

HERITAGE COMMERCE CORP
Form 10-Q
November 06, 2015

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

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended September 30, 2015

OR

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

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

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

California
(State or Other Jurisdiction of
Incorporation or Organization)

77-0469558
(I.R.S. Employer Identification No.)

150 Almaden Boulevard, San Jose, California
(Address of Principal Executive Offices)

95113
(Zip Code)

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

N/A

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been

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subject to such filing requirements for the past 90 days. YES NO

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

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

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

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

The Registrant had 32,076,505 shares of Common Stock outstanding on October 26, 2015.

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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, Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended, Rule 3b-6 promulgated thereunder and are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Any statements about our expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and may be forward-looking. These forward-looking statements often can be, but are not always, identified by the use of words such as "assume," "expect," "intend," "plan," "project," "believe," "estimate," "predict," "anticipate," "may," "might," "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:

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;

changes in the financial performance or condition of the Company's customers, or changes in the performance or creditworthiness of our customers' suppliers or other counterparties, which could lead to decreased loan utilization rates, delinquencies, or defaults and could negatively affect our customers' ability to meet certain credit obligations;

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

changes in consumer spending, borrowings and saving habits;

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

our ability to increase market share and control expenses;

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

risks associated with concentrations in real estate related loans;

other-than-temporary impairment charges to our securities portfolio;

an oversupply of inventory and deterioration in values of California commercial real estate;

a prolonged slowdown in construction activity;

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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;

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

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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;

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

the impact of cyber security attacks or other disruptions to the Company's information systems and any resulting compromise of data or disruptions in service;

the effect and uncertain impact on the Company of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the rules and regulations promulgated by supervisory and oversight agencies implementing the new legislation;

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

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

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

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

the successful integration of the business, employees and operations of Focus Business Bank with the Company and our ability to achieve the projected synergies of this acquisition; and

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

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-K. Except as required by applicable laws or regulations, we do not undertake any obligation to update or revise any forward looking statement, whether as a result of new information, future events or otherwise.

Table of Contents**Part I FINANCIAL INFORMATION****ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

HERITAGE COMMERCE CORP
CONSOLIDATED BALANCE SHEETS (Unaudited)

	September 30, 2015	December 31, 2014
	(Dollars in thousands)	
Assets		
Cash and due from banks	\$ 28,691	\$ 23,256
Interest-bearing deposits in other financial institutions	364,247	99,147
Total cash and cash equivalents	392,938	122,403
Securities available-for-sale, at fair value	257,410	206,335
Securities held-to-maturity, at amortized cost (fair value of \$110,035 at September 30, 2015 and \$94,953 at December 31, 2014)	111,004	95,362
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	7,873	1,172
Loans, net of deferred fees	1,332,405	1,088,643
Allowance for loan losses	(18,737)	(18,379)
Loans, net	1,313,668	1,070,264
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	10,630	10,598
Company owned life insurance	59,549	51,257
Premises and equipment, net	7,513	7,451
Goodwill	44,898	13,044
Other intangible assets	8,906	3,276
Accrued interest receivable and other assets	47,818	35,941
Total assets	\$ 2,262,207	\$ 1,617,103
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	\$ 758,440	\$ 517,662
Demand, interest-bearing	440,517	225,821
Savings and money market	490,572	384,644
Time deposits-under \$250	65,626	57,443
Time deposits-\$250 and over	174,703	163,452
Time deposits-brokered	24,150	28,116
CDARS money market and time deposits	8,015	11,248
Total deposits	1,962,023	1,388,386
Other short-term borrowings	1,000	
Accrued interest payable and other liabilities	51,208	44,359
Total liabilities	2,014,231	1,432,745
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		

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Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at September 30, 2015 and December 31, 2014 (liquidation preference of \$21,004 at September 30, 2015 and December 31, 2014)

