HERITAGE COMMERCE CORP
Form 10-Q
November 06, 2015

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 September 30, 2015

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

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

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 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;

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;

Table of Contents

- 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		

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

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			Accumulated Other Comprehensive Income / (Loss)	Total Shareholders' Equity
	Shares	Amount	Shares	Amount	Retained Earnings		
	(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

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 acquistion:				
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

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.

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.

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 oustanding, 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

Table of Contents

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			
	Unrealized Gains (Losses) on Available-for-Sale Securities and I/O Strips(1)	Unamortized Unrealized Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity(1)	Defined Benefit Pension Plan Items(1)	Total(1)
	(Dollars in thousands)			
Beginning balance July 1, 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 comprensive 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 comprensive 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.

Table of Contents

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			
	Unrealized Gains (Losses) on Available-for-Sale Securities and I/O Strips(1)	Unamortized Unrealized Gain on Available-for-Sale Securities Reclassified to Held-to-Maturity(1)	Defined Benefit Pension Plan Items(1)	Total(1)
	(Dollars in thousands)			
Beginning balance January 1, 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 comprensive 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 comprensive 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.

Table of Contents

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, 2015	2014	Affected Line Item Where Net Income is Presented
	(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.

Table of Contents

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, 2015	2014	Affected Line Item Where Net Income is Presented
	(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

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 Fair Value	Less Than 12 Months Unrealized Losses	12 Months or More Fair Value	12 Months or More Unrealized Losses	Total Fair Value	Total Unrealized Losses
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	$ 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)

December 31, 2014	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized (Losses)	12 Months or More Fair Value	12 Months or More Unrealized (Losses)	Total Fair Value	Total Unrealized (Losses)
	(Dollars in thousands)					
Securities available-for-sale:						
Agency mortgage-backed securities	$ 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)

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

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

December 31, 2014

	Commercial	Real Estate	Consumer	Total
		(Dollars in thousands)		
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 404	$	$	$ 404
Collectively evaluated for impairment	10,783	7,070	122	17,975
Total allowance balance	$ 11,187	$ 7,070	$ 122	$ 18,379
Loans:				
Individually evaluated for impairment	$ 2,701	$ 3,315	$ 6	$ 6,022
Collectively evaluated for impairment	459,702	604,644	18,861	1,083,207
Total loan balance	$ 462,403	$ 607,959	$ 18,867	$ 1,089,229

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

5) Loans (Continued)

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of September 30, 2015 and December 31, 2014. The recorded investment included in the following table represents loan principal net of any partial charge-offs recognized on the loans. The unpaid principal balance represents the recorded balance prior to any partial charge-offs. The recorded investment in consumer loans collateralized by residential real estate property that are in process of foreclosure according to local requirements of the applicable jurisdiction are not material as of September 30, 2015 and December 31, 2014.

	September 30, 2015			December 31, 2014		
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
	(Dollars in thousands)					
With no related allowance recorded:						
Commercial	$ 947	$ 947	$	$ 2,282	$ 1,872	$
Real estate:						
Commercial and residential	3,933	3,074		2,510	1,651	
Land and construction	529	492		1,808	1,319	
Home Equity	312	312		345	345	
Consumer	4	4		6	6	
Total with no related allowance recorded	5,725	4,829		6,951	5,193	
With an allowance recorded:						
Commercial	857	857	$ 133	829	829	404
Total with an allowance recorded	857	857	133	829	829	404
Total	$ 6,582	$ 5,686	$ 133	$ 7,780	$ 6,022	$ 404

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

	Three Months Ended September 30, 2015					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 1,403	$ 3,117	$ 496	$ 317	$ 5	$ 5,338
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

5) Loans (Continued)

	Three Months Ended September 30, 2014					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 3,790	$ 2,273	$ 1,672	$ 513	$ 19	$ 8,267
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

	Nine Months Ended September 30, 2015					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 1,605	$ 3,031	$ 819	$ 327	$ 5	$ 5,787
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

	Nine Months Ended September 30, 2014					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 4,411	$ 3,034	$ 1,705	$ 575	$ 69	$ 9,794
Interest income during impairment	$ 56	$	$	$	$	$ 56
Cash-basis interest earned	$	$	$	$	$	$

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

	September 30,		December 31,
	2015	2014	2014
	(Dollars in thousands)		

Nonaccrual loans held-for-investment	$	5,503	$	7,010	$	5,855
Restructured and loans over 90 days past due and still accruing				200		
Total nonperforming loans	$	5,503	$	7,210	$	5,855
Other restructured loans	$	183	$		$	167
Impaired loans, excluding loans held-for-sale	$	5,686	$	7,210	$	6,022

25

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

5) Loans (Continued)

The following table presents the nonperforming loans by class for the periods indicated:

	September 30, 2015			December 31, 2014		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	$ 1,620	$	$ 1,620	$ 2,534		$ 2,534
Real estate:						
Commercial and residential	3,075		3,075	1,651		1,651
Land and construction	492		492	1,320		1,320
Home equity	312		312	344		344
Consumer	4		4	6		6
Total	$ 5,503	$	$ 5,503	$ 5,855	$	$ 5,855

The following tables present the aging of past due loans by class for the periods indicated:

	September 30, 2015					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 4,201	$ 466	$ 373	$ 5,040	$ 549,129	$ 554,169
Real estate:						
Commercial and residential					606,819	606,819
Land and construction			2,551	2,551	82,316	84,867
Home equity					74,624	74,624
Consumer					12,595	12,595
Total	$ 4,201	$ 466	$ 2,924	$ 7,591	$ 1,325,483	$ 1,333,074

	December 31, 2014					
						Total

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	
			(Dollars in thousands)			
Commercial	$ 3,002	$ 195	$ 1,978	$ 5,175	$ 457,228	$ 462,403
Real estate:						
Commercial and residential			1,065	1,065	477,270	478,335
Land and construction					67,980	67,980
Home equity					61,644	61,644
Consumer					18,867	18,867
Total	$ 3,002	$ 195	$ 3,043	$ 6,240	$ 1,082,989	$ 1,089,229

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

5) Loans (Continued)

Past due loans 30 days or greater totaled $7,591,000 and $6,240,000 at September 30, 2015 and December 31, 2014, respectively, of which $3,774,000 and $3,130,000 were on nonaccrual. At September 30, 2015, there were also $1,729,000 loans less than 30 days past due included in nonaccrual loans held for investment. At December 31, 2014, there were also $2,725,000 loans less than 30 days past due included in nonaccrual loans held for investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

Credit Quality Indicators

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

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

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

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

5) Loans (Continued)

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

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

Loss. Loans classified as loss are considered uncollectable or of so little value that their continuance as assets is not warranted. This classification does not necessarily mean that a loan has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery would occur. Loans classified as loss are immediately charged off against the allowance for loan losses. Therefore, there is no balance to report at September 30, 2015 and December 31, 2014.

The following table provides a summary of the loan portfolio by loan type and credit quality classification at period end:

	September 30, 2015			December 31, 2014		
	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total
	(Dollars in thousands)					
Commercial	$ 543,879	$ 10,290	$ 554,169	$ 455,767	$ 6,636	$ 462,403
Real estate:						
Commercial and residential	601,671	5,148	606,819	472,061	6,274	478,335
Land and construction	84,375	492	84,867	66,660	1,320	67,980
Home equity	73,286	1,338	74,624	60,736	908	61,644
Consumer	12,279	316	12,595	18,518	349	18,867
Total	$ 1,315,490	$ 17,584	$ 1,333,074	$ 1,073,742	$ 15,487	$ 1,089,229

* Classified loans in the table above include Small Business Administration ("SBA") guarantees.

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

The book balance of troubled debt restructurings at September 30, 2015 was $187,000, which included $4,000 of nonaccrual loans and $183,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2014 was $1,083,000, which included $916,000 of nonaccrual loans and

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

5) Loans (Continued)

$167,000 of accruing loans. Approximately $5,000 and $113,000 in specific reserves were established with respect to these loans as of September 30, 2015 and December 31, 2014, respectively. As of September 30, 2015 and December 31, 2014, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

There were no new loans modified as troubled debt restructurings during the three and nine month periods ended September 30, 2015 and 2014.

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the three and nine month periods ended September 30, 2015 and 2014.

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

6) Business Combinations

Bay View Funding

On October 8, 2014, HBC entered into a Stock Purchase Agreement ("Purchase Agreement") with BVF/CSNK Acquisition Corp., a Delaware corporation ("BVF/CSNK") pursuant to which HBC agreed to acquire all of the outstanding common stock from the stockholders of BVF/CSNK for an aggregate purchase price of $22,520,000 ("Acquisition"). The Acquisition closed on November 1, 2014. Based in Santa Clara, California, BVF/CSNK through its wholly-owned subsidiary CSNK Working Capital Finance Corp., a California corporation, dba Bay View Funding ("Bay View Funding") provides business essential working capital factoring financing to various industries throughout the United States. 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 beginning November 1, 2014.

The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate more accurate or appropriate values for the assets acquired and liabilities assumed, which may be reflective of conditions or events that existed at the acquisition date. Deferred tax assets may be adjusted for uncertain tax positions of Bay View Funding, with a corresponding change to goodwill.

