HERITAGE COMMERCE CORP
Form 10-Q
August 05, 2016

Use these links to rapidly review the document
TABLE OF CONTENTS

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2016

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 32,295,563 shares of Common Stock outstanding on July 28, 2016.

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

		Page No.
Cautionary Note on Forward-Looking Statements		3
Part I. FINANCIAL INFORMATION		
Item 1.	Consolidated Financial Statements (unaudited)	5
	Consolidated Balance Sheets	5
	Consolidated Statements of Income	6
	Consolidated Statements of Comprehensive Income	7
	Consolidated Statements of Changes in Shareholders' Equity	8
	Consolidated Statements of Cash Flows	9
	Notes to Unaudited Consolidated Financial Statements	10
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	56
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	97
Item 4.	Controls and Procedures	97
PART II. OTHER INFORMATION		
Item 1.	Legal Proceedings	98
Item 1A.	Risk Factors	98
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	98
Item 3.	Defaults Upon Senior Securities	98
Item 4.	Mine Safety Disclosures	98
Item 5.	Other Information	98
Item 6.	Exhibits	99
SIGNATURES		100
EXHIBIT INDEX		101

Table of Contents

Cautionary Note Regarding Forward-Looking Statements

This Report on Form 10-Q contains various statements that may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, 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 their impact on us and our customers;
- changes in the financial performance or condition of the Company's customers;
- volatility in credit and equity markets and its effect on the global economy;
- 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;
- 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;

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;

changes in our capital management policies, including those regarding business combinations, dividends, and share repurchases, among others;

Table of Contents

- operational issues stemming from, and/or capital spending necessitated by, the potential need to adapt to industry changes in information technology systems, on which we are highly dependent;

- the ability to keep pace with, and implement on a timely basis, technological changes;

- 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;

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

- 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;

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

Table of Contents

Part I FINANCIAL INFORMATION

ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HERITAGE COMMERCE CORP

CONSOLIDATED BALANCE SHEETS (Unaudited)

	June 30, 2016	December 31, 2015
	(Dollars in thousands)	
Assets		
Cash and due from banks	$ 30,820	$ 24,112
Interest-bearing deposits in other financial institutions	128,024	319,980
Total cash and cash equivalents	158,844	344,092
Securities available-for-sale, at fair value	390,435	385,079
Securities held-to-maturity, at amortized cost (fair value of $214,624 at June 30, 2016 and $109,821 at December 31, 2015)	210,170	109,311
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	4,879	7,297
Loans, net of deferred fees	1,464,114	1,358,716
Allowance for loan losses	(19,921)	(18,926)
Loans, net	1,444,193	1,339,790
Federal Home Loan Bank and Federal Reserve Bank stock and other investments, at cost	15,190	12,694
Company owned life insurance	58,765	60,021
Premises and equipment, net	7,542	7,773
Goodwill	45,664	45,664
Other intangible assets	7,734	8,518
Accrued interest receivable and other assets	34,876	41,340
Total assets	$ 2,378,292	$ 2,361,579
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	$ 834,590	$ 821,405
Demand, interest-bearing	499,512	496,278
Savings and money market	480,677	496,843
Time deposits-under $250	60,761	62,026
Time deposits-$250 and over	182,591	160,815
Time deposits-brokered	6,079	17,825
CDARS money market and time deposits	9,574	7,583
Total deposits	2,073,784	2,062,775
Short-term borrowings		3,000
Accrued interest payable and other liabilities	46,995	50,368
Total liabilities	2,120,779	2,116,143
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		
	19,519	19,519

Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at June 30, 2016 and December 31, 2015 (liquidation preference of $21,004 at June 30, 2016 and December 31, 2015)		
Common stock, no par value; 60,000,000 shares authorized; 32,294,063 shares issued and outstanding at June 30, 2016 and 32,113,479 shares issued and outstanding at December 31, 2015	194,765	193,364
Retained earnings	45,371	38,773
Accumulated other comprehensive loss	(2,142)	(6,220)
Total shareholders' equity	257,513	245,436
Total liabilities and shareholders' equity	$ 2,378,292	$ 2,361,579

