Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

9) Fair Value (Continued)

cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

FHLB and FRB Stock

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

Accrued Interest Receivable/Payable

The carrying amounts of accrued interest approximate fair value resulting in a Level 2 or Level 3 classification.

Deposits

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

Subordinated Debt

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

Off-balance Sheet Instruments

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

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering for sale at one time the entire holdings of a particular financial instrument. Fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

10) Equity Plan

The Company has maintained an Amended and Restated 2004 Equity Plan (the "2004 Plan") for directors, officers, and key employees. The Equity Plan provides for the grant of incentive and non-qualified stock options and restricted stock. The Equity Plan provides that the option price for both incentive and non-qualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally, options vest over four years. All options expire no later than ten years from the date of grant. The 2004 Plan was terminated on May 23, 2013. On May 23, 2013, the Company's shareholders approved the 2013 Equity Incentive Plan (the "2013 Plan") for equity awards including stock options and restricted stock for directors, officers, and key employees. As of September 30, 2013, there were no equity awards issued and 1,750,000 shares available for issuance under the 2013 Plan.

Stock option activity under the 2004 Plan is as follows:

Total Stock Options	**Number of Shares**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Life (Years)**	**Aggregate Intrinsic Value**
Outstanding at January 1, 2013	1,314,347	$ 12.90		
Granted	272,050	$ 6.57		
Exercised	(8,874)	$ 3.94		
Forfeited or expired	(44,102)	$ 12.31		
Outstanding at September 30, 2013	1,533,421	$ 11.84	5.8	$ 1,542,000
Vested or expected to vest	1,456,750		5.8	$ 1,465,000
Exercisable at September 30, 2013	1,066,878		4.5	$ 862,000

As of September 30, 2013, there was $1,749,000 of total unrecognized compensation cost related to nonvested stock options granted under the 2004 Plan. That cost is expected to be recognized over a weighted-average period of approximately 3.0 years.

Restricted stock activity under the 2004 Plan is as follows:

Total Restricted Stock Award	**Number of Shares**	**Weighted Average Grant Date Fair Value**
Nonvested shares at January 1, 2013	88,000	$ 5.74
Granted	10,000	$ 6.51
Vested	(40,000)	$ 5.16
Nonvested shares at September 30, 2013	58,000	$ 6.28

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

10) Equity Plan (Continued)

As of September 30, 2013, there was $153,000 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the 2004 Plan. The cost is expected to be recognized over a weighted-average period of approximately 1 year.

11) Subordinated Debt

The Company has supported its growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt issued to the trusts is senior to the outstanding shares of common stock and Series C Preferred Stock. As a result, payments must be made on the subordinated debt before any dividends can be paid on the common stock and Series C Preferred Stock. Under the terms of the subordinated debt, the Company may defer interest payments for up to five years. Interest payments on the subordinated notes payable to the Company's subsidiary grantor Trusts are deductible for tax purposes. The subordinated debt is not registered with the Securities and Exchange Commission. For regulatory reporting purposes, the subordinated debt qualified for Tier 1 capital treatment at September 30, 2012, and December 31, 2012.

During the third quarter of 2012, the Company redeemed its 10.875% fixed-rate subordinated debentures in the amount of $7,000,000 issued to Heritage Capital Trust I (and the related premium cost of $304,500) and the Company's 10.600% fixed-rate subordinated debentures in the amount of $7,000,000 issued to Heritage Statutory Trust I (and the related premium cost of $296,800). The related trust securities issued by Capital Trust I and Statutory Trust I were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved. A $15,000,000 distribution from the Bank to the HCC provided the cash for the redemption. The Company incurred a charge of $601,300 in 2012 for the early payoff premium on the redemption of the subordinated debt.