The following table presents pro forma financial information as if the acquisition had occurred on January 1, 2014, which includes the pre-acquisition period for Bay View Funding. The historical unaudited pro forma financial information has been adjusted to reflect supportable items that are directly attributable to the acquisition and expected to have a continuing impact on consolidated results of operations, as such, one-time acquisition costs are not included. The unaudited pro forma financial information is provided for informational purposes only. The unaudited pro forma financial information is not necessarily, and should not be assumed to be, an indication of the results that would have been achieved had the acquisition been completed as of the dates indicated or that may be achieved in the

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

6) Business Combinations (Continued)

future. The preparation of the unaudited pro forma combined consolidated financial statements and related adjustments required management to make certain assumptions and estimates.

UNAUDITED	For the Three Months Ended September 30, 2014		For the Nine Months Ended September 30, 2014	
	(Dollars in thousands, except per share amounts)			
Net interest income	$	16,872	$	49,004
Noninterest income		2,026		6,424
Total revenue	$	18,898	$	55,428
Net income	$	4,014	$	11,441
Net income per share basic	$	0.13	$	0.36
Net income per share diluted	$	0.13	$	0.36

Focus Business Bank

On April 23, 2015, the Company and Focus entered into a definitive agreement and plan of merger and reorganization whereby Focus would merge into HBC. The Company completed the merger of its wholly-owned bank subsidiary HBC with Focus on August 20, 2015 for an aggregate transaction value of $66,558,000. Shareholders of Focus received a fixed exchange ratio at closing of 1.8235 shares of the Company's common stock for each share of Focus common stock. Upon closing of the transaction, the Company issued 5,456,713 shares of the Company's common stock to Focus shareholders for a total value of $58,278,000 based on the Company's closing stock price of $10.68 on August 20, 2015. In addition, the Company paid cash to the Focus holders of in-the-money stock options on August 20, 2015 totaling $8,280,000.

The Company believes the merger provides the opportunity to combine two independent business banking franchises with similar philosophies and cultures into a combined $2.3 billion business bank based in San Jose. The pooling of the two banks' resources and knowledge enhance our capabilities, operational efficiencies, and community outreach. The Company also believes the combined bank will be much better positioned to meet the needs of our customers, shareholders and the community.

Focus's results of operations have been included in the Company's results of operations beginning August 21, 2015. The one-time pre-tax severance, retention, acquisition and integration costs totaled $2,865,000 and $3,407,000 for the three months and nine months ended September 30, 2015, respectively.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

6) Business Combinations (Continued)

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition. The Company is in the process of finalizing the purchase accounting for the acquisition.

		(Dollars in thousands)
Assets acquired:		
Cash and cash equivalents	$	174,066
Securities available-for-sale		53,940
Securities held-to-maturity		8,665
Loans held-for-sale SBA		4,416
Net loans		172,669
Goodwill		31,854
Core deposit intangible asset		6,285
Corporate owned life insurance		7,067
Other assets, net		18,700
Total assets acquired		477,662
Liabilities asssumed:		
Deposits		405,123
Other liabilities		5,981
Total liabilities		411,104
Net assets acquired	$	66,558

The fair value of net assets acquired includes fair value adjustments to certain receivables of which some were considered impaired and some were not considered impaired as of the acquisition date. The fair value adjustments were determined using discounted contractual cash flows, adjusted for expected losses and prepayments, where appropriate. The gross contractual amount of four purchased credit impaired loans as of the acquisition date totaled $1,124,000. As of that date, contractual cash flows not expected to be collected on the purchased credit impaired loans totaled $770,000, which represents 68.5% of their gross outstanding principal balances. The receivables that were not considered impaired at the acquisition date were not subject to the guidance relating to purchased credit impaired loans, which have shown evidence of credit deterioration since origination. Receivables acquired that were not subject to these requirements include nonimpaired loans with a fair value and gross contractual amounts receivable of $176,551,000 and $181,124,000 respectively, on the date of acquisition. As of that date, the purchase discount on these nonimpaired loans totaled $4,573,000, which represents 2.5% of their gross outstanding principal balances.

Goodwill of $31,854,000 arising from the acquisition is largely attributable to synergies and cost savings resulting from combining the operations of the companies. As this transaction was structured as a taxfree exchange, the goodwill will not be deductible for tax purposes. The fair values of assets acquired and liabilities assumed are subject to adjustment during the first twelve months after the acquisition date if additional information becomes available to indicate a more accurate or appropriate

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

6) Business Combinations (Continued)

value for an asset or liability. The loans with a fair value of $177,085,000 and $1,694,000 of income tax attributes related to the purchase accounting adjustments and Focus' legacy deferred tax assets are subject to change pending receipt of the final valuations and analyses. Loan valuations may be adjusted based on new information obtained by the Company in future periods that may reflect conditions or events that existed on the acquisition date. Deferred tax assets may be adjusted for purchase accounting adjustments on open areas such as loans or upon filing Focus' final August 20, 2015 "stub" period tax returns. The closing equity balance for Focus is also subject to adjustments for invoices received after the close of the transaction that were attributable to Focus operations through August 20, 2015.

The following table summarizes the consideration paid for Focus:

	August 20, 2015 (Dollars in thousands)	
Cash paid for Focus in-the-money stock options	$	8,280
Common stock issued to Focus shareholders at $10.68 per share		58,278
Total consideration	$	66,558

The following table presents pro forma financial information as if the acquisition had occurred on January 1, 2014, which includes the pre-acquisition period for Focus. The historical unaudited pro forma financial information has been adjusted to reflect supportable items that are directly attributable to the acquisition and expected to have a continuing impact on consolidated results of operations, as such, one-time acquisition costs are not included. The unaudited pro forma financial information is provided for informational purposes only. The unaudited pro forma financial information is not necessarily, and should not be assumed to be, an indication of the results that would have been achieved had the acquisition been completed as of the dates indicated or that may be achieved in the future. The preparation of the unaudited pro forma combined consolidated financial statements and related adjustments required management to make certain assumptions and estimates.

UNAUDITED	For the Three Months Ended September 30, 2015		For the Three Months Ended September 30, 2014	
	(Dollars in thousands, except per share amounts)			
Net interest income	$	21,057	$	16,667
Provision for loan losses		(301)		1
Noninterest income		2,863		2,368
Noninterest expense		15,667		12,898
Income before income taxes		8,554		6,136
Income tax expense		3,806		2,261
Net income	$	4,748	$	3,875
Net income per share basic	$	0.13	$	0.10
Net income per share diluted	$	0.13	$	0.10

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

6) Business Combinations (Continued)

UNAUDITED	For the Nine Months Ended September 30, 2015	For the Nine Months Ended September 30, 2014
	(Dollars in thousands, except per share amounts)	
Net interest income	$ 61,814	$ 49,213
Provision for loan losses	(289)	(32)
Noninterest income	8,568	7,452
Noninterest expense	46,002	38,727
Income before income taxes	24,669	17,970
Income tax expense	9,932	6,562
Net income	$ 14,737	$ 11,408
Net income per share basic	$ 0.39	$ 0.30
Net income per share diluted	$ 0.39	$ 0.30

(7) Goodwill and Other Intangible Assets

Goodwill

The Company recognized $13,044,000 of goodwill upon its acquisition of Bay View Funding on November 1, 2014, and $31,854,000 upon its acquisition of Focus on August 20, 2015.

Other Intangible Assets

Core deposit and customer relationship intangible assets acquired in the 2007 acquisition of Diablo Valley Bank were $5,049,000 and $276,000, respectively. These assets are amortized over their estimated useful lives of 10 years. The customer relationship intangible asset was fully amortized at December 31, 2014. Accumulated amortization of these intangible assets was $4,592,000 and $4,257,000 at September 30, 2015 and December 31, 2014, respectfully.

The core deposit intangible asset acquired in the acquisition of Focus in August 2015 was $6,285,000. This asset is amortized over its estimated useful lives of 10 years. Accumulated amortization of this intangible asset was $88,000 at September 30, 2015.

Other intangible assets acquired in the acquisition of Bay View Funding in November 2014 included: a below market value lease intangible asset of $109,000 (amortized over 3 years), customer relationship and brokered relationship intangible assets of $1,900,000, (amortized over the 10 year estimated useful lives), and a non compete agreement intangible asset of $250,000 (amortized over 3 years). Accumulated amortization of these intangible assets was $283,000 and $51,000 at September 30, 2015 and December 31, 2014, respectfully.

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

(7) Goodwill and Other Intangible Assets (Continued)

Estimated amortization expense for 2015 and each of the next five years follows:

	Diablo Valley Bank Core Deposit Intangible	Focus Core Deposit Intangible	Bay View Funding Below Market Value Lease Intangible	Bay View Funding Customer & Brokered Relationship Intangible	Bay View Funding Non-Compete Agreement Intangible	Total Amortization Expense
	(Dollars in thousands)					
2015	$ 446	$ 286	$ 36	$ 190	$ 83	$ 1,041
2016	427	831	36	190	83	1,567
2017	195	875	31	190	70	1,361
2018		775		190		965
2019		734		190		924
2020		716		190		906
	$ 1,068	$ 4,217	$ 103	$ 1,140	$ 236	$ 6,764

Impairment testing of the intangible assets is performed at the individual asset level. Impairment exists if the carrying amount of the asset is not recoverable and exceeds its fair value at the date of the impairment test. For intangible assets, estimates of expected future cash flows (cash inflows less cash outflows) that are directly associated with an intangible asset are used to determine the fair value of that asset. Management makes certain estimates and assumptions in determining the expected future cash flows from core deposit and customer relationship intangibles including account attrition, expected lives, discount rates, interest rates, servicing costs and other factors. Significant changes in these estimates and assumptions could adversely impact the valuation of these intangible assets. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset. Based on its assessment, management concluded that there was no impairment of intangible assets at September 30, 2015 and December 31, 2014.

