

HERITAGE FINANCIAL CORP /WA/
Form 10-Q
August 08, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934
For the quarterly period ended June 30, 2014
OR
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934
Commission File Number 0-29480

HERITAGE FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	91-1857900 (I.R.S. Employer Identification No.)
201 Fifth Avenue SW, Olympia, WA (Address of principal executive offices) (360) 943-1500 (Registrant's telephone number, including area code)	98501 (Zip Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been 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, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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Large accelerated filer Accelerated filer x
Non-accelerated filer 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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date:

As of August 1, 2014 there were 30,346,724 shares of the registrant's common stock, no par value per share, outstanding.

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FORWARD LOOKING STATEMENTS:

“Safe Harbor” statement under the Private Securities Litigation Reform Act of 1995: This Quarterly Report on Form 10-Q (“Form 10-Q”) contains forward-looking statements that are subject to risks and uncertainties, including, but not limited to: our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired, including those from Cowlitz Bank, Pierce Commercial Bank, Northwest Commercial Bank, Valley Community Bancshares and Washington Banking Company transactions described in this Form 10-Q, or may in the future acquire, into our operations and our ability to realize related revenue synergies and cost savings within expected time frames or at all, and any goodwill charges related thereto and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, which might be greater than expected; the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be effected by deterioration in the housing and commercial real estate markets, which may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses no longer being adequate to cover actual losses, and require us to increase our allowance for loan losses; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Board of Governors of the Federal Reserve System (“Federal Reserve”) and of our bank subsidiary by the Federal Deposit Insurance Corporation (“FDIC”), the Washington State Department of Financial Institutions, Division of Banks (“Division”) or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our allowance for loan losses, write-down assets, or change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules including as a result of Basel III; our ability to control operating costs and expenses; the impact of the Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) and the implementing regulations; further increases in premiums for deposit insurance; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our Condensed Consolidated Statements of Financial Condition; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; failure or security breach of computer systems on which we depend; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our expansion strategy of pursuing acquisitions and de novo branching; increased competitive pressures among financial service companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board (“FASB”), including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; and other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and other risks detailed from time to time in our filings with the Securities and Exchange Commission (“SEC”) including our Annual Report on Form 10-K for the year ended December 31, 2013.

The Company cautions readers not to place undue reliance on any forward-looking statements. Moreover, you should treat these statements as speaking only as of the date they are made and based only on information then actually known to the Company. The Company does not undertake and specifically disclaims any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the

date of such statements. These risks could cause our actual results for future periods to differ materially from those expressed in any forward-looking statements by, or on behalf of, us, and could negatively affect the Company's operating results and stock price performance.

As used throughout this report, the terms "we", "our", "us", or the "Company" refer to Heritage Financial Corporation and its consolidated subsidiary, unless the context otherwise requires.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

June 30, 2014 and December 31, 2013

(Dollars in thousands)

(Unaudited)

	June 30, 2014	December 31, 2013
ASSETS		
Cash on hand and in banks	\$73,067	\$40,162
Interest earning deposits	73,458	90,238
Cash and cash equivalents	146,525	130,400
Other interest earning deposits	14,138	15,662
Investment securities available for sale, at fair value	652,477	163,134
Investment securities held to maturity (fair value of \$39,539 and \$36,340, respectively)	38,768	36,154
Loans held for sale	7,378	—
Noncovered loans receivable, net	2,069,532	1,168,166
Allowance for loan losses for noncovered loans	(22,369	) (22,657
Noncovered loans receivable, net of allowance for loan losses	2,047,163	1,145,509
Covered loans receivable, net	159,662	63,754
Allowance for loan losses for covered loans	(6,114	) (6,167
Covered loans receivable, net of allowance for loan losses	153,548	57,587
Total loans receivable, net	2,200,711	1,203,096
Federal Deposit Insurance Corporation indemnification asset	9,120	4,382
Other real estate owned (\$3,045 and \$182 covered by FDIC shared-loss agreements, respectively)	8,106	4,559
Premises and equipment, net	66,255	34,348
Federal Home Loan Bank stock, at cost	12,547	5,741
Bank owned life insurance	32,614	—
Accrued interest receivable	9,315	5,462
Prepaid expenses and other assets	63,272	25,120
Other intangible assets, net	12,164	1,615
Goodwill	118,189	29,365
Total assets	\$3,391,579	\$1,659,038
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits	\$2,866,542	\$1,399,189
Junior subordinated debentures	18,973	—
Securities sold under agreement to repurchase	25,450	29,420
Accrued expenses and other liabilities	30,785	14,667
Total liabilities	2,941,750	1,443,276
Stockholders' equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at June 30, 2014 and December 31, 2013	—	—
Common stock, no par value, 50,000,000 shares authorized; 30,213,363 and 16,210,747 shares issued and outstanding at June 30, 2014 and December 31,	366,158	138,659