	19,519	19,519
Common stock, no par value; 60,000,000 shares authorized; 32,076,505 shares issued and outstanding at September 30, 2015 and 26,503,505 shares issued and outstanding at December 31, 2014	193,070	133,676
Retained earnings	37,366	33,014
Accumulated other comprehensive loss	(1,979)	(1,851)
Total shareholders' equity	247,976	184,358
Total liabilities and shareholders' equity	\$ 2,262,207	\$ 1,617,103

See notes to unaudited consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF INCOME (Unaudited)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(Dollars in thousands, except per share data)			
Interest income:				
Loans, including fees	\$ 17,713	\$ 12,077	\$ 48,360	\$ 34,832
Securities, taxable	1,670	1,675	4,828	5,555
Securities, non-taxable	568	506	1,589	1,518
Other investments and interest-bearing deposits in other financial institutions	355	234	1,070	634
Total interest income	20,306	14,492	55,847	42,539
Interest expense:				
Deposits	623	500	1,664	1,527
Short-term borrowings				1
Total interest expense	623	500	1,664	1,528
Net interest income before provision for loan losses	19,683	13,992	54,183	41,011
Provision (credit) for loan losses	(301)	(24)	(339)	(232)
Net interest income after provision for loan losses	19,984	14,016	54,522	41,243
Noninterest income:				
Service charges and fees on deposit accounts	748	631	2,086	1,897
Increase in cash surrender value of life insurance	429	401	1,225	1,196
Servicing income	214	316	819	977
Gain on sales of SBA loans	267	259	660	858
Gain on sales of securities		47		97
Other	408	216	1,366	909
Total noninterest income	2,066	1,870	6,156	5,934
Noninterest expense:				
Salaries and employee benefits	10,358	6,228	26,112	19,290
Occupancy and equipment	1,063	1,055	3,135	2,987
Acquisition and integration related costs	688	234	1,265	287
Professional fees	612	617	946	1,329
Data processing	411	238	950	741
Software subscriptions	292	264	883	702
Insurance expense	273	292	855	830
Correspondent bank charges	269	174	760	539
Amortization of intangible assets	277	115	655	345
Advertising and promotion	262	87	689	504
FDIC deposit insurance premiums	251	220	727	674
Foreclosed assets	113		(93)	(19)
Other	1,550	968	4,428	3,598
Total noninterest expense	16,419	10,492	41,312	31,807
Income before income taxes	5,631	5,394	19,366	15,370

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Income tax expense	2,172	1,969	7,292	5,545
Net income	3,459	3,425	12,074	9,825
Dividends on preferred stock	(448)	(280)	(1,344)	(728)
Net income available to common shareholders	\$ 3,011	\$ 3,145	\$ 10,730	\$ 9,097

Earnings per common share:

Basic	\$ 0.10	\$ 0.11	\$ 0.37	\$ 0.31
Diluted	\$ 0.10	\$ 0.11	\$ 0.36	\$ 0.31

See notes to unaudited consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)**

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2015	2014	2015	2014
	(Dollars in thousands)			
Net income	\$ 3,459	\$ 3,425	\$ 12,074	\$ 9,825
Other comprehensive income (loss):				
Change in net unrealized holding gains (loss) on available-for-sale securities and I/O strips	2,185	(1,166)	(331)	5,717
Deferred income taxes	(912)	487	144	(2,404)
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(13)	(14)	(41)	(41)
Deferred income taxes	5	6	17	17
Reclassification adjustment for gains realized in income		(47)		(97)
Deferred income taxes		20		41
Change in unrealized gains on securities and I/O strips, net of deferred income taxes	1,265	(714)	(211)	3,233
Change in net pension and other benefit plan liabilities adjustment	47	(9)	143	(27)
Deferred income taxes	(20)	3	(60)	11
Change in pension and other benefit plan liabilities net of deferred income taxes	27	(6)	83	(16)
Other comprehensive income (loss)	1,292	(720)	(128)	3,217
Total comprehensive income	\$ 4,751	\$ 2,705	\$ 11,946	\$ 13,042

See notes to unaudited consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)**