8) Income Taxes

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

Realization of the Company's deferred tax assets is primarily dependent upon the Company generating sufficient taxable income to obtain benefit from the reversal of net deductible temporary differences and utilization of tax credit carryforwards are as of December 31, 2014 for Federal and California state income tax purposes. The amount of deferred tax assets considered realizable is subject to adjustment in future periods based on estimates of future taxable income. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is "more likely than not"

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

8) Income Taxes (Continued)

that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions. In accordance with Accounting for Uncertainty in Income Taxes, the Company estimated the need for a reserve for income taxes of $250,000 for uncertain state income tax positions of Bay View Funding. It is also estimated that a need for a reserve for uncertain tax positions of $82,000 for the Company.

The Company had net deferred tax assets of $20,111,000, and $18,527,000, at September 30, 2015, and December 31, 2014, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at September 30, 2015 and December 31, 2014 will be fully realized in future years.

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. As a result of the change in accounting method, the Company reclassified $353,000 of low income housing investment losses during the third quarter of 2014 that was previously reported as noninterest expense for the six months of 2014. 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. The following tables reflect noninterest expense, income tax expense, and the effective tax rate as originally reported and with the low income housing investment losses reclassified under the proportional amortization method of accounting for the periods indicated:

	For the Three Months Ended 09/30/14	For the Nine Months Ended 09/30/14
	(Dollars in thousands)	
Noninterest expense as originally reported	$ 10,139	$ 31,807
Low income housing investment losses reclassified to income tax expense	353	
Noninterest expense under the proportional method	$ 10,492	$ 31,807
Income tax expense as originally reported	$ 2,322	$ 5,545
Low income housing investment losses reclassified from noninterest expense	(353)	
Income tax expense under the proportional method	$ 1,969	$ 5,545
Effective tax rate as originally reported	40.4%	36.1%
Effective under the proportional method	36.5%	36.1%

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

8) Income Taxes (Continued)

The following table reflects the carry amounts of the low income housing investments included in accrued interest receivable and other assets, and the future commitments as of September 30, 2015 and December 31, 2014:

	September 30, 2015	December 31, 2014
	(Dollars in thousands)	
Low income housing investments	$ 4,532	$ 5,268
Future commitments	$ 1,827	$ 1,827

The Company expects $938,000 of the future commitments to be paid in 2015, $550,000 in 2016, and $339,000 in 2017 through 2023.

For tax purposes, the Company had low income housing tax credits of $175,000 and $198,000 for the three months ended September 30, 2015 and September 30, 2014, respectively, and low income housing investment losses of $230,000 and $272,000, respectively. For tax purposes, the Company had low income housing tax credits of $525,000 and $404,000 for the nine months ended September 30, 2015 and September 30, 2014, respectively, and low income housing investment losses of $687,000 and $624,000, respectively. The Company recognized low income housing investment expense as a component of income tax expense.

9) Benefit Plans

Supplemental Retirement Plan

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(Dollars in thousands)			
Components of net periodic benefit cost:				
Service cost	$ 216	$ 179	$ 648	$ 537
Interest cost	221	228	663	684
Amortization of net actuarial loss	96	35	288	105
Net periodic benefit cost	$ 533	$ 442	$ 1,599	$ 1,326

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

9) Benefit Plans (Continued)

Split-Dollar Life Insurance Benefit Plan

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

	September 30, 2015	December 31, 2014
	(Dollars in thousands)	
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	$ 4,641	$ 4,353
Interest cost	127	196
Amortization of net actuarial loss		92
Projected benefit obligation at end of period	$ 4,768	$ 4,641

	September 30, 2015	December 31, 2014
	(Dollars in thousands)	
Net actuarial loss	$ 692	$ 540
Prior transition obligation	1,440	1,507
Accumulated other comprehensive loss	$ 2,132	$ 2,047

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(Dollars in thousands)			
Amortization of prior transition obligation	$ (28)	$ (25)	$ (84)	$ (77)
Interest cost	42	49	126	147
Net periodic benefit cost	$ 14	$ 24	$ 42	$ 70

10) Equity

Series C Preferred Stock

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is mandatorily convertible into common stock at a conversion price of $3.75 per share upon a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering. The 21,004 shares of Series C Preferred Stock are convertible into 5,601,000 shares of common stock. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. The holders of Series C Preferred Stock receive dividends on an as converted basis when dividends are also

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

10) Equity (Continued)

declared for holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of $1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

11) Fair Value

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

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

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

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

Financial Assets and Liabilities Measured on a Recurring Basis

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

11) Fair Value (Continued)

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

		Fair Value Measurements Using		
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Dollars in thousands)			
Assets at September 30, 2015:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 170,399	$	$ 170,399	$
Corporate bonds	36,608		36,608	
Trust preferred securities	15,000		15,000	
Collateralized mortgage obligations	11,791		11,791	
U.S. Government sponsored entities	11,125		11,125	
Municipals tax exempt	5,765		5,765	
U.S. Treasury	4,039	4,039		
Municipals taxable	2,683		2,683	
I/O strip receivables	1,441		1,441	
Assets at December 31, 2014:				
Available-for-sale securities:				
Agency mortgage-backed securities	$ 154,172	$	$ 154,172	$
Corporate bonds	36,863		36,863	
Trust preferred securities	15,300		15,300	
I/O strip receivables	1,481		1,481	

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

Assets and Liabilities Measured on a Non-Recurring Basis

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. The appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Foreclosed assets are valued at the time the loan is foreclosed upon and the asset is transferred to foreclosed assets. The fair value is based primarily on third party appraisals, less costs to sell. The appraisals may utilize a single valuation approach or a combination of approaches including the comparable sales and income approach. Adjustments are routinely made in the appraisal process by the

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

11) Fair Value (Continued)

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

		Fair Value Measurements Using		
	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(Dollars in thousands)		
Assets at September 30, 2015:				
Impaired loans held-for-investment:				
Commercial	$ 723			$ 723
Real estate:				
Commercial and residential	524			524
Land and construction	492			492
	$ 1,739			$ 1,739
Assets at December 31, 2014:				
Impaired loans held-for-investment:				
Commercial	$ 859			$ 859
Real estate:				
Commercial and residential	587			587
Land and construction	1,176			1,176
	$ 2,622			$ 2,622
Foreclosed assets:				
Real estate:				
Land and construction	$ 31			$ 31
	$ 31			$ 31

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

11) Fair Value (Continued)

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

	September 30, 2015	December 31, 2014
	(Dollars in thousands)	
Impaired loans held-for-investment:		
Book value of impaired loans held-for-investment carried at fair value	$ 1,872	$ 3,026
Book value of impaired loans held-for-investment carried at cost	3,814	2,996
Total impaired loans held-for-investment	$ 5,686	$ 6,022
Impaired loans held-for-investment carried at fair value:		
Book value of impaired loans held-for-investment carried at fair value	$ 1,872	$ 3,026
Specific valuation allowance	(133)	(404)
Impaired loans held-for-investment carried at fair value, net	$ 1,739	$ 2,622

Impaired loans held-for-investment which are measured primarily for impairment using the fair value of the collateral were $5,686,000 at September 30, 2015. In addition, these loans had a specific valuation allowance of $133,000 at September 30, 2015. Impaired loans held-for-investment totaling $1,872,000 at September 30, 2015, were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at period-end. The remaining $3,814,000 of impaired loans were carried at cost at September 30, 2015, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during the first nine months of 2015 on impaired loans held-for-investment carried at fair value at September 30, 2015 resulted in a credit to the provision for loan losses of $191,000.

At September 30, 2015, foreclosed assets had a carrying amount of $393,000, with no valuation allowance at September 30, 2015.

Impaired loans held-for-investment of $6,022,000 at December 31, 2014, after partial charge-offs of $107,000 in 2014, were analyzed for additional impairment primarily using the fair value of collateral. In addition, these loans had a specific valuation allowance of $404,000 at December 31, 2014. Impaired loans held-for-investment totaling $3,026,000 at December 31, 2014 were carried at fair value as a result of the aforementioned partial charge-offs and specific valuation allowances at year-end. The remaining $2,996,000 of impaired loans were carried at cost at December 31, 2014, as the fair value of the collateral exceeded the cost basis of each respective loan. Partial charge-offs and changes in specific valuation allowances during 2014 on impaired loans held-for-investment carried at fair value at December 31, 2014 resulted in a credit to the provision for loan losses of $100,000.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

11) Fair Value (Continued)

At December 31, 2014, foreclosed assets had a carrying amount of $696,000, with no valuation allowance at December 31, 2014.