During the third quarter of 2013, the Company completed the redemption of its $9,000,000 floating-rate subordinated debt. The Company redeemed its Floating Rate Junior Subordinated Debentures due July 31, 2031 in the amount of $5,000,000 issued to Heritage Statutory Trust II and the Company's Floating Rate Junior Subordinated Debentures due September 26, 2032, in the amount of $4,000,000 issued to Heritage Statutory Trust III (collectively referred to as the "Floating Rate Sub Debt"). The Company used available cash and proceeds from a $9,000,000 distribution from the Bank for the redemption. The Company incurred a total charge of $167,000 in the second quarter of 2013, representing the agency origination fees associated with the Floating Rate Sub Debt.

12) Loss Contingencies

The Company's policy is to accrue for legal costs associated with both asserted and unasserted claims when it is probable that such costs will be incurred and such costs can be reasonably estimated. The Company had previously accrued for such costs associated with an unasserted claim arising from an apparent transfer of funds for personal use by an authorized signatory of a customer. The litigation is in the very early stages and the Company intends to vigorously defend the litigation. At this time it is not possible to determine the amount of the loss, if any, arising from the claim in excess of the legal expenses expected to be incurred in defense of the litigation.

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2013

(Unaudited)

13) Subsequent Event

On October 24, 2013, the Company announced that its Board of Directors declared a $0.03 per share quarterly cash dividend to holders of common stock and Series C preferred stock (on an as converted basis). The dividend will be paid on November 25, 2013, to shareholders of record on November 7, 2013.

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

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

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are discussed in our Form 10-K for the year ended December 31, 2012. There are no changes to these policies as of September 30, 2013.

EXECUTIVE SUMMARY

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

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

Performance Overview

For the three months ended September 30, 2013, net income was $3.2 million, or $0.10 per average diluted common share, compared to $2.5 million, or $0.08 per average diluted common share, for the three months ended September 30, 2012. The Company's annualized return on average assets was 0.90% and annualized return on average equity was 7.58% for the third quarter of 2013, compared to 0.73% and 5.91%, respectively, a year ago.

For the nine months ended September 30, 2013, net income available to common shareholders was $8.2 million, or $0.26 per average diluted common share, an increase from $6.0 million, or $0.19 per average diluted common share, for the nine months ended September 30, 2012. In the first quarter of 2012, the Company redeemed its $40 million of Series A Fixed Rate Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") issued to the U.S. Treasury Department under the TARP Capital Purchase Program, and recorded the final payment for dividends and discount accretion on its Series A Preferred Stock, which totaled $1.2 million. The Company's annualized return on average assets was 0.78% and annualized return on average equity was 6.44% for the first nine months of 2013, compared to 0.72% and 5.59%, respectively, a year ago.

Late in the fourth quarter of 2012, the Company received short-term demand deposits in the amount of $467.5 million from one customer for specific transactions. Of this amount, $195.6 million was subsequently withdrawn, for a net outstanding balance of $271.9 million at December 31, 2012. The

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outstanding balance of the short-term demand deposits was $144,000 at September 30, 2013. Because of the short-term nature of these funds, the excess liquidity was placed in low-interest earning deposits at The Federal Reserve Bank at December 31, 2012.

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

The net interest margin increased 17 basis points to 3.94% for the third quarter of 2013, compared to 3.77% for the third quarter of 2012, primarily due to a lower cost of funds, higher yields on securities, and a higher average loan balance, partially offset by a lower yield on loans. The net interest margin decreased 8 basis points to 3.85% for the nine months ended September 30, 2013, compared to 3.93% for the nine months ended September 30, 2012, primarily as a result of a lower yield on loans, and a higher average balance of short-term deposits at the Federal Reserve Bank, partially offset by a higher average balance of loans and a lower cost of funds.

Net interest income increased 9% to $12.8 million for the third quarter of 2013, compared to $11.8 million for the third quarter of 2012, primarily due to a higher average volume of loans. For the nine months ended September 30, 2013, net interest income increased 3% to $37.1 million, compared to $36.2 million for the nine months ended September 30, 2012.

Asset quality and net recoveries for the first nine months of 2013 resulted in a credit to the provision for loan losses of $534,000 for the third quarter of 2013 and a credit to the provision for loan losses of $804,000 for the first nine months of 2013. The provision for loan losses was $1.2 million for the third quarter of 2012 and $2.1 million for the first nine months of 2012.