Nine Months Ended September 30, 2015 and 2014

	Preferred Stock		Common Stock		Retained Earnings	Accumulated Other Comprehensive Income / (Loss)	Total Shareholders' Equity
	Shares	Amount	Shares	Amount			
(Dollars in thousands, except share data)							
Balance, January 1, 2014	21,004	\$ 19,519	26,350,938	\$ 132,561	\$ 25,345	\$ (4,029)	\$ 173,396
Net income					9,825		9,825
Other comprehensive income						3,217	3,217
Issuance of restricted stock awards, net			15,000				
Amortization of restricted stock awards, net of forfeitures and taxes					(49)		(49)
Cash dividend declared \$0.13 per share					(4,156)		(4,156)
Stock option expense, net of forfeitures and taxes					641		641
Stock options exercised			9,042	42			42
Balance, September 30, 2014	21,004	\$ 19,519	26,374,980	\$ 133,195	\$ 31,014	\$ (812)	\$ 182,916
Balance, January 1, 2015	21,004	\$ 19,519	26,503,505	\$ 133,676	\$ 33,014	\$ (1,851)	\$ 184,358
Net income					12,074		12,074
Other comprehensive loss						(128)	(128)
Issuance of 5,456,713 shares to acquire Focus Business Bank			5,456,713	58,278			58,278
Issuance of restricted stock awards, net			68,855				
Amortization of restricted stock awards, net of forfeitures and taxes					126		126
Cash dividend declared \$0.24 per share					(7,722)		(7,722)
Stock option expense, net of forfeitures and taxes					721		721
Stock options exercised			47,432	269			269
Balance, September 30, 2015	21,004	\$ 19,519	32,076,505	\$ 193,070	\$ 37,366	\$ (1,979)	\$ 247,976

See notes to unaudited consolidated financial statements

Table of Contents**HERITAGE COMMERCE CORP****CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**

	Nine Months Ended September 30,	
	2015	2014
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 12,074	\$ 9,825
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	1,027	859
Gain on sales of securities available-for-sale		(97)
Gain on sales of SBA loans	(660)	(858)
Proceeds from SBA loans originated for sale	8,695	14,439
Net change in SBA loans originated for sale	(10,320)	(11,106)
Credit provision for loan losses	(339)	(232)
Increase in cash surrender value of life insurance	(1,225)	(1,196)
Depreciation and amortization	527	539
Gain on sale of foreclosed assets, net	(106)	
Amortization of intangible assets	655	345
Stock option expense, net	721	641
Amortization of restricted stock awards, net	126	(49)
Gain on proceeds of company owned life insurance		(51)
Effect of changes in:		
Accrued interest receivable and other assets	4,114	(3,730)
Accrued interest payable and other liabilities	687	2,511
Net cash provided by operating activities	15,976	11,840
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(19,953)	(34,775)
Purchase of securities held-to-maturity	(9,138)	(2,347)
Maturities/paydowns/calls of securities available-for-sale	21,705	19,696
Maturities/paydowns/calls of securities held-to-maturity	2,308	2,345
Proceeds from sale of securities available-for-sale		108,603
Net change in loans	(69,160)	(115,043)
Change in Federal Home Loan Bank and Federal Reserve Bank stock	(32)	(66)
Purchase of premises and equipment	(589)	(676)
Proceeds from sale of foreclosed assets	1,571	
Proceeds from company owned life insurance		406
Cash received in bank acquisition, net of cash paid	165,786	
Net cash provided by (used in) investing activities	92,498	(21,857)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	168,514	55,601
Payment of cash dividends	(7,722)	(4,156)
Exercise of stock options	269	42
Other short-term borrowing	1,000	
Net cash provided by financing activities	162,061	51,487
Net decrease in cash and cash equivalents	270,535	41,470
Cash and cash equivalents, beginning of period	122,403	112,605
Cash and cash equivalents, end of period	\$ 392,938	\$ 154,075