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

	September 30, 2015			
	Fair Value	Valuation Techniques	Unobservable Inputs	Range (Weighted Average)
	(Dollars in thousands)			
Impaired loans held-for-investment:				
Commercial	$ 723	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)
Real estate:				
Commercial and residential	$ 524	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)
Land and construction	$ 492	Market Approach	Discount adjustment for differences between comparable sales	0% to 1% (1%)

	December 31, 2014			
	Fair Value	Valuation Techniques	Unobservable Inputs	Range (Weighted Average)
	(Dollars in thousands)			
Impaired loans held-for-investment:				
Commercial	$ 859	Market Approach	Discount adjustment for differences between comparable sales	0% to 3% (3%)
Real estate:				
Commercial and residential	$ 587	Market Approach	Discount adjustment for differences between	0% to 3% (3%)

				comparable sales	
Land and construction	$	1,176	Market Approach	Discount adjustment for differences between comparable sales	1% to 2% (2%)
Foreclosed assets:					
Commercial	$	31	Market Approach	Discount adjustment for differences between comparable sales	Less than 1%

The Company obtains third party appraisals on its impaired loans held- for-investment and foreclosed assets to determine fair value. Generally, the third party appraisals apply the "market approach," which is a valuation technique that uses prices and other relevant information generated by

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

11) Fair Value (Continued)

market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business. Adjustments are then made based on the type of property, age of appraisal, current status of property and other related factors to estimate the current value of collateral.

The carrying amounts and estimated fair values of financial instruments at September 30, 2015 are as follows:

		Estimated Fair Value			
	Carrying Amounts	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
		(Dollars in thousands)			
Assets:					
Cash and cash equivalents	$ 392,938	$ 392,938	$	$	$ 392,938
Securities available-for-sale	257,410		257,410		257,410
Securities held-to-maturity	111,004		110,035		110,035
Loans (including loans held-for-sale), net	1,321,541		7,873	1,328,678	1,336,551
FHLB and FRB stock	10,630				N/A
Accrued interest receivable	5,212		1,906	3,306	5,212
Loan servicing rights and I/O strips receivables	3,820		5,470		5,470
Liabilities:					
Time deposits	$ 272,494	$	$ 228,490	$	$ 228,490
Other deposits	1,689,529		1,733,533		1,733,533
Short-term borrowings	1,000		1,000		1,000
Accrued interest payable	215		215		215

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

11) Fair Value (Continued)

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2014:

	Carrying Amounts	Estimated Fair Value Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
		(Dollars in thousands)			
Assets:					
Cash and cash equivalents	$ 122,403	$ 122,403	$	$	$ 122,403
Securities available-for-sale	206,335		206,335		206,335
Securities held-to-maturity	95,362		94,953		94,953
Loans (including loans held-for-sale), net	1,071,436		1,172	1,071,854	1,073,026
FHLB and FRB stock	10,598				N/A
Accrued interest receivable	5,044		1,435	3,609	5,044
Loan servicing rights and I/O strips receivables	2,046		3,906		3,906
Liabilities:					
Time deposits	$ 256,223	$	$ 256,589	$	$ 256,589
Other deposits	1,132,163		1,132,163		1,132,163
Accrued interest payable	201		201		201

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

Cash and Cash Equivalents

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

Loans

The fair value of loans held-for-sale is estimated based upon binding contracts and quotes from third parties resulting in a Level 2 classification.

Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

11) Fair Value (Continued)

FHLB and FRB Stock

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

Accrued Interest Receivable/Payable

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

Deposits

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

Short-term Borrowings

The carrying amount approximates the fair value of short-term borrowings that reprice frequently and fully.

Off-balance Sheet Instruments

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

Limitations

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

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

12) Equity Plan

The Company maintained an Amended and Restated 2004 Equity Plan (the "2004 Plan") for directors, officers, and key employees. The 2004 Plan was terminated on May 23, 2013. On May 23, 2013, the Company's shareholders approved the 2013 Equity Incentive Plan (the "2013 Plan"). The equity plans provide for the grant of incentive and nonqualified stock options and restricted stock. The equity plans provide that the option price for both incentive and nonqualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally options vest over four years. All options expire no later than ten years from the date of grant. Restricted stock is subject to time vesting. For the nine months ended September 30, 2015, the Company granted 223,000 shares of nonqualified stock options and 73,855 shares of restricted stock subject to time vesting requirements. There were 984,392 shares available for the issuance of equity awards under the 2013 Plan as of September 30, 2015.

Stock option activity under the equity plans is as follows:

Total Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2015	1,726,106	$ 11.23		
Granted	223,000	$ 9.36		
Exercised	(47,432)	$ 5.66		
Forfeited or expired	(128,248)	$ 18.66		
Outstanding at September 30, 2015	1,773,426	$ 10.60	6.0	$ 5,593,499
Vested or expected to vest	1,684,755		6.0	$ 5,313,824
Exercisable at September 30, 2015	1,197,888		4.8	$ 3,787,661

As of September 30, 2015, there was $2,058,000 of total unrecognized compensation cost related to nonvested stock options granted under the equity plans. That cost is expected to be recognized over a weighted-average period of approximately 2.63 years.

Restricted stock activity under the equity plans is as follows:

Total Restricted Stock Award	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested shares at January 1, 2015	100,000	$ 8.25
Granted	73,855	$ 9.30
Vested	(13,750)	$ 6.98

Forfeited or expired	(5,000)	$	8.70
Nonvested shares at September 30, 2015	155,105	$	8.85

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

12) Equity Plan (Continued)

As of September 30, 2015, there was $1,150,000 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the equity plans. The cost is expected to be recognized over a weighted-average period of approximately 3.3 years.

13) Capital Requirements

The Company and its subsidiary bank are subject to various regulatory capital requirements administered by the banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements and operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and HBC must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off balance sheet items as calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

As of January 1, 2015, HCC and HBC along with other community banking organizations became subject to new capital requirements on January 1, 2015 and certain provisions of the new rules will be phased in from 2015 through 2019. The Federal Banking regulators approved the new rules to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of The Dodd Frank Wall Street Reform and Consumer Protection Act of 2010, as amended. The Company's consolidated capital ratios and the Bank's capital ratios exceeded the regulatory guidelines for a well-capitalized financial institution under the Basel III regulatory requirements at September 30, 2015.

Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios (set forth in the tables below) of total, Tier 1 capital, and common equity Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of September 30, 2015 and December 31, 2014, the Company and HBC met all capital adequacy guidelines to which they were subject.

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

13) Capital Requirements (Continued)

The Company's consolidated capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of September 30, 2015, and under the Basel I regulatory requirements as of December 31, 2014.

	Actual		To Be Well-Capitalized Under Basel III Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel III	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
As of September 30, 2015:						
Total Capital (to risk-weighted assets)	$ 217,200	12.3%	N/A	N/A	$ 141,097	8.0%
Tier 1 Capital (to risk-weighted assets)	$ 197,720	11.2%	N/A	N/A	$ 105,825	6.0%
Common Equity Tier 1 Capital (to risk-weighted assets)	$ 180,353	10.2%	N/A	N/A	$ 79,367	4.5%
Tier 1 Capital (to average assets)	$ 197,720	10.4%	N/A	N/A	$ 76,079	4.0%

	Actual		To Be Well-Capitalized Under Basel I Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel I	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
As of December 31, 2014:						
Total Capital (to risk-weighted assets)	$ 186,068	13.9%	$ 134,109	10.0%	$ 107,287	8.0%
Tier 1 Capital (to risk-weighted assets)	$ 169,278	12.6%	$ 80,465	6.0%	$ 53,644	4.0%
Tier 1 Capital (to average assets)	$ 169,278	10.6%	N/A	N/A	$ 63,949	4.0%

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

13) Capital Requirements (Continued)

HBC's actual capital amounts and ratios are presented in the following table, together with capital adequacy requirements, under the Basel III regulatory requirements as of September 30, 2015, and under the Basel I regulatory requirements as of December 31, 2014.

	Actual		To Be Well-Capitalized Under Basel III Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel III	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
As of September 30, 2015:						
Total Capital (to risk-weighted assets)	$ 213,519	12.1%	$ 176,043	10.0%	$ 140,835	8.0%
Tier 1 Capital (to risk-weighted assets)	$ 194,039	11.0%	$ 140,835	8.0%	$ 105,626	6.0%
Common Equity Tier 1 Capital (to risk-weighted assets)	$ 194,039	11.0%	$ 114,420	6.5%	$ 79,220	4.5%
Tier 1 Capital (to average assets)	$ 194,039	10.2%	$ 95,015	5.0%	$ 76,012	4.0%

	Actual		To Be Well-Capitalized Under Basel I Regulatory Requirements		Required For Capital Adequacy Purposes Under Basel I	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
As of December 31, 2014:						
Total Capital (to risk-weighted assets)	$ 175,765	13.1%	$ 134,095	10.0%	$ 107,276	8.0%
Tier 1 Capital (to risk-weighted assets)	$ 158,976	11.9%	$ 80,457	6.0%	$ 53,638	4.0%
Tier 1 Capital (to average assets)	$ 158,976	9.9%	$ 79,959	5.0%	$ 63,967	4.0%

At September 30, 2015, the Company's and HBC's regulatory capital increased concurrent with average assets for capital purposes and risk-weighted assets due to the common stock issuance of the Focus transaction, net of normal fluctuations to regulatory capital from dividends, share based compensation, and net income.