Noninterest income was $1.7 million for the third quarter of 2013, compared to $2.9 million for the third quarter of 2012. Noninterest income was $5.3 million for the first nine months of 2013, compared to $6.8 million for the first nine months of 2012. Noninterest income was lower in the third quarter and first nine months of 2013, compared to the same periods in 2012, primarily due to a lower gain on sales of securities. There was no gain on the sale of securities for the third quarter of 2013, and a $38,000 gain on sale of securities for the first nine months of 2013, compared to $1.1 million and $1.2 million, respectively, for the comparable periods a year ago.

Noninterest expense was $10.4 million for the third quarter of 2013, compared to $10.1 million for the third quarter of 2012. For the nine months ended September 30, 2013, noninterest expense was $31.6 million, compared to $30.5 million for the nine months ended September 30, 2012. The increase in noninterest expense for the third quarter and first nine months of 2013, compared to the same periods a year ago, was primarily due to increased salaries and employee benefits expense due to annual salary increases and hiring of additional lending relationship officers.

The efficiency ratio was 71.25% for the third quarter of 2013, compared to 68.69% for the third quarter of 2012. The efficiency ratio for the nine months ended September 30, 2013 was 74.32%, compared to 70.95% for the nine months ended September 30, 2012.

Income tax expense for the quarter ended September 30, 2013 was $1.5 million, compared to $939,000 for the third quarter of 2012. The effective tax rate for the third quarter of 2013 was 32%, compared to 27% for the third quarter of 2012. For the first nine months of 2013, income tax expense was $3.5 million, compared to $3.1 million for the first nine months of 2012. The effective tax rate for the nine months ended September 30, 2013 and 2012 was 30%.

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

Cash, Federal funds sold, interest-bearing deposits in other financial institutions and securities available-for-sale decreased 27% to $322.4 million at September 30, 2013, from $442.3 million at

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September 30, 2012, and decreased 57% from $741.5 million at December 31, 2012. Excluding the short term deposits at the Federal Reserve Bank offsetting the short term demand deposits from one customer of $271.9 million at December 31, 2012, total cash, Federal funds sold, interest bearing deposits in other financial institutions and securities available for sale was $469.6 million at December 31, 2012.

Securities held-to-maturity, at amortized cost, were $89.7 million at September 30, 2013, compared to $25.6 million at September 30, 2012, and $51.5 million at December 31, 2012.

Total loans, excluding loans held-for-sale, increased $93.7 million, or 12%, to $893.1 million at September 30, 2013, compared to $799.4 million at September 30, 2012, and increased $80.7 million, or 10%, from $812.3 million at December 31, 2012.

Nonperforming assets were $15.7 million, or 1.12% of total assets at September 30, 2013, compared to $22.0 million, or 1.62% of total assets at September 30, 2012, and $19.5 million, or 1.15% of total assets at December 31, 2012.

Classified assets, net of Small Business Administration ("SBA") guarantees, decreased 49% to $23.3 million at September 30, 2013 from $46.0 million at September 30, 2012, and decreased 37% from $36.8 million at December 31, 2012.

Net recoveries were $534,000 for the third quarter of 2013, compared to net charge-offs $2.1 million for the third quarter of 2012.

The allowance for loan losses at September 30, 2013 was $19.3 million, or 2.17% of total loans, representing 127.95% of nonperforming loans. The allowance for loan losses at September 30, 2012 was $19.1 million, or 2.39% of total loans, representing 100.03% of nonperforming loans. The allowance for loan losses at December 31, 2012 was $19.0 million, or 2.34% of total loans, representing 104.58% of nonperforming loans.

Deposits (excluding all time deposits, CDARS deposits, and the short term demand deposits from one customer of $271.9 million at December 31, 2012) increased to $901.0 million at September 30, 2013, an increase of $54.2 million, or 6% from $846.8 million at September 30, 2012, and increased $17.2 million, or 2%, from $883.8 million at December 31, 2012.