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Supplemental disclosures of cash flow information:				
Interest paid	\$	1,650	\$	1,523
Income taxes paid		6,500		3,250
Due to broker for securities purchased, settling after quarter-end		344		
Supplemental schedule of non-cash investing activity:				
Loans transferred to foreclosed assets	\$	1,236	\$	31
Summary of assets acquired and liabilities assumed through acquisition:				
Cash and cash equivalents, net of cash paid	\$	165,786	\$	
Securities available-for-sale		53,940		
Securities held-to-maturity		8,665		
Loans held-for-sale SBA		4,416		
Net loans		172,669		
Goodwill and other intangible assets		38,139		
Corporate owned life insurance		7,067		
Other assets, net		18,700		
Deposits		(405,123)		
Other liabilities		(5,981)		
Common stock issued to acquire Focus Business Bank	\$	58,278	\$	

See notes to unaudited consolidated financial statements

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HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2015

(Unaudited)

1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company" or "HCC") and its wholly owned subsidiary, Heritage Bank of Commerce ("HBC"), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes that were included in the Company's Form 10-K for the year ended December 31, 2014.

The Company acquired BVF/CSNK Acquisition Corp., a Delaware corporation ("BVF/CSNK") on November 1, 2014, the parent company of CSNK Working Capital Finance Corp. dba Bay View Funding ("Bay View Funding"). BVF/CSNK was subsequently merged into Bay View Funding and Bay View Funding became a wholly owned subsidiary of HBC. Bay View Funding's results of operations have been included in the Company's results of operations beginning November 1, 2014.

As discussed in Note 6, the Company completed its acquisition of Focus Business Bank ("Focus") on August 20, 2015. Focus was merged with HBC, with HBC as the surviving bank. Focus's results of operations have been included in the Company's results of operations beginning August 21, 2015.

HBC is a commercial bank serving customers located in Santa Clara, Alameda, Contra Costa, and San Benito counties of California. BVF provides business-essential working capital factoring financing to various industries throughout the United States. No customer accounts for more than 10 percent of revenue for HBC or the Company. With the acquisition of Bay View Funding, the Company now has two reportable segments consisting of Banking and Factoring. The Company's management uses segment in its operating and strategic planning.

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

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

The results for the three and nine months ended September 30, 2015 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2015.

Business Combinations

The Company accounts for acquisitions of businesses using the acquisition method of accounting. Under the acquisition method, assets acquired and liabilities assumed are recorded at their estimated fair values at the date of acquisition. Management utilizes various valuation techniques including discounted cash flow analyses to determine these fair values. Any excess of the purchase price over amounts allocated to the acquired assets, including identifiable intangible assets, and liabilities assumed is recorded as goodwill.

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HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

1) Basis of Presentation (Continued)

Goodwill and Other Intangible Assets

Goodwill resulted from the acquisition of Bay View Funding on November 1, 2014 and Focus on August 21, 2015. Goodwill represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified.

Other intangible assets consist of core deposit and customer relationship intangible assets arising from the Diablo Valley Bank acquisition in June 2007, a core deposit intangible asset from the Focus acquisition in August 2015, and a below market value lease intangible asset, customer relationship and brokered relationship intangible assets, and a non compete agreement intangible asset arising from the Bay View Funding acquisition in November 2014. They are initially measured at fair value and then are amortized over their estimated useful lives. The core deposits intangible assets from the acquisitions of Diablo Valley Bank and Focus Business Bank are being amortized on an accelerated method over ten years. The customer relationship intangible from the acquisition of Diablo Valley Bank was being amortized on an accelerated method over seven years, and was fully amortized at December 31, 2014. The below market value lease intangible asset, customer relationship and brokered relationship intangible assets, and non compete agreement intangible asset from the acquisition of Bay View Funding are being amortized on the straight line method over three, ten, and three years, respectively.

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 January 2014, the Financial Accounting Standards Board ("FASB") amended existing guidance clarifying that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. For entities other than public business entities, the amendments in this update are effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. The Company has adopted the new guidance and it does not have a material impact on the consolidated financial statements.