HCC is dependent upon dividends from HBC. Under California General Corporation Law, the holders of common stock are entitled to receive dividends when and as declared by the Board of Directors, out of funds legally available. The California Financial Code provides that a state licensed bank may not make a cash distribution to its shareholders in excess of the lesser of the following: (i) the bank's retained earnings; or (ii) the bank's net income for its last three fiscal years, less the amount of any distributions made by the bank to its shareholders during such period. However, a bank, with the prior approval of the Commissioner of the California Department of Business

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

13) Capital Requirements (Continued)

Oversight Division of Financial Institutions ("DBO") may make a distribution to its shareholders of an amount not to exceed the greater of (i) a bank's retained earnings; (ii) its net income for its last fiscal year; or (iii) its net income for the current fiscal year. Also with the prior approval of the Commissioner of the DBO and the shareholders of the bank, the bank may make a distribution to its shareholders, as a reduction in capital of the bank. In the event that the Commissioner determines that the shareholders' equity of a bank is inadequate or that the making of a distribution by a bank would be unsafe or unsound, the Commissioner may order a bank to refrain from making such a proposed distribution. As of September 30, 2015, HBC would be required to obtain regulatory approval from the DBO for a dividend or other distribution to HCC. Similar restrictions applied to the amount and sum of loan advances and other transfers of funds from HBC to the parent company.

14) Loss Contingencies

The Company's policy is to accrue for legal costs associated with both asserted and unasserted claims when it is probable that such costs will be incurred and such costs can be reasonably estimated. A number of parties have filed complaints in the Superior Court of California for the County of Santa Clara asserting certain claims against the Company arising from the transfer of funds. The litigation is in the early stages and it is not possible to determine the amount of the loss, if any, arising from the claim in excess of the legal expenses expected to be incurred in defense of the litigation. The Company intends to vigorously defend the litigation.

15) Business Segment Information

The following presents the Company's operating segments. The Company operates through two business segments: Banking segment and Factoring segment. Transactions between segments consist primarily of borrowed funds. Intersegment interest expense is allocated to the Factoring segment based on the Company's prime rate and funding costs. The provision for loan loss is allocated based on the segment's allowance for loan loss determination which considers the effects of charge-offs. Noninterest income and expense directly attributable to a segment are assigned to it. Taxes are paid on a consolidated basis and allocated for segment purposes. The Factoring segment includes only factoring

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

15) Business Segment Information (Continued)

originated by Bay View Funding, which has been included in the results of operations since the acquisition on November 1, 2014.

	For the Three Months Ended September 30, 2015		
	Banking(1)	**Factoring**	**Consolidated**
	(Dollars in thousands)		
Interest income	$ 17,117	$ 3,189	$ 20,306
Intersegment interest allocations	280	(280)	
Total interest expense	623		623
Net interest income	16,774	2,909	19,683
Provision (credit) for loan losses	(291)	(10)	(301)
Net interest income after provision	17,065	2,919	19,984
Noninterest income	1,869	197	2,066
Noninterest expense	14,616	1,803	16,419
Intersegment expense allocations	112	(112)	
Income before income taxes	4,430	1,201	5,631
Income tax expense	1,668	504	2,172
Net income	$ 2,762	$ 697	$ 3,459
Total assets	$ 2,218,007	$ 44,200	$ 2,262,207
Loans, net of deferred fees	$ 1,290,062	$ 42,343	$ 1,332,405

(1) Includes the holding company's results of operations

Table of Contents

HERITAGE COMMERCE CORP

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2015

(Unaudited)

15) Business Segment Information (Continued)

	For the Nine Months Ended September 30, 2015		
	Banking(1)	Factoring	Consolidated
	(Dollars in thousands)		
Interest income	$ 46,458	$ 9,389	$ 55,847
Intersegment interest allocations	822	(822)	
Total interest expense	1,664		1,664
Net interest income	45,616	8,567	54,183
Provision (credit) for loan losses	(328)	(11)	(339)
Net interest income after provision	45,944	8,578	54,522
Noninterest income	5,581	575	6,156
Noninterest expense	35,930	5,382	41,312
Intersegment expense allocations	266	(266)	
Income before income taxes	15,861	3,505	19,366
Income tax expense	5,820	1,472	7,292
Net income	$ 10,041	$ 2,033	$ 12,074
Total assets	$ 2,218,007	$ 44,200	$ 2,262,207
Loans, net of deferred fees	$ 1,290,062	$ 42,343	$ 1,332,405

(1) Includes the holding company's results of operations

16) Subsequent Events

On October 26, 2015, the Company announced that its Board of Directors declared a $0.08 per share quarterly cash dividend to holders of common stock and Series C Preferred Stock (on an as converted basis). The dividend will be paid on November 24, 2015, to shareholders of record on November 10, 2015.

Table of Contents

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

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

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are discussed in our Form 10-K for the year ended December 31, 2014. There are no changes to these policies as of September 30, 2015, except for the following policies on segment reporting to include two reportable segments consisting of Banking and Factoring as a result of the acquisition of Bay View Funding, and business combinations as a result of both the Bay View Funding and Focus acquisitions:

Segment Reporting

HBC is a commercial bank serving customers 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 through its Banking and Factoring business segments. No customer accounts for more than 10 percent of revenue for HBC or the Company. The Company's management uses segments results in its operating and strategic planning.

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.

EXECUTIVE SUMMARY

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

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

Table of Contents

Performance Overview

For the three months ended September 30, 2015, net income was $3.5 million, or $0.10 per average diluted common share, compared to $3.4 million, or $0.11 per average diluted common share, for the three months ended September 30, 2014. The Company's annualized return on average tangible assets was 0.71% and annualized return on average tangible equity was 7.46% for the three months ended September 30, 2015, compared to 0.88% and 7.51%, respectively, for the three months ended September 30, 2014.

For the nine months ended September 30, 2015, net income was $12.1 million, or $0.36 per average diluted common share, compared to $9.8 million, or $0.31 per average diluted common share, for the nine months ended September 30, 2014. The Company's annualized return on average tangible assets was 0.93% and annualized return on average tangible equity was 9.22% for the nine months ended September 30, 2015, compared to 0.88% and 7.40%, respectively, for the nine months ended September 30, 2014.

Bay View Funding Acquisition

On November 1, 2014, the Company acquired Bay View Funding, by purchasing all of the outstanding common stock from the stockholders of Bay View Funding for an aggregate purchase price of $22.52 million. Bay View Funding became a wholly owned subsidiary of HBC. Based in Santa Clara, California, Bay View Funding, provides business essential working capital factoring financing to various industries throughout the United States. Bay View Funding's results of operations have been included in the Company's results beginning November 1, 2014. The following table reflects selected financial information for Bay View Funding at or for the periods indicated:

	(Dollars in thousands)	
Total factored receivables at September 30, 2015	$	42,343
Average factored receivables:		
For the three months ended September 30, 2015	$	43,364
For the nine months ended September 30, 2015	$	41,791
Total full time equivalent employees at September 30, 2015		37

Focus Business Bank Merger

On April 23, 2015, the Company and Focus entered into a definitive agreement and plan of merger and reorganization whereby Focus would merge into HBC. The Company completed the merger of its wholly-owned bank subsidiary HBC with Focus on August 20, 2015 for an aggregate transaction value of $66.6 million. Shareholders of Focus received a fixed exchange ratio at closing of 1.8235 shares of the Company's common stock for each share of Focus common stock. Upon closing of the transaction, the Company issued 5,456,713 shares of the Company's common stock to Focus shareholders for a total value of $58.3 million based on the Company's closing stock price of $10.68 on August 20, 2015. In addition, the Company paid cash to the Focus holders of in-the-money stock options on August 20, 2015 totaling $8.3 million.

The Company believes the merger provides the opportunity to combine two independent business banking franchises with similar philosophies and cultures into a combined $2.3 billion business bank based in San Jose. The pooling of the two banks' resources and knowledge enhance our capabilities, operational efficiencies, and community outreach. The Company also believes the combined bank will be much better positioned to meet the needs of our customers, shareholders and the community.

The Focus acquisition added $168.1 million in Federal funds sold and interest-bearing deposits in other financial institutions, $62.0 million in investment securities (at fair value), $167.3 million in loans (at fair value, including loans held-for-sale), and $396.5 million in deposits at September 30, 2015. The

Table of Contents

Focus acquisition added $79.4 million in average total loans, $189.1 million in average total assets, and $176.0 million in average total deposits for the three months ended September 30, 2015. The Focus acquisition added $26.8 million in average total loans, $63.7 million in average total assets, and $59.3 million in average total deposits for the nine months ended September 30, 2015. Focus's results of operations have been included in the Company's results of operations beginning August 21, 2015. The one-time pre-tax severance, retention, acquisition and integration costs totaled $2.9 million and $3.4 million for the three months and nine months ended September 30, 2015, respectively.

Third Quarter and Year-to-Date 2015 Highlights

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

The net interest margin (FTE) increased 46 basis points to 4.39% for the third quarter of 2015, from 3.93% for the third quarter of 2014, primarily due to loan growth, higher yields on securities, and revenue from the higher yielding Bay View Funding factored receivables portfolio partially offset by the temporary investment of the excess liquidity from the Focus acquisition into lower yielding Federal funds sold and deposits at the Federal Reserve Bank. For the first nine months of 2015, net interest margin increased 52 basis points to 4.54%, compared to 4.02% for the first nine months of 2014, primarily due to revenue from the higher yielding Bay View Funding factored receivables portfolio, and a special dividend of $203,000 paid by the FHLB in the second quarter of 2015, partially offset by the temporary investment of excess liquidity from the Focus acquisition. At September 30, 2015, Federal funds sold and interest-bearing deposits in other financial institutions totaled $364.2 million. Average Federal funds sold and interest-bearing deposits in other financial institutions were $226.3 million for the third quarter of 2015, compared to $114.9 million for the second quarter of 2015.