2013, respectively		
Retained earnings	82,362	78,265
Accumulated other comprehensive income (loss), net	1,309	(1,162)
Total stockholders' equity	449,829	215,762
Total liabilities and stockholders' equity	\$3,391,579	\$1,659,038
See accompanying Notes to Condensed Consolidated Financial Statements.		

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CONDENSED CONSOLIDATED STATEMENTS OF INCOME

For the Three and Six Months Ended June 30, 2014 and 2013

(Dollars in thousands, except per share amounts)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
INTEREST INCOME:				
Interest and fees on loans	\$27,446	\$16,028	\$43,897	\$32,747
Taxable interest on investment securities	1,812	404	2,451	777
Nontaxable interest on investment securities	638	345	1,074	680
Interest and dividends on other interest earning assets	127	82	214	139
Total interest income	30,023	16,859	47,636	34,343
INTEREST EXPENSE:				
Deposits	1,297	909	2,151	1,847
Junior subordinated debentures	115	—	115	—
Other borrowings	15	10	33	19
Total interest expense	1,427	919	2,299	1,866
Net interest income	28,596	15,940	45,337	32,477
Provision for loan losses for noncovered loans	370	209	349	709
Provision for loan losses for covered loans	321	1,099	800	1,457
Total provision for loan losses	691	1,308	1,149	2,166
Net interest income after provision for loan losses	27,905	14,632	44,188	30,311
NONINTEREST INCOME:				
Bargain purchase gain on bank acquisition	—	—	—	399
Service charges and other fees	2,777	1,432	4,175	2,785
Merchant Visa income, net	316	211	561	384
Change in FDIC indemnification asset	109	281	72	14
Gain on sale of investment securities, net	87	—	267	—
Gain on sale of loans, net	233	—	233	—
Other income	1,258	433	1,779	1,059
Total noninterest income	4,780	2,357	7,087	4,641
NONINTEREST EXPENSE:				
Compensation and employee benefits	12,779	7,617	20,790	15,206
Occupancy and equipment	2,816	1,995	5,433	3,915
Data processing	4,003	720	4,999	1,856
Marketing	496	386	1,001	712
Professional services	3,230	640	4,060	1,670
State and local taxes	554	305	803	584
Impairment loss on investment securities, net	37	24	45	26
Federal deposit insurance premium	460	275	712	507
Other real estate owned, net	214	5	266	(98)
Amortization of intangible assets	489	114	645	229
Other expense	1,915	926	3,018	2,120
Total noninterest expense	26,993	13,007	41,772	26,727
Income before income taxes	5,692	3,982	9,503	8,225
Income tax expense	1,544	1,292	2,812	2,650

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Net income	\$4,148	\$2,690	\$6,691	\$5,575
Basic earnings per common share	\$0.16	\$0.18	\$0.32	\$0.37
Diluted earnings per common share	\$0.16	\$0.18	\$0.32	\$0.37
Dividends declared per common share	\$0.08	\$0.08	\$0.16	\$0.16

See accompanying Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Three and Six Months Ended June 30, 2014 and 2013

(Dollars in thousands)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2014	2013	June 30, 2014	2013
Net income	\$4,148	\$2,690	\$6,691	\$5,575
Change in fair value of securities available for sale, net of tax of \$1,089, \$(1,049), \$1,410 and \$(1,232), respectively	2,022	(1,947	) 2,615	(2,289)
Reclassification adjustment of net gain from sale of available for sale securities included in income, net of tax of \$(30), \$0, \$(93) and \$0, respectively	(57	) —	(174) —
Accretion of other-than-temporary impairment on securities held to maturity, net of tax of \$8, \$12, \$16 and \$19, respectively	15	22	30	36
Other comprehensive income (loss)	\$1,980	\$(1,925	) \$2,471	\$(2,253)
Comprehensive income	\$6,128	\$765	\$9,162	\$3,322