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HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

1) Basis of Presentation (Continued)

In January 2014, the FASB issued guidance for accounting for investments in qualified affordable housing projects, which represents a consensus of the Emerging Issues Task Force and sets forth new accounting for qualifying investments in flow through limited liability entities that invest in affordable housing projects. The new guidance allows a limited liability investor that meets certain conditions to amortize the cost of its investment in proportion to the tax credits and other tax benefits it receives. The new accounting method, referred to as the proportional amortization method, allows amortization of the tax credit investment to be reflected along with the primary benefits, the tax credits and other tax benefits, on a net basis in the income statement within the income tax expense (benefit) line. For public business entities, the guidance is effective for interim and annual periods beginning after December 15, 2014. If elected, the proportional amortization method is required to be applied retrospectively. Early adoption is permitted in the annual period for which financial statements have not been issued.

The Company adopted the proportional amortization method of accounting for its low income housing investments in the third quarter of 2014. The Company quantified the impact of adopting the proportional amortization method compared to the equity method to its current year and prior period financial statements. The Company determined that the adoption of the proportional amortization method did not have a material impact to its financial statements. The low income housing investment losses, net of the tax benefits received, are included in income tax expense for all periods reflected on the consolidated income statements. See *Note 8 Income Taxes* for more information on the adoption of the proportional method of accounting for low income housing investments.

In May 2014, the FASB issued an update to the guidance for accounting for revenue from contracts with customers. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2017. We are evaluating the impact of adopting the new guidance on the consolidated financial statements.

In September 2015, the FASB issued an update simplifying the accounting for measurement-period adjustments. This update applies to all entities that have reported provisional amounts for items in a business combination for which the accounting is incomplete by the end of the reporting period in which the combination occurs and during the measurement period have an adjustment to provisional amounts recognized. The amendments in this update require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2015****(Unaudited)****1) Basis of Presentation (Continued)**

the adjustment amounts are determined. The amendments in this update require that the acquirer record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The amendments in this update require an entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The amendments in this update are effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. The amendments in this update should be applied prospectively to adjustments to provisional amounts that occur after the effective date of this update with earlier application permitted for financial statements that have not been issued. We are currently evaluating the impact of adopting the new guidance on the consolidated financial statements, but it is not expected to have a material impact.

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. The Series C Preferred Stock participates 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 using the treasury stock method. 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,	
	2015	2014	2015	2014
	(Dollars in thousands, except per share amounts)			
Net income available to common shareholders	\$ 3,011	\$ 3,145	\$ 10,730	\$ 9,097
Less: undistributed earnings allocated to Series C Preferred Stock	(111)	(320)	(706)	(993)
Distributed and undistributed earnings allocated to common shareholders	\$ 2,900	\$ 2,825	\$ 10,024	\$ 8,104
Weighted average common shares outstanding for basic earnings per common share	29,075,782	26,371,413	27,386,471	26,367,314
Dilutive effect of stock options outstanding, using the the treasury stock method	256,670	145,450	202,993	134,646
Shares used in computing diluted earnings per common share	29,332,452	26,516,863	27,589,464	26,501,960
Basic earnings per share	\$ 0.10	\$ 0.11	\$ 0.37	\$ 0.31
Diluted earnings per share	\$ 0.10	\$ 0.11	\$ 0.36	\$ 0.31

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HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

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

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

	For the Three Months Ended September 30, 2015 and 2014				Total(1)
	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)		
	(Dollars in thousands)				
Beginning balance July 1, 2015, net of taxes	\$ 2,206	\$ 419	\$ (5,896)	\$ (3,271)	
Other comprehensive income (loss) before reclassification, net of taxes	1,273		(12)	1,261	
Amounts reclassified from other comprehensive income (loss), net of taxes		(8)	39	31	
Net current period other comprehensive income (loss), net of taxes	1,273	(8)	27	1,292	
Ending balance September 30, 2015, net of taxes	\$ 3,479	\$ 411	\$ (5,869)	\$ (1,979)	
Beginning balance July 1, 2014, net of taxes	\$ 3,533	\$ 450	\$ (4,075)	\$ (92)	
Other comprehensive income (loss) before reclassification, net of taxes	(679)		(12)	(691)	
Amounts reclassified from other comprehensive income (loss), net of taxes	(27)	(8)	6	(29)	
Net current period other comprehensive income (loss), net of taxes	(706)	(8)	(6)	(720)	
Ending balance September 30, 2014, net of taxes	\$ 2,827	\$ 442	\$ (4,081)	\$ (812)	

(1) Amounts in parenthesis indicate debits.