Net interest income increased 41% to $19.7 million for the third quarter of 2015, compared to $14.0 million for the thid quarter of 2014. Net interest income increased 32% to $54.2 million for the nine months ended September 30, 2015, compared to $41.0 million for the nine months ended September 30, 2014.

There was a $301,000 credit provision for loan losses for the third quarter of 2015, compared to a $24,000 credit provision for loan losses for the third quarter of 2014. For the nine months ended September 30, 2015, there was a $339,000 credit provision for loan losses compared to a $232,000 credit provision for loan losses for the nine months ended September 30, 2014.

Noninterest income was $2.1 million for the third quarter of 2015, compared to $1.9 million for the third quarter of 2014. For the nine months ended September 30, 2015 noninterest income was $6.2 million, compared to $5.9 million for the nine months ended September 30, 2014.

Total noninterest expense for the third quarter of 2015 increased to $16.4 million, from $10.5 million for the third quarter of 2014. Noninterest expense for the nine months ended September 30, 2015 increased to $41.3 million, compared to $31.8 million for the nine months ended September 30, 2014. The increase in noninterest expense for the nine months ended September 30, 2015, was primarily due to costs related to the Focus transaction, and the additional operating costs of Focus and Bay View Funding. Noninterest expense included Focus pre-tax severance, retention, acquisition and integration costs of $2.9 million and $3.4 million for the three months and nine months ended September 30, 2015, respectively. The Company will incur additional Focus related acquisition and integration expenses in the fourth quarter of 2015 for severance and retention, systems integration costs, lease termination and other non-recurring expenses.

The efficiency ratio for the third quarter of 2015 was 75.49%, compared to 66.15% for the third quarter of 2014. The efficiency ratio for the nine months ended September 30, 2015 was 68.47%, compared to 67.75% for the nine months ended September 30, 2014. The increase in the efficiency ratio in the third quarter and nine months ended September 30, 2015 compared to the same periods in 2014 was primarily due to one-time Focus acquisition costs. Excluding the impact of the one-time Focus acquisition and severance and retention costs, the efficiency ratio was 62.32% for the third quarter of 2015, and 62.76% for the nine months ended September 30, 2015.

Income tax expense for the third quarter of 2015 was $2.2 million, compared to $2.0 million for the second quarter of 2014. The effective tax rate for the third quarter of 2015 was 38.6%, compared to 40.4% for the third quarter of 2014. Income tax expense for the nine months ended September 30, 2015 was $7.3 million, compared to $5.5 million for the nine months ended September 30, 2014. The effective tax rate for the nine months ended September 30, 2015 was 37.7%, compared to 36.1% for the nine months ended September 30, 2014.

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

Primarily due to the Focus transaction, cash, Federal funds sold, interest-bearing deposits in other financial institutions and securities available-for-sale increased 88% to $650.3 million at September 30, 2015, from $345.8 million at September 30, 2014, and increased 98% from $328.7 million at December 31, 2014.

At September 30, 2015, investment securities held-to-maturity totaled $111.0 million, compared to $94.8 million at September 30, 2014, and $95.4 million at December 31, 2014.

Loans (excluding loans-held-for-sale) increased $302.8 million, or 29%, to $1.33 billion at September 30, 2015, compared to $1.03 billion at September 30, 2014, which included an increase of $139.9 million, or 14%, in the Company's legacy loan portfolio, and $162.9 million from the Focus transaction. Loans increased $243.8 million, or 22%, from $1.09 billion at December 31, 2014 which included an increase of $80.9 million, or 7%, in the Company's legacy loan portfolio, and $162.9 million from the Focus transaction.

Nonperforming assets were $5.9 million, or 0.26% of total assets, at September 30, 2015, compared to $7.7 million, or 0.50%, of total assets, at September 30, 2014, and $6.6 million, or 0.41% of total assets, at December 31, 2014. At September 30, 2015, $5.0 million of the NPAs were in the Company's legacy loan portfolio, and $931,000 of the NPAs were in the Focus loan portfolio.

Classified assets, net of SBA guarantees, increased to $18.0 million at September 30, 2015, from $17.7 million at September 30, 2014, and $16.0 million at December 31, 2014. The increase in classified assets at September 30, 2015 from September 30, 2014 and December 31, 2014 was primarily due to the Focus acquisition. At September 30, 2015, $10.3 million of the classified assets were in the the Company's legacy loan portfolio, and $7.7 million of the classified assets were in the Focus loan portfolio.

Net recoveries totaled $281,000 for the third quarter of 2015, compared to net charge-offs of $27,000 for the third quarter 2014, and net charge-offs of $56,000 for the fourth quarter of 2014.

The allowance for loan losses at September 30, 2015 was $18.7 million, or 1.41% of total loans, representing 340.49% of nonperforming loans. The allowance for loan losses at September 30, 2014 was $18.5 million, or 1.80% of total loans, representing 257.16% of nonperforming loans. The allowance for loan losses at December 31, 2014 was $18.4 million, or 1.69% of total loans, representing 313.90% of nonperforming loans. The loans acquired from Focus are included in total loans; however, there is no allowance for loan losses attributed to these loans at

Table of Contents

September 30, 2015 because upon acquisition they were marked to fair market value, and included a fair value adjustment of $4.9 million at September 30, 2015.

Deposits increased $620.2 million, or 46%, to $1.96 billion at September 30, 2015, compared to $1.34 billion at September 30, 2014, which included an increase of $223.7 million, or 17%, in the Company's legacy deposit portfolio, and $396.5 million from the Focus transaction. Deposits increased $573.6 million, or 41%, at September 30, 2015, compared to $1.39 billion at December 31, 2014, which included an increase of $177.1 million, or 13%, in the Company's legacy deposit portfolio, and $396.5 million from the Focus transaction.

The ratio of noncore funding (which consists of time deposits of $250,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase and short-term borrowings) to total assets was 9.19% at September 30, 2015, compared to 13.06% at September 30, 2014, and 12.54% at December 31, 2014.

The loan to deposit ratio was 67.91% at September 30, 2015, compared to 76.73% at September 30, 2014, and 78.41% at December 31, 2014.

The Company announced it will pay a quarterly cash dividend of $0.08 per share in the fourth quarter of 2015 to holders of common stock and Series C convertible perpetual preferred stock ("Series C Preferred Stock"), on an as converted basis.

As of January 1, 2015, along with other community banking organizations, the Company and the Bank became subject to new capital requirements, and certain provisions of the new rules will be phased in from 2015 through 2019 under the Dodd-Frank Act and Basel III. The Company's consolidated capital ratios and the Bank's capital ratios are presented in the table below.

	At September 30, 2015				
Capital Ratios	**Heritage Commerce Corp**	**Heritage Bank of Commerce**	**Transitional Minimum Regulatory Requirement Effective January 1, 2015**	**Minimum Regulatory Requirement(1) Effective January 1, 2019**	**Well-capitalized by Regulatory Definition Under FDICIA Effective January 1, 2015**
Total Risk-Based	12.3%	12.1%	8.0%	10.5%	10.0%
Tier 1 Risk-Based	11.2%	11.0%	6.0%	8.5%	8.0%
Common Equity Tier 1 Risk-based	10.2%	11.0%	4.5%	7.0%	6.5%
Leverage	10.4%	10.2%	4.0%	4.0%	5.0%

(1) Includes 2.5% capital conservation buffer.

Deposits

The composition and cost of the Company's deposit base are important in analyzing the Company's net interest margin and balance sheet liquidity characteristics. Except for brokered time deposits, the Company's depositors are generally located in its primary market area. Depending on loan demand and other funding requirements, the Company also obtains deposits from wholesale sources including deposit brokers. HBC is a member of the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program allows customers with deposits in excess of FDIC insured limits to obtain coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through this program are considered brokered deposits under regulatory guidelines. The Company has a policy to monitor all deposits that may be sensitive to interest rate changes to help assure that liquidity risk does not become excessive due to concentrations.

Deposits totaled $1.96 billion at September 30, 2015, compared to $1.34 billion at September 30, 2014, and $1.39 billion at December 31, 2014. Deposits (excluding all time deposits and CDARS deposits) increased $608.0 million, or 56%, to $1.69 billion at September 30, 2015, from $1.10 billion at

September 30, 2014 and increased $561.4 million, or 50%, from $1.13 billion at December 31, 2014. At September 30, 2015, total deposits from Focus were $396.5 million, which was comprised of $125.3 million of noninterest-bearing demand deposits, $191.1 million of interest-bearing demand deposits, $10.6 million of time deposits (under $250,000), and $11.9 million of time deposits ($250,000 and over).

The Company had $24.2 million in brokered deposits at September 30, 2015, compared to $28.1 million at September 30, 2014 and December 31, 2014. Deposits from title insurance companies, escrow accounts and real estate exchange facilitators was $24.6 million at September 30, 2015, compared to $33.6 million at September 30, 2014, and $41.5 million at December 31, 2014. Certificates of deposit from the State of California totaled $98.0 million at September 30, 2015, September 30, 2014 and December 31, 2014.