See accompanying Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

For the Six Months Ended June 30, 2014 and 2013

(In thousands, except per share amounts)

(Unaudited)

	Number of common shares	Common stock	Retained earnings	Accumulated other comprehensive income (loss), net	Total stock- holders' equity
Balance at December 31, 2012	15,118	\$ 121,832	\$ 75,362	\$ 1,744	\$ 198,938
Restricted and unrestricted stock awards issued, net of forfeitures	99	—	—	—	—
Stock option compensation expense	—	42	—	—	42
Exercise of stock options (including excess tax benefits from nonqualified stock options)	3	37	—	—	37
Restricted stock compensation expense	—	722	—	—	722
Excess tax benefits from restricted stock	—	68	—	—	68
Common stock repurchased	(12)	(182)	—	—	(182)
Net income	—	—	5,575	—	5,575
Other comprehensive loss, net of tax	—	—	—	(2,253)	(2,253)
Cash dividends declared on common stock (\$0.16 per share)	—	—	(2,422)	—	(2,422)
Balance at June 30, 2013	15,208	\$ 122,519	\$ 78,515	\$ (509)	\$ 200,525
Balance at December 31, 2013	16,211	\$ 138,659	\$ 78,265	\$ (1,162)	\$ 215,762
Restricted and unrestricted stock awards issued, net of forfeitures	6	—	—	—	—
Stock option compensation expense	—	20	—	—	20
Exercise of stock options (including excess tax benefits from nonqualified stock options)	38	427	—	—	427
Restricted stock compensation expense	—	539	—	—	539
Excess tax benefits from restricted stock	—	33	—	—	33
Common stock repurchased	(17)	(271)	—	—	(271)
Net income	—	—	6,691	—	6,691
Other comprehensive income, net of tax	—	—	—	2,471	2,471
Common stock issued in business combination	13,975	226,751	—	—	226,751
Cash dividends declared on common stock (\$0.16 per share)	—	—	(2,594)	—	(2,594)
Balance at June 30, 2014	30,213	\$ 366,158	\$ 82,362	\$ 1,309	\$ 449,829

See accompanying Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Six Months Ended June 30, 2014 and 2013

(Dollars in thousands)

(Unaudited)

	Six Months Ended June 30,	
	2014	2013
Cash flows from operating activities:		
Net income	\$6,691	\$5,575
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,829	2,572
Changes in net deferred loan fees, net of amortization	(393	) 397
Provision for loan losses	1,149	2,166
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities	(3,176	) (156)
Restricted and unrestricted stock compensation expense	539	722
Stock option compensation expense	20	42
Excess tax benefits from stock options and restricted and unrestricted stock	(33	) (68)
Amortization of intangible assets	645	229
Bargain purchase gain on bank acquisition	—	(399)
Gain on sale of investment securities, net	(267) —
Impairment loss on investment of securities	45	26
Origination of loans held for sale	(12,592	) (6,784)
Gain on sale of loans	(233	) (142)
Proceeds from sale of loans	9,329	8,602
Earnings on bank owned life insurance	(95) —
Valuation adjustment on other real estate owned	—	(22)
Gain on other real estate owned, net	(65	) (232)
Write-off of furniture, equipment and leasehold improvements	421	—
Net cash provided by operating activities	6,814	12,528
Cash flows from investing activities:		
Loans originated, net of principal payments	4,969	(39,426)
Maturities of other interest earning deposits	1,494	—
Maturities of investment securities available for sale	17,916	31,369
Maturities of investment securities held to maturity	521	784
Purchase of investment securities available for sale	(206,075	) (32,508)
Purchase of investment securities held to maturity	(3,313	) (3,733)
Purchase of premises and equipment	(1,978	) (3,451)
Proceeds from sales of other real estate owned	3,857	4,666
Proceeds from sales of investment securities available for sale	157,987	—
Proceeds from redemption of FHLB stock	258	101
Investment in new market tax credit partnership	(25,000) —
Net cash received from acquisitions	31,591	748
Net cash used in investing activities	(17,773	) (41,450)
Cash flows from financing activities:		