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(Dollars in thousands, except per share data)			
Interest income:				
Loans, including fees	$ 19,735	$ 15,643	$ 38,923	$ 30,647
Securities, taxable	2,829	1,554	5,603	3,157
Securities, exempt from Federal tax	575	515	1,154	1,021
Other investments and interest-bearing deposits in other financial institutions	365	463	886	716
Total interest income	23,504	18,175	46,566	35,541
Interest expense:				
Deposits	760	533	1,518	1,041
Total interest expense	760	533	1,518	1,041
Net interest income before provision for loan losses	22,744	17,642	45,048	34,500
Provision (credit) for loan losses	351	22	752	(38)
Net interest income after provision for loan losses	22,393	17,620	44,296	34,538
Noninterest income:				
Gain on proceeds from company owned life insurance	1,019		1,019	
Service charges and fees on deposit accounts	783	715	1,550	1,338
Increase in cash surrender value of life insurance	440	396	889	796
Servicing income	371	299	742	605
Gain on sales of securities	347		527	
Gain on sales of SBA loans	279	186	584	393
Other	421	568	963	958
Total noninterest income	3,660	2,164	6,274	4,090
Noninterest expense:				
Salaries and employee benefits	8,742	7,712	17,689	15,754
Occupancy and equipment	1,081	1,036	2,157	2,072
Professional fees	708	239	1,533	333
Other	3,850	3,630	7,687	6,734
Total noninterest expense	14,381	12,617	29,066	24,893
Income before income taxes	11,672	7,167	21,504	13,735
Income tax expense	4,377	2,690	8,103	5,120
Net income	7,295	4,477	13,401	8,615
Dividends on preferred stock	(504)	(448)	(1,008)	(896)
Net income available to common shareholders	$ 6,791	$ 4,029	$ 12,393	$ 7,719

Earnings per common share:								
Basic	$	0.19	$	0.14	$	0.35	$	0.27
Diluted	$	0.19	$	0.14	$	0.35	$	0.27

See notes to unaudited consolidated financial statements

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Net income	$ 7,295	$ 4,477	$ 13,401	$ 8,615
Other comprehensive income (loss):				
Change in net unrealized holding gains on available-for-sale securities and I/O strips	2,723	(3,404)	7,562	(2,516)
Deferred income taxes	(1,144)	1,430	(3,176)	1,056
Change in net unamortized unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	(76)	(14)	(90)	(28)
Deferred income taxes	32	6	38	12
Reclassification adjustment for gains on sales of securities realized in income	(347)		(527)	
Deferred income taxes	146		221	
Change in unrealized gains on securities and I/O strips, net of deferred income taxes	1,334	(1,982)	4,028	(1,476)
Change in net pension and other benefit plan liabilities adjustment	38	48	86	96
Deferred income taxes	(16)	(20)	(36)	(40)
Change in pension and other benefit plan liabilities net of deferred income taxes	22	28	50	56
Other comprehensive income (loss)	1,356	(1,954)	4,078	(1,420)
Total comprehensive income	$ 8,651	$ 2,523	$ 17,479	$ 7,195

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

Six Months Ended June 30, 2016 and 2015

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income / (Loss)	Total Shareholders' Equity
	(Dollars in thousands, except share data)						
Balance, January 1, 2015	21,004	$ 19,519	26,503,505	$ 133,676	$ 33,014	$ (1,851)	$ 184,358
Net income					8,615		8,615
Other comprehensive loss						(1,420)	(1,420)
Issuance of restricted stock awards, net			68,855				
Amortization of restricted stock awards, net of forfeitures and taxes				34			34
Cash dividend declared $0.16 per share					(5,145)		(5,145)
Stock option expense, net of forfeitures and taxes				475			475
Stock options exercised			23,734	122			122
Balance, June 30, 2015	21,004	$ 19,519	26,596,094	$ 134,307	$ 36,484	$ (3,271)	$ 187,039
Balance, January 1, 2016	21,004	$ 19,519	32,113,479	$ 193,364	$ 38,773	$ (6,220)	$ 245,436
Net income					13,401		13,401
Other comprehensive income						4,078	4,078
Issuance of restricted stock awards, net			82,372				
Amortization of restricted stock awards, net of forfeitures and taxes				296			296
Cash dividend declared $0.18 per share					(6,803)		(6,803)
Stock option expense, net of forfeitures and taxes				482			482
Stock options exercised			98,212	623			623
Balance, June 30, 2016	21,004	$ 19,519	32,294,063	$ 194,765	$ 45,371	$ (2,142)	$ 257,513