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HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

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

	For the Nine Months Ended September 30, 2015 and 2014				Total(1)
	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)		
	(Dollars in thousands)				
Beginning balance January 1, 2015, net of taxes	\$ 3,666	\$ 435	\$ (5,952)	\$ (1,851)	
Other comprehensive income (loss) before reclassification, net of taxes	(187)		(36)	(223)	
Amounts reclassified from other comprehensive income (loss), net of taxes		(24)	119	95	
Net current period other comprehensive income (loss), net of taxes	(187)	(24)	83	(128)	
Ending balance September 30, 2015, net of taxes	\$ 3,479	\$ 411	\$ (5,869)	\$ (1,979)	
Beginning balance January 1, 2014, net of taxes	\$ (430)	\$ 466	\$ (4,065)	(4,029)	
Other comprehensive (loss) before reclassification, net of taxes	3,313		(32)	3,281	
Amounts reclassified from other comprehensive income (loss), net of taxes	(56)	(24)	16	(64)	
Net current period other comprehensive income (loss), net of taxes	3,257	(24)	(16)	3,217	
Ending balance September 30, 2014, net of taxes	\$ 2,827	\$ 442	\$ (4,081)	\$ (812)	

(1) Amounts in parenthesis indicate debits.

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HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

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

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Three Months Ended September 30,		Affected Line Item Where Net Income is Presented
	2015	2014	
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	\$	\$ 47	Realized gains on sale of securities
		(20)	Income tax expense
		27	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	13	14	Interest income on taxable securities
	(5)	(6)	Income tax expense
	8	8	Net of tax
Amortization of defined benefit pension plan items			
Prior transition obligation	28	25	
Actuarial losses	(96)	(35)	
	(68)	(10)	Salaries and employee benefits
	29	4	Income tax expense
	(39)	(6)	Net of tax
Total reclassification for the period	\$ (31)	\$ 29	

(1) Amounts in parenthesis indicate debits.

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HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

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

Details About AOCI Components	Amounts Reclassified from AOCI(1) For the Nine Months Ended September 30,		Affected Line Item Where Net Income is Presented
	2015	2014	
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	\$	\$ 97	Realized gains on sale of securities
		(41)	Income tax expense
		56	Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	41	41	Interest income on taxable securities
	(17)	(17)	Income tax expense
	24	24	Net of tax
Amortization of defined benefit pension plan items			
Prior transition obligation	84	77	
Actuarial losses	(288)	(105)	
	(204)	(28)	Salaries and employee benefits
	85	12	Income tax benefit
	(119)	(16)	Net of tax
Total reclassification for the period	\$ (95)	\$ 64	

(1) Amounts in parenthesis indicate debits.

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2015****(Unaudited)****4) Securities**

The amortized cost and estimated fair value of securities at September 30, 2015 and December 31, 2014 were as follows:

September 30, 2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(Dollars in thousands)				
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 166,943	\$ 3,673	\$ (217)	\$ 170,399
Corporate bonds	35,817	833	(42)	36,608
Trust preferred securities	15,000			15,000
Collateralized mortgage obligations	11,700	92	(1)	11,791
U.S. Government sponsored entities	11,039	86		11,125
Municipals tax exempt	5,683	82		5,765
U.S. Treasury	4,036	3		4,039
Municipals taxable	2,645	38		2,683
Total	\$ 252,863	\$ 4,807	\$ (260)	\$ 257,410