Liquidity

Our liquidity position refers to our ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely fashion. At September 30, 2015, we had $392.9 million in cash and cash equivalents and approximately $445.3 million in available borrowing capacity from various sources including the Federal Home Loan Bank ("FHLB"), the Federal Reserve Bank of San Francisco ("FRB"), and Federal funds facilities with several financial institutions. The Company also had $218.3 million at fair value in unpledged securities available at September 30, 2015. Our loan to deposit ratio decreased to 67.91% at September 30, 2015, compared to 76.73% at September 30, 2014, and 78.41% at December 31, 2014.

Lending

Our lending business originates principally through our branch offices located in our primary markets. In addition, Bay View Funding provides factoring financing throughout the United States. Loans, excluding loans held-for-sale, increased 29% to $1.33 billion at September 30, 2015, from $1.03 billion at September 30, 2014, and increased 22% from $1.09 billion at December 31, 2014. At September 30, 2015, the Focus loan portfolio totaled $162.9 million (at fair value), which was comprised of $76.6 million of commercial and industrial loans ("C&I"), $83.9 million of commercial and residential real estate loans, $834,000 of land and construction loans, $1.2 million of home equity loans, and $353,000 of consumer loans.

The loan portfolio remains well-diversified with C&I loans accounting for 42% of the loan portfolio at September 30, 2015, which included $42.3 million of factored receivables at Bay View Funding. Commercial and residential real estate loans accounted for 45% of the total loan portfolio. Consumer and home equity loans accounted for 7% of total loans, and land and construction loans accounted for the remaining 6% of total loans at September 30, 2015.

Net Interest Income

The management of interest income and expense is fundamental to the performance of the Company. Net interest income, the difference between interest income and interest expense, is the largest component of the Company's total revenue. Management closely monitors both total net interest income and the net interest margin (net interest income divided by average earning assets). Net interest income increased 41% to $19.7 million for the third quarter of 2015, compared to $14.0 million for the third quarter of 2014. Net interest income increased 32% to $54.2 million for the nine months ended September 30, 2015, compared to $41.0 million for the nine months ended September 30, 2014. The increase in the net interest income for the third quarter and for the nine months ended September 30, 2015, compared to the same periods in 2014, was primarily the result of the Focus acquisition, organic growth in the loan portfolio, contribution to revenue from operations from Bay

Table of Contents

View Funding, and increases in core deposits. Net interest income for the nine months ended September 30, 2015 also increased from a special dividend of $203,000 paid by the FHLB in the second quarter of 2015.

For the three months and nine months ended September 30, 2015, net interest income included the accretion of $262,000 from the loan interest rate and credit fair value adjustments in loan interest income, and the accretion of $2,000 from the securities fair value adjustment to securities interest income.

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

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

Management of Credit Risk

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

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

Noninterest Income

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

Table of Contents

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company's performance. Noninterest expense for the third quarter of 2015 was $16.4 million, compared to $10.5 million for the third quarter of 2014. Noninterest expense for the nine months ended September 30, 2015 was $41.3 million, compared to $31.8 million for the nine months ended September 30, 2014. The increase in noninterest expense for the third quarter and nine months ended September 30, 2015 was primarily due to costs related to the Focus transaction, and the additional operating costs of Focus and Bay View Funding. The one-time pre-tax severance, retention, acquisition and integration costs totaled $2.9 million and $3.4 million for the three months and nine months ended September 30, 2015, respectively.

Capital Management

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

RESULTS OF OPERATIONS

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

Net Interest Income and Net Interest Margin

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

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

Table of Contents

Distribution, Rate and Yield

NET INTEREST INCOME AND NET INTEREST MARGIN	For the Three Months Ended September 30, 2015 Average Balance	Interest Income/ Expense	Average Yield/ Rate	For the Three Months Ended September 30, 2014 Average Balance	Interest Income/ Expense	Average Yield/ Rate
	(Dollars in thousands)					
Assets:						
Loans, gross(1)	$ 1,232,989	$ 17,713	5.70%	$ 1,004,271	$ 12,077	4.77%
Securities taxable	244,313	1,670	2.71%	238,748	1,675	2.78%
Securities tax exempt(2)	91,127	874	3.80%	79,926	779	3.87%
Federal funds sold and interest-bearing deposits in other financial institutions	237,372	355	0.59%	118,847	234	0.78%
Total interest earning assets(2)	1,805,801	20,612	4.53%	1,441,792	14,765	4.06%
Cash and due from banks	34,921			26,535		
Premises and equipment, net	7,374			7,435		
Intangible assets	30,135			1,247		
Other assets	77,816			66,245		
Total assets	$ 1,956,047			$ 1,543,254		
Liabilities and shareholders' equity:						
Deposits:						
Demand, noninterest-bearing	$ 652,529			$ 471,326		
Demand, interest-bearing	326,922	144	0.17%	212,579	89	0.17%
Savings and money market	444,702	240	0.21%	379,733	171	0.18%
Time deposits under $100	20,681	15	0.29%	20,163	16	0.31%
Time deposits $100 and over	206,909	173	0.33%	196,062	158	0.32%
Time deposits brokered	24,861	50	0.80%	31,116	63	0.80%
CDARS money market and time deposits	16,678	1	0.02%	14,755	3	0.08%
Total interest-bearing deposits	1,040,753	623	0.24%	854,408	500	0.23%
Total deposits	1,693,282	623	0.15%	1,325,734	500	0.15%
Short-term borrowings	166		0.00%	52		0.00%
Total interest-bearing liabilities	1,040,919	623	0.24%	854,460	500	0.23%
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,693,448	623	0.15%	1,325,786	500	0.15%
Other liabilities	48,494			35,373		
Total liabilities	1,741,942			1,361,159		
Shareholders' equity	214,105			182,095		
Total liabilities and shareholders' equity	$ 1,956,047			$ 1,543,254		

Net interest income(2) / margin	19,989	4.39%	14,265	3.93%
Less tax equivalent adjustment(2)	(306)		(273)	
Net interest income	$ 19,683		$ 13,992	

(1) Includes loans held for sale. Yield amounts earned on loans include loan fees and costs. Nonaccrual loans are included in average balance.

(2) Reflects tax equivalent adjustment for tax exempt income based on a 35% tax rate.

Table of Contents

NET INTEREST INCOME AND NET INTEREST MARGIN	For the Nine Months Ended September 30, 2015 Average Balance	Interest Income/ Expense	Average Yield/ Rate	For the Nine Months Ended September 30, 2014 Average Balance	Interest Income/ Expense	Average Yield/ Rate
	(Dollars in thousands)					
Assets:						
Loans, gross(1)	$ 1,136,208	$ 48,360	5.69%	$ 970,032	$ 34,832	4.80%
Securities taxable	230,608	4,828	2.80%	264,437	5,555	2.81%
Securities tax exempt(2)	84,286	2,444	3.88%	79,905	2,336	3.91%
Federal funds sold and interest-bearing deposits in other financial institutions	171,503	1,070	0.83%	78,476	634	1.08%
Total interest earning assets(2)	1,622,605	56,702	4.67%	1,392,850	43,357	4.16%
Cash and due from banks	28,647			25,068		
Premises and equipment, net	7,388			7,295		
Goodwill and other intangible assets	20,721			1,365		
Other assets	73,417			64,136		
Total assets	$ 1,752,778			$ 1,490,714		
Liabilities and shareholders' equity:						
Deposits:						
Demand, noninterest-bearing	$ 578,117			$ 445,585		
Demand, interest-bearing	265,095	349	0.18%	203,713	248	0.16%
Savings and money market	403,385	623	0.21%	357,535	489	0.18%
Time deposits under $100	19,812	45	0.30%	20,643	49	0.32%
Time deposits $100 and over	202,512	485	0.32%	195,122	473	0.32%
Time deposits brokered	26,578	157	0.79%	39,249	262	0.89%
CDARS money market and time deposits	13,711	5	0.05%	16,091	6	0.05%
Total interest-bearing deposits	931,093	1,664	0.24%	832,353	1,527	0.25%
Total deposits	1,509,210	1,664	0.15%	1,277,938	1,527	0.16%
Short-term borrowings	80		0.00%	556	1	0.24%
Total interest-bearing liabilities	931,173	1,664	0.24%	832,909	1,528	
Total interest-bearing liabilities and demand, noninterest-bearing / cost of funds	1,509,290	1,664	0.15%	1,278,494	1,528	0.25%
Other liabilities	47,757			33,253		
Total liabilities	1,557,047			1,311,747		
Shareholders' equity	195,731			178,967		
Total liabilities and shareholders' equity	$ 1,752,778			$ 1,490,714		
Net interest income(2) / margin		55,038	4.54%		41,829	4.02%
Less tax equivalent adjustment(2)		(855)			(818)	

Net interest income	$ 54,183	$ 41,011

(1) Includes loans held-for-sale. Yield amounts earned on loans include loan fees and costs. Nonaccrual loans are included in average balance.

(2) Reflects tax equivalent adjustment for tax exempt income based on a 35% tax rate.

Volume and Rate Variances

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

Table of Contents

balance times the prior period rate, and rate variances are equal to the increase or decrease in the average rate times the prior period average balance. Variances attributable to both rate and volume changes are equal to the change in rate times the change in average balance and are included below in the average volume column.