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 13,401	$ 8,615
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	1,746	662
Gain on sale of securities available-for-sale	(527)	
Gain on sale of SBA loans	(584)	(393)
Proceeds from SBA loans originated for sale	8,398	4,767
SBA loans originated for sale	(8,187)	(6,996)
Provision (credit) for loan losses	752	(38)
Increase in cash surrender value of life insurance	(889)	(796)
Depreciation and amortization	361	366
Amortization of intangible assets	784	378
Gain on sale of foreclosed assets, net		(106)
Stock option expense, net	482	475
Amortization of restricted stock awards, net	296	34
Gain on proceeds from company owned life insurance	(1,019)	
Effect of changes in:		
Accrued interest receivable and other assets	3,280	(831)
Accrued interest payable and other liabilities	(3,359)	1,051
Net cash provided by operating activities	14,935	7,188
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(75,803)	(19,953)
Purchase of securities held-to-maturity	(109,934)	(6,153)
Maturities/paydowns/calls of securities available-for-sale	27,789	14,195
Maturities/paydowns/calls of securities held-to-maturity	8,591	1,786
Proceeds from sale of securities available-for-sale	49,171	
Net change in loans	(102,413)	(43,308)
Change in Federal Home Loan Bank and Federal Reserve Bank stock and other investments	(2,496)	(25)
Purchase of premises and equipment	(130)	(164)
Proceeds from sale of foreclosed assets	49	1,571
Proceeds from company owned life insurance	3,164	
Net cash used in investing activities	(202,012)	(52,051)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	11,009	58,751
Exercise of stock options	623	122
Repayment of short-term borrowings	(3,000)	
Payment of cash dividends	(6,803)	(5,145)
Net cash provided by financing activities	1,829	53,728
Net (decrease) increase in cash and cash equivalents	(185,248)	8,865
Cash and cash equivalents, beginning of period	344,092	122,403
Cash and cash equivalents, end of period	$ 158,844	$ 131,268

Supplemental disclosures of cash flow information:

Interest paid	$ 1,512	$ 1,057
Income taxes paid	4,955	3,860
Due to broker for securities purchased, settling after quarter-end		730
Supplemental schedule of non-cash investing activity:		
Transfer of loans held for sale to loan portfolio	2,791	
Loans transferred to foreclosed assets	49	1,236

See notes to unaudited consolidated financial statements

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2016

(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, 2015.

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.

The Company acquired 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 primarily located in Santa Clara, Alameda, Contra Costa, and San Benito counties of California. Bay View Funding 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 results 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 six months ended June 30, 2016 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2016.

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.

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2016

(Unaudited)

1) Basis of Presentation (Continued)

Adoption of New Accounting Standards

In September 2015, the FASB issued ASU No. 2015-16, *Simplifying the Accounting for Measurement Period Adjustment.* 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 the adjustment amounts are determined. The amendments in this update require that the acquirer's 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 Company has evaluated the adoption of the new guidance and has determined it did not have a material impact on the consolidated financial statements.

Newly Issued, but not yet Effective Accounting Standards

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments Recognition and Measurement of Financial Assets and Liabilities*. The new guidance is intended to improve the recognition and measurement of financial instruments by requiring: equity investments (other than equity method or consolidation) to be measured at fair value with changes in fair value recognized in net income; public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; separate presentation of financial assets and financial liabilities by measurement category and form of financial assets (i.e. securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement to disclose the fair value of financial instruments measured at amortized cost for organizations that are not public business entities; eliminating the requirement for non-public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is to be required to be disclosed for financial instruments measured at amortized cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from the change in the instrument-specific credit risk (also referred to as "own credit") when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. The new guidance is effective for public business entities for fiscal years beginning after December 15, 2017. 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.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*. The standard requires a lessee to recognize assets and liabilities on the balance sheet for leases with lease terms greater than 12 months.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2016

(Unaudited)

1) Basis of Presentation (Continued)