Securities held-to-maturity:				
Municipals tax exempt	\$ 94,704	\$ 1,109	\$ (1,988)	\$ 93,825
Agency mortgage-backed securities	16,300	26	(116)	16,210
Total	\$ 111,004	\$ 1,135	\$ (2,104)	\$ 110,035

December 31, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(Dollars in thousands)				
Securities available-for-sale:				
Agency mortgage-backed securities	\$ 150,570	\$ 3,867	\$ (265)	\$ 154,172
Corporate bonds	35,927	959	(23)	36,863
Trust preferred securities	15,000	300		15,300
Total	\$ 201,497	\$ 5,126	\$ (288)	\$ 206,335

Securities held-to-maturity:				
Municipals tax exempt	\$ 79,882	\$ 1,011	\$ (1,346)	\$ 79,547

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Agency mortgage-backed securities	15,480	44	(118)	15,406
Total	\$ 95,362	\$ 1,055	\$ (1,464)	\$ 94,953

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2015****(Unaudited)****4) Securities (Continued)**

Securities with unrealized losses at September 30, 2015 and December 31, 2014, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

September 30, 2015	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 42,937	\$ (194)	\$ 2,274	\$ (23)	\$ 45,211	\$ (217)
Corporate bonds	5,111	(42)	\$	\$	5,111	(42)
Collateralized mortgage obligations	249	(1)	\$	\$	249	(1)
Total	\$ 48,297	\$ (237)	\$ 2,274	\$ (23)	\$ 50,571	\$ (260)
Securities held-to-maturity:						
Municipals tax exempt	\$ 28,243	\$ (577)	\$ 23,283	\$ (1,411)	\$ 51,526	\$ (1,988)
Agency mortgage-backed securities	5,704	(40)	\$ 4,475	\$ (76)	10,179	(116)
Total	\$ 33,947	\$ (617)	\$ 27,758	\$ (1,487)	\$ 61,705	\$ (2,104)
	(Dollars in thousands)					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
December 31, 2014						
Securities available-for-sale:						
Agency mortgage-backed securities	\$ 12,491	\$ (27)	\$ 35,614	\$ (238)	\$ 48,105	\$ (265)
Corporate bonds			5,148	(23)	5,148	(23)
Total	\$ 12,491	\$ (27)	\$ 40,762	\$ (261)	\$ 53,253	\$ (288)
Securities held-to-maturity:						
	\$ 4,869	\$ (29)	\$ 4,974	\$ (89)	\$ 9,843	\$ (118)

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Agency mortgage-backed securities

Municipals	Tax Exempt						
		1,884	(16)	42,867	(1,330)	44,751	(1,346)
Total		\$ 6,753	\$ (45)	\$ 47,841	\$ (1,419)	\$ 54,594	\$ (1,464)

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, 2015, the Company held 476 securities (206 available-for-sale and 270 held-to-maturity), of which 179 had fair values below amortized cost. At September 30, 2015, there were \$2,274,000 of agency mortgage-backed securities available-for-sale, \$4,475,000 of agency mortgage-backed securities held-to-maturity, and \$23,283,000 of municipals bonds held-to-maturity carried with an unrealized loss for over 12 months. The total unrealized loss for securities over 12 months was \$1,510,000 at September 30, 2015. The unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2015****(Unaudited)****4) Securities (Continued)**

believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company does not consider these securities to be other than temporarily impaired at September 30, 2015.

At December 31, 2014, the Company held 361 securities (130 available-for-sale and 231 held-to-maturity), of which 151 had fair values below amortized cost. At December 31, 2014, there were \$35,614,000 of agency mortgage backed securities available-for-sale, \$5,148,000 of corporate bonds available for sale, \$4,974,000 of agency mortgage backed securities held-to-maturity and \$42,867,000 of municipals bonds held to maturity carried with an unrealized loss for over 12 months. The total unrealized loss for securities over 12 months was \$1,680,000 at December 31, 2014. The unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company does not consider these securities to be other than temporarily impaired at December 31, 2014.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(Dollars in thousands)			
Proceeds	\$	\$ 58,592	\$	\$ 108,603
Gross gains		288		1,008
Gross losses		(241)		(911)