The ratio of noncore funding (which consists of time deposits $100,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase and short-term borrowings) to total assets was 19.45% at September 30, 2013, compared to 19.52% at September 30, 2012, and 17.63% at December 31, 2012. The ratio of noncore funding to total assets was 21.00% at December 31, 2012, excluding the short term deposits of $271.9 million at the Federal Reserve Bank offsetting the short term demand deposits from one customer.

The loan to deposit ratio was 74.70% at September 30, 2013, compared to 70.24% at September 30, 2012, and 54.91% at December 31, 2012. The loan to deposit ratio was 67.27% at December 31, 2012, excluding the $271.9 million of short-term demand deposits from one customer.

During the third quarter of 2013, the Company completed the redemption of its $9 million floating-rate subordinated debt, which will save approximately $360,000 of interest expense on an annual basis.

The Company announced it will pay a quarterly cash dividend of $0.03 per share in the fourth quarter of 2013 to holders of common stock and Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"), on an as converted basis.

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Capital ratios exceed regulatory requirements for a well-capitalized financial institution, both on a consolidated basis and at the bank level at September 30, 2013:

Capital Ratios	Heritage Commerce Corp	Heritage Bank of Commerce	Well-Capitalized Financial Institution Regulatory Guidelines
Total Risk-Based	15.2%	13.7%	10.0%
Tier 1 Risk-Based	14.0%	12.5%	6.0%
Leverage	11.5%	10.2%	5.0%

Deposits

The composition and cost of the Company's deposit base are important in analyzing the Company's net interest margin and balance sheet liquidity characteristics. Except for brokered and State of California time deposits, the Company's depositors are generally located in its primary market area. Depending on loan demand and other funding requirements, the Company also obtains deposits from wholesale sources including deposit brokers. The Company had $62.8 million in brokered deposits at September 30, 2013, compared to $89.2 million at September 30, 2012, and $97.8 million at December 31, 2012. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators decreased to $13.6 million at September 30, 2013, compared to $29.2 million at September 30, 2012, and $21.4 million at December 31, 2012. Certificates of deposit from the State of California totaled $98.0 million at September 30, 2013, compared to $65.0 million at September 30, 2012, and $85.0 million at December 31, 2012. Total deposits at September 30, 2013 were $1.20 billion, compared to $1.14 billion at September 30, 2012 and $1.48 billion at December 31, 2012. Deposits (excluding all time deposits, CDARS deposits, and the short-term demand deposits from one customer of $271.9 million at December 31, 2012) increased to $901.0 million at September 30, 2013, an increase of $54.2 million, or 6% from $846.8 million at September 30, 2012, and increased $17.2 million, or 2%, from $883.8 million at December 31, 2012. The Company has a policy to monitor all deposits that may be sensitive to interest rate changes to help assure that liquidity risk does not become excessive due to concentrations.

HBC is a member of the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program allows customers with deposits in excess of FDIC insured limits to obtain coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through this program are considered brokered deposits under regulatory guidelines. Deposits in the CDARS program totaled $14.3 million at September 30, 2013, compared to $5.1 million at September 30, 2012, and $10.2 million at December 31, 2012.

Liquidity

Our liquidity position refers to our ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely fashion. At September 30, 2013, we had $41.9 million in cash and cash equivalents and approximately $409.7 million in available borrowing capacity from various sources including the Federal Home Loan Bank ("FHLB"), the Federal Reserve Bank of San Francisco ("FRB"), and Federal funds facilities with several financial institutions. The Company also had $233.6 million in unpledged securities available at September 30, 2013. Our loan to deposit ratio increased to 74.70% at September 30, 2013, compared to 70.24% at September 30, 2012, and increased from 54.91% at December 31, 2012. The loan to deposit ratio was 67.27% at December 31, 2012, excluding the short-term demand deposits of $271.9 million from one customer.