A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. When measuring assets and liabilities arising from a lease, a lessee (and a lessor) should include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. Similarly, optional payments to purchase the underlying asset should be included in the measurement of lease assets and lease liabilities only if the lessee is reasonably certain to exercise that purchase option. *Reasonably certain* is a high threshold that is consistent with and intended to be applied in the same way as the *reasonably assured* threshold in the previous leases guidance. In addition, also consistent with the previous leases guidance, a lessee (and a lessor) should exclude most variable lease payments in measuring lease assets and lease liabilities, other than those that depend on an index or a rate or are in substance fixed payments. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term. The new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, and early adoption is permitted. We are currently evaluating the impact of adopting the new guidance on our consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation Stock Compensation*: *Improvements to Employee Share-Based Payment Accounting*. The standard is intended to simplify several areas of accounting for share-based compensation arrangements, including the income tax impact, classification on the statement of cash flows and forfeitures. All excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) should be recognized as income tax expense or benefit in the income statement. The tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. An entity also should recognize excess tax benefits regardless of whether the benefit reduces taxes payable in the current period. Excess tax benefits should be classified along with other income tax cash flows as an operating activity. An entity can make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest (current GAAP) or account for forfeitures when they occur. The threshold to qualify for equity classification permits withholding up to the maximum statutory tax rates in the applicable jurisdictions. Cash paid by an employer when directly withholding shares for tax withholding purposes should be classified as a financing activity. A nonpublic entity can make an accounting policy election to apply a practical expedient to estimate the expected term for all awards with performance or service conditions that meet certain conditions. A nonpublic entity can make a one-time accounting policy election to switch from measuring all liability-classified awards at fair value to intrinsic value. The new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, and early adoption is permitted. We are currently evaluating the impact of adopting the new guidance on our consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments Credit Losses: Measurement of Credit Losses on Financial Instruments*. The standard is the final guidance on the new current expected credit loss ("CECL") model. The amendments in this update replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2016

(Unaudited)

1) Basis of Presentation (Continued)

requires consideration of a broader range of reasonable and supportable information to estimate future credit loss estimates. As CECL encompasses all financial assets carried at amortized cost, the requirement that reserves be established based on an organization's reasonable and supportable estimate of expected credit losses extends to held to maturity ("HTM") debt securities. The update amends the accounting for credit losses on available-for-sale securities ("AFS"), whereby credit losses will be presented as an allowance as opposed to a write-down. In addition, CECL will modify the accounting for purchased loans with credit deterioration since origination, so that reserves are established at the date of acquisition for purchased loans. Lastly, the amendment requires enhanced disclosures on the significant estimates and judgments used to estimate credit losses, as well as on the credit quality and underwriting standards of an organization's portfolio. These disclosures require organizations to present the currently required credit quality disclosures disaggregated by the year of origination or vintage. The guidance allows for a modified retrospective approach with a cumulative effect adjustment to the balance sheet upon adoption (charge to retained earnings instead of the income statement). The new guidance is effective for public business entities for fiscal years, and interim periods within those years, beginning after December 15, 2019, and early adoption is permitted. We are currently evaluating the impact of adopting the new guidance on our consolidated financial statements.

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2016

(Unaudited)

2) Earnings Per Share (Continued)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(Dollars in thousands, except per share amounts)			
Net income available to common shareholders	$ 6,791	$ 4,029	$ 12,393	$ 7,719
Less: undistributed earnings allocated to Series C Preferred Stock	(576)	(331)	(979)	(605)
Distributed and undistributed earnings allocated to common shareholders	$ 6,215	$ 3,698	$ 11,414	$ 7,114
Weighted average common shares outstanding for basic earnings per common share	32,243,935	26,573,909	32,184,825	26,541,816
Dilutive effect of stock options oustanding, using the the treasury stock method	268,676	193,346	260,691	182,444
Shares used in computing diluted earnings per common share	32,512,611	26,767,255	32,445,516	26,724,260
Basic earnings per share	$ 0.19	$ 0.14	$ 0.35	$ 0.27
Diluted earnings per share	$ 0.19	$ 0.14	$ 0.35	$ 0.27

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2016

(Unaudited)