The amortized cost and estimated fair values of securities as of September 30, 2015, are shown by contractual maturity below. The expected maturities will differ from contractual maturities if borrowers have the right to call or pre-pay obligations with or without call or pre-payment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after 3 months through one year	\$ 4,919	\$ 4,932
Due after one through five years	19,794	20,200
Due after five through ten years	38,979	39,594
Due after ten years	22,228	22,285
Agency mortgage-backed securities	166,943	170,399
Total	\$ 252,863	\$ 257,410

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2015****(Unaudited)****4) Securities (Continued)**

	Held-to-maturity	
	Amortized Cost	Estimated Fair Value
	(Dollars in thousands)	
Due after 3 months or less	\$ 1,090	\$ 1,146
Due after 3 months through one year	2,066	2,089
Due after one through five years	4,810	4,876
Due after five through ten years	13,415	13,911
Due after ten years	73,323	71,803
Agency mortgage-backed securities	16,300	16,210
Total	\$ 111,004	\$ 110,035

5) Loans

Loans were as follows for the periods indicated:

	September 30, 2015	December 31, 2014
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	\$ 554,169	\$ 462,403
Real estate:		
Commercial and residential	606,819	478,335
Land and construction	84,867	67,980
Home equity	74,624	61,644
Consumer	12,595	18,867
Loans	1,333,074	1,089,229
Deferred loan origination fees, net	(669)	(586)
Loans, net of deferred fees	1,332,405	1,088,643
Allowance for loan losses	(18,737)	(18,379)
Loans, net	\$ 1,313,668	\$ 1,070,264

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2015****(Unaudited)****5) Loans (Continued)**

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

	Three Months Ended September 30, 2015			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 11,193	\$ 7,450	\$ 114	\$ 18,757
Charge-offs	(8)		(9)	(17)
Recoveries	284	14		298
Net recoveries	276	14	(9)	281
Provision (credit) for loan losses	(941)	672	(32)	(301)
Balance, end of period	\$ 10,528	\$ 8,136	\$ 73	\$ 18,737

	Three Months Ended September 30, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 11,454	\$ 7,069	\$ 69	\$ 18,592
Charge-offs	(132)		(25)	(157)
Recoveries	123	7		130
Net (charge-offs) recoveries	(9)	7	(25)	(27)
Provision (credit) for loan losses	163	(205)	18	(24)
Balance, end of period	\$ 11,608	\$ 6,871	\$ 62	\$ 18,541

	Nine Months Ended September 30, 2015			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 11,187	\$ 7,070	\$ 122	\$ 18,379
Charge-offs	(229)	(2)	(9)	(240)
Recoveries	766	141	30	937
Net recoveries	537	139	21	697

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Provision (credit) for loan losses	(1,196)	927	(70)	(339)
Balance, end of period	\$ 10,528	\$ 8,136	\$ 73	\$ 18,737

Table of Contents**HERITAGE COMMERCE CORP****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2015****(Unaudited)****5) Loans (Continued)****Nine Months Ended September 30, 2014**

	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	\$ 12,533	\$ 6,548	\$ 83	\$ 19,164
Charge-offs	(726)		(25)	(751)
Recoveries	309	51		360
Net (charge-offs) recoveries	(417)	51	(25)	(391)
Provision (credit) for loan losses	(508)	272	4	(232)
Balance, end of period	\$ 11,608	\$ 6,871	\$ 62	\$ 18,541

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, 2015			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	\$ 133	\$	\$	\$ 133
Collectively evaluated for impairment	10,395	8,136	73	18,604
Total allowance balance	\$ 10,528	\$ 8,136	\$ 73	\$ 18,737
Loans:				
Individually evaluated for impairment	\$ 1,804	\$ 3,878	\$ 4	\$ 5,686
Collectively evaluated for impairment	552,365	762,432	12,591	1,327,388
Total loan balance	\$ 554,169	\$ 766,310	\$ 12,595	\$ 1,333,074