	Three Months Ended September 30, 2015 vs. 2014 Increase (Decrease) Due to Change In:		
	Average Volume	Average Rate	Net Change
	(Dollars in thousands)		
Income from interest earning assets:			
Loans, gross	$ 3,285	$ 2,351	$ 5,636
Securities taxable	39	(44)	(5)
Securities tax exempt(1)	108	(13)	95
Federal funds sold and interest-bearing deposits in other financial institutions	178	(57)	121
Total interest income from interest earnings assets(1)	3,610	2,237	5,847
Expense on interest-bearing liabilities:			
Demand, interest-bearing	53	2	55
Savings and money market	39	30	69
Time deposits under $100		(1)	(1)
Time deposits $100 and over	10	5	15
Time deposits brokered	(13)		(13)
CDARS money market and time deposits		(2)	(2)
Short-term borrowings			
Total interest expense on interest-bearing liabilities	89	34	123
Net interest income(1)	$ 3,521	$ 2,203	5,724
Less tax equivalent adjustment(1)			(33)
Net interest income			$ 5,691

(1) Reflects tax equivalent adjustment for tax exempt income based on a 35% tax rate.

Table of Contents

	Nine Months Ended September 30, 2015 vs. 2014 Increase (Decrease) Due to Change In: Average Volume	Average Rate	Net Change
	(Dollars in thousands)		
Income from interest earning assets:			
Loans, gross	$ 7,077	$ 6,451	$ 13,528
Securities taxable	(710)	(17)	(727)
Securities tax exempt(1)	125	(17)	108
Federal funds sold and interest-bearing deposits in other financial institutions	583	(147)	436
Total interest income from interest earnings assets(1)	7,075	6,270	13,345
Expense on interest-bearing liabilities:			
Demand, interest-bearing	75	26	101
Savings and money market	61	73	134
Time deposits under $100	(1)	(3)	(4)
Time deposits $100 and over	18	(6)	12
Time deposits brokered	(75)	(30)	(105)
CDARS money market and time deposits	(1)		(1)
Short-term borrowings		(1)	(1)
Total interest expense on interest-bearing liabilities	77	59	136
Net interest income(1)	$ 6,998	$ 6,211	13,209
Less tax equivalent adjustment(1)			(37)
Net interest income			$ 13,172

(1) Reflects tax equivalent adjustment for tax exempt income based on a 35% tax rate.

The Company's net interest margin (FTE), expressed as a percentage of average earning assets, increased 46 basis points to 4.39% for the third quarter of 2015, from 3.93% for the third quarter of 2014, primarily due to loan growth, higher yields on securities, and revenue from the higher yielding Bay View Funding factored receivables portfolio, partially offset by the temporary investment of the excess liquidity from the Focus acquisition into lower yielding Federal funds sold and deposits at the Federal Reserve Bank. For the first nine months of 2015, net interest margin increased 52 basis points to 4.54%, compared to 4.02% for the first nine months of 2014, primarily due to revenue from the higher yielding Bay View Funding factored receivables portfolio, and a special dividend of $203,000 paid by the FHLB in the second quarter of 2015, partially offset by the temporary investment of excess liquidity from the Focus acquisition.

Net interest income increased 41% to $19.7 million for the third quarter of 2015, compared to $14.0 million for the third quarter of 2014. Net interest income increased 32% to $54.2 million for the nine months ended September 30, 2015, compared to $41.0 million the nine months ended September 30, 2014. The increase in the net interest income for the third quarter and for the nine months ended September 30, 2015, compared to the same periods in 2014, was primarily the result of the Focus acquisition, organic growth in the loan portfolio, contribution to revenue from operations from Bay View Funding, and increases in core deposits. Net interest income for the nine months ended September 30, 2015 also increased from the special dividend paid by the FHLB in the second quarter of 2015.

Table of Contents

For the three months and nine months ended September 30, 2015, net interest income included the accretion of $262,000 from the loan interest rate and credit fair value adjustments in loan interest income, and the accretion of $2,000 from the securities fair value adjustment to securities interest income.

A majority of the Company's earning assets are variable-rate loans that re-price when the Company's prime lending rate is changed, compared to a large base of core deposits that are generally slower to re-price. This causes the Company's balance sheet to be asset-sensitive, which means that all else being equal, the Company's net interest margin will be lower during periods when short-term interest rates are falling and higher when rates are rising.

Provision for Loan Losses

Credit risk is inherent in the business of making loans. The Company establishes an allowance for loan losses through charges to earnings, which are presented in the statements of income as the provision for loan losses. Specifically identifiable and quantifiable known losses are promptly charged off against the allowance. The provision for loan losses is determined by conducting a quarterly evaluation of the adequacy of the Company's allowance for loan losses and charging the shortfall or excess, if any, to the current quarter's expense. This has the effect of creating variability in the amount and frequency of charges to the Company's earnings. The provision for loan losses and level of allowance for each period are dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of the quality of the loan portfolio, the valuation of problem loans and the general economic conditions in the Company's market area.

There was a credit provision for loan losses of $301,000 for the third quarter of 2015, compared to a credit provision for loan losses of $24,000 for the third quarter of 2014. The credit provision for loan losses for the nine months ended September 30, 2015 was $339,000, compared to a credit to the provision for loan losses of $232,000 for the nine months ended September 30, 2014. There was no impact to the provision for loan losses from the Focus transaction for the three months and nine months ended September 30, 2015.

The allowance for loan losses totaled $18.7 million, or 1.41% of total loans at September 30, 2015, compared to $18.5 million, or 1.80% of total loans at September 30, 2014, and $18.4 million, or 1.69% of total loans at December 31, 2014. The allowance for loan losses to total loans decreased at September 30, 2015, compared to September 30, 2014 and December 31, 2014, primarily due to the impact of the Focus acquisition. The loans acquired from Focus are included in total loans; however, there is no allowance for loan losses attributed to these loans at September 30, 2015 because they were marked to fair market value on acquisition, and included a fair value adjustment of $4.9 million at September 30, 2015. Excluding the $162.9 million (at fair value) Focus loan portfolio, the ALLL to total loans was 1.60% at September 30, 2015. Net recoveries totaled $281,000 for the third quarter of 2015, compared to net charge-offs of $27,000 for the third quarter of 2014, and net charge-offs of $56,000 for the fourth quarter of 2014. The allowance for loan losses to total nonperforming loans was 340.49% at September 30, 2015, compared to 257.16% at September 30, 2014, and 313.90% at December 31, 2014. Provisions for loan losses are charged to operations to bring the allowance for loan losses to a level deemed appropriate by the Company based on the factors discussed under "Allowance for Loan Losses".

Table of Contents

Noninterest Income

The following table sets forth the various components of the Company's noninterest income for the periods indicated:

	For the Three Months Ended September 30, 2015	For the Three Months Ended September 30, 2014	Increase (decrease) 2015 versus 2014 Amount	Increase (decrease) 2015 versus 2014 Percent
	(Dollars in thousands)			
Service charges and fees on deposit accounts	$ 748	$ 631	$ 117	19%
Increase in cash surrender value of life insurance	429	401	28	7%
Servicing income	214	316	(102)	32%
Gain on sales of SBA loans	267	259	8	3%
Gain on sales of securities		47	(47)	100%
Other	408	216	192	89%
Total noninterest income	$ 2,066	$ 1,870	$ 196	10%

	For the Nine Months Ended September 30, 2015	For the Nine Months Ended September 30, 2014	Increase (decrease) 2015 versus 2014 Amount	Increase (decrease) 2015 versus 2014 Percent
	(Dollars in thousands)			
Service charges and fees on deposit accounts	$ 2,086	$ 1,897	$ 189	10%
Increase in cash surrender value of life insurance	1,225	1,196	29	2%
Servicing income	819	977	(158)	16%
Gain on sales of SBA loans	660	858	(198)	23%
Gain on sales of securities		97	(97)	100%
Other	1,366	909	457	50%
Total noninterest income	$ 6,156	$ 5,934	$ 222	4%

Noninterest income was $2.1 million for the third quarter of 2015, compared to $1.9 million for the third quarter of 2014. For the nine months ended September 30, 2015 noninterest income was $6.2 million compared to $5.9 million for the nine months ended September 30, 2014.

Historically, a significant percentage of the Company's noninterest income has been associated with its SBA lending activity, as gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. For the three months ended September 30, 2015, SBA loan sales resulted in an $267,000 gain, compared to a $259,000 gain on sale of SBA loans for the three months ended September 30, 2014. For the nine months ended September 30, 2015, SBA loan sales resulted in a $660,000 gain, compared to a $858,000 gain on sale of SBA loans for the nine months ended September 30, 2014.

The servicing assets that result from the sales of SBA loans with servicing retained are amortized over the expected term of the loans using a method approximating the interest method. Servicing income generally declines as the respective loans are repaid.

Table of Contents

Noninterest Expense

The following table sets forth the various components of the Company's noninterest expense for the periods indicated:

	For the Three Months Ended September 30,		Increase (decrease) 2015 versus 2014	
	2015	2014	Amount	Percent
	(Dollars in thousands)			
Salaries and employee benefits	$ 10,358	$ 6,228	$ 4,130	66%
Occupancy and equipment	1,063	1,055	8	1%
Acquisition and integration related costs	688	234	454	194%
Professional fees	612	617	(5)	1%
Data processing	411	238	173	73%
Software subscriptions	292	264	28	11%
Insurance expense	273	292	(19)	7%
Correspondent bank charges	269	174	95	55%
Amortization of intangible assets	277	115	162	141%
Advertising and promotion	262	87	175	201%
FDIC deposit insurance premiums	251	220	31	14%
Foreclosed assets	113		113	N/A
Other	1,550	968	582	60%