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Lending

Our lending business originates principally through our branch offices located in our primary markets. Total loans, excluding loans held-for-sale, increased 12% to $893.1 million at September 30, 2013, from $799.4 million at September 30, 2012, and increased 10% from $812.3 million at December 31, 2012. The loan portfolio remains well diversified with commercial and industrial ("C&I") loans accounting for 46% of the total loan portfolio at September 30, 2013. Commercial and residential real estate loans accounted for 43% of the total loan portfolio at September 30, 2013, of which 51% were owner-occupied by businesses. Consumer and home equity loans accounted for 8% of the total loan portfolio, and land and construction loans accounted for the remaining 3% of the total loan portfolio at September 30, 2013. The yield on the loan portfolio was 4.85% for the third quarter of 2013, compared to 5.10% for the third quarter of 2012. The yield on the loan portfolio was 4.97% for the nine months ended September 30, 2013, compared to 5.25% for nine months ended September 30, 2012.

Net Interest Income

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

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

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

Management of Credit Risk

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

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increase in the allowance for loan losses would have an adverse effect, which may be material, on our financial condition and results of operation.

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

Noninterest Income

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

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company's performance. Noninterest expense for the third quarter of 2013 increased to $10.4 million, compared to $10.1 million for the same period in 2012. Noninterest expense for the first nine months of 2013 increased to $31.6 million, compared to $30.5 million for the first nine months of 2012. The increase in noninterest expense for the third quarter and first nine months of 2013, compared to the same periods a year ago, was primarily due to increased salaries and employee benefits expense due to annual salary increases and hiring of additional lending relationship officers.

Capital Management

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

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

On June 21, 2010, HCC issued to various institutional investors 53,996 shares of Series B Mandatorily Convertible Cumulative Perpetual Preferred Stock ("Series B Preferred Stock") and 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") for an aggregate purchase price of $75 million. The Series B Preferred Stock was mandatorily convertible into 5,601,000 shares of common stock upon approval by the shareholders at a conversion price of $3.75 per share. The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of $3.75 per share upon both approval by the shareholders and, thereafter, a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. At the Company's Special Meeting of Shareholders held on September 15, 2010, its shareholders approved the issuance of common stock upon the conversion of the Series B Preferred Stock and upon the conversion of the Series C Preferred Stock as required by The NASDAQ Stock Market and California corporate law. As a result, on September 16, 2010, the Series B Preferred Stock was converted into 14,398,992 shares of common stock of HCC and the shares of Series B Preferred Stock ceased to be outstanding. The Series C Preferred Stock remains outstanding until it has been converted into common stock in accordance with its terms. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. Holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock.

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On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve, the Company repurchased all shares of the Series A Preferred Stock and paid the related accrued and unpaid dividends. The repurchase of the Series A Preferred Stock will save $2.0 million in annual dividends. On June 12, 2013, the Company completed the repurchase of the common stock warrant for $140,000.

During the third quarter of 2012, the Company completed the redemption of $14 million fixed-rate subordinated debt, and during the third quarter of 2013, the Company completed the redemption of its remaining $9 million of floating-rate subordinated debt.

RESULTS OF OPERATIONS

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

Net Interest Income and Net Interest Margin

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

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

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Distribution, Rate and Yield

NET INTEREST INCOME AND NET INTEREST MARGIN	For the Three Months Ended September 30, 2013 Average Balance	Interest Income/ Expense	Average Yield/ Rate	For the Three Months Ended September 30, 2012 Average Balance	Interest Income/ Expense	Average Yield/ Rate
	(Dollars in thousands)					
Assets:						
Loans, gross(1)	$ 877,417	$ 10,733	4.85%	$ 791,585	$ 10,146	5.10%
Securities taxable	310,460	2,247	2.87%	408,665	2,681	2.61%
Securities tax exempt(2)	69,866	671	3.81%	1,182	8	2.69%
Federal funds sold and interest-bearing deposits in other financial institutions	58,294	42	0.29%	45,877	30	0.26%
Total interest earning assets(2)	1,316,037	13,693	4.13%	1,247,309	12,865	4.10%
Cash and due from banks	23,724			21,804		
Premises and equipment, net	7,513			7,711		
Intangible assets	1,716			2,201		
Other assets	70,491			80,965		
Total assets	$ 1,419,481					