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

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

	Three Months Ended June 30, 2016 and 2015			
	Unrealized Gains on Available-for-Sale Securities and I/O Strips	Unamortized Unrealized Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity	Defined Benefit Pension Plan Items	Total
	(Dollars in thousands)			
Beginning balance April 1, 2016, net of taxes	$ 3,792	$ 395	$ (7,685)	$ (3,498)
Other comprehensive income (loss) before reclassification, net of taxes	1,579		(5)	1,574
Amounts reclassified from other comprehensive income (loss), net of taxes	(201)	(44)	27	(218)
Net current period other comprensive income (loss), net of taxes	1,378	(44)	22	1,356
Ending balance June 30, 2016, net of taxes	$ 5,170	$ 351	$ (7,663)	$ (2,142)
Beginning balance April 1, 2015, net of taxes	$ 4,180	$ 427	$ (5,924)	$ (1,317)
Other comprehensive loss before reclassification, net of taxes	(1,974)		(2)	(1,976)
Amounts reclassified from other comprehensive income (loss), net of taxes		(8)	30	22
Net current period other comprehensive income (loss), net of taxes	(1,974)	(8)	28	(1,954)
Ending balance June 30, 2015, net of taxes	$ 2,206	$ 419	$ (5,896)	$ (3,271)

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2016

(Unaudited)

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

	Six Months Ended June 30, 2016 and 2015			
	Unrealized Gains on Available-for-Sale Securities and I/O Strips	Unamortized Unrealized Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity	Defined Benefit Pension Plan Items	Total
	(Dollars in thousands)			
Beginning balance January 1, 2016, net of taxes	$ 1,090	$ 403	$ (7,713)	$ (6,220)
Other comprehensive income (loss) before reclassification, net of taxes	4,386		(5)	4,381
Amounts reclassified from other comprehensive income (loss), net of taxes	(306)	(52)	55	(303)
Net current period other comprensive income (loss), net of taxes	4,080	(52)	50	4,078
Ending balance June 30, 2016, net of taxes	$ 5,170	$ 351	$ (7,663)	$ (2,142)
Beginning balance January 1, 2015, net of taxes	$ 3,666	$ 435	$ (5,952)	$ (1,851)
Other comprehensive loss before reclassification, net of taxes	(1,460)		(23)	(1,483)
Amounts reclassified from other comprehensive income (loss), net of taxes		(16)	79	63
Net current period other comprehensive income (loss), net of taxes	(1,460)	(16)	56	(1,420)
Ending balance June 30, 2015, net of taxes	$ 2,206	$ 419	$ (5,896)	$ (3,271)

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2016

(Unaudited)

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

Details About AOCI Components	Amounts Reclassified from AOCI Three Months Ended June 30, 2016	2015	Affected Line Item Where Net Income is Presented
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	$ 347	$	Gains on sale of securities
	(146)		Income tax expense
	201		Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	76	14	Interest income on taxable securities
	(32)	(6)	Income tax expense
	44	8	Net of tax
Amortization of defined benefit pension plan items(1)			
Prior transition obligation	13	44	
Actuarial losses	(60)	(96)	
	(47)	(52)	Salaries and employee benefits
	20	22	Income tax expense
	(27)	(30)	Net of tax
Total reclassification for the period	$ 218	$ (22)	

(1) This AOCI component is included in the computation of net periodic benefit cost (see Note 9 Benefit Plans) and includes split-dollar life insurance benefit plan.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2016

(Unaudited)

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

Details About AOCI Components	Amounts Reclassified from AOCI Six Months Ended June 30, 2016	2015	Affected Line Item Where Net Income is Presented
	(Dollars in thousands)		
Unrealized gains on available-for-sale securities and I/O strips	$ 527	$	Gains on sale of securities
	(221)		Income tax expense
	306		Net of tax
Amortization of unrealized gain on securities available-for-sale that were reclassified to securities held-to-maturity	90	28	Interest income on taxable securities
	(38)	(12)	Income tax expense
	52	16	Net of tax
Amortization of defined benefit pension plan items(1)	26	56	
Prior transition obligation	(120)	(192)	
Actuarial losses	(94)	(136)	Salaries and employee benefits
	39	57	Income tax expense