

HERITAGE COMMERCE CORP  
Form 10-Q  
August 06, 2010

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(MARK ONE)

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

For the quarterly period ended June 30, 2010

OR

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

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

**Heritage Commerce Corp**

(Exact name of Registrant as Specified in its Charter)

**California**  
(State or Other Jurisdiction of  
Incorporation or Organization)

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

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

**95113**  
(Zip Code)

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

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

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, 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 <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input checked="" type="checkbox"/>
(Do not check if a smaller reporting company)			

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

The Registrant had 11,820,509 shares of Common Stock outstanding on July 31, 2010.

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**Quarterly Report on Form 10-Q**  
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Table of Contents**Part I FINANCIAL INFORMATION****ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****Heritage Commerce Corp****Consolidated Balance Sheets (Unaudited)**

	June 30, 2010	December 31, 2009
	(Dollars in thousands)	
Assets		
Cash and due from banks	\$ 108,310	\$ 45,372
Federal funds sold	100	100
Interest-bearing deposits in other financial institutions	90	90
Total cash and cash equivalents	108,500	45,562
Securities available-for-sale, at fair value	142,212	109,966
Loans held-for-sale SBA, at lower of cost or market, including deferred costs	12,291	10,742
Loans held-for-sale Other, at lower of cost or market, including deferred costs	17,079	
Loans, including deferred costs	937,773	1,070,113
Allowance for loan losses	(26,753)	(28,768)
Loans, net	911,020	1,041,345
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	8,299	8,454
Company owned life insurance	42,827	42,313
Premises and equipment, net	8,726	9,006
Goodwill		43,181
Intangible assets	3,302	3,589
Accrued interest receivable and other assets	49,504	49,712
Total assets	\$ 1,303,760	\$ 1,363,870
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest bearing	\$ 249,017	\$ 260,840
Demand, interest-bearing	153,173	146,828
Savings and money market	281,619	295,404
Time deposits under \$100	38,201	40,197
Time deposits \$100 and over	133,443	129,831
Time deposits CDARS	18,240	38,154
Time deposits brokered	163,732	178,031
Total deposits	1,037,425	1,089,285
Securities sold under agreement to repurchase	20,000	25,000
Subordinated debt	23,702	23,702
Short-term borrowings	3,992	20,000
Accrued interest payable and other liabilities	32,997	33,578
Total liabilities	1,118,116	1,191,565
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized		

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Series A fixed rate cumulative preferred stock, 40,000 shares issued and outstanding (liquidation preference of \$1,000 per share plus accrued dividends)	39,846	39,846
Discount on Series A preferred stock	(1,415)	(1,598)
Series B mandatorily convertible cumulative perpetual preferred stock, 53,996 shares issued and outstanding at June 30, 2010 and none at December 31, 2009 (liquidation preference of \$1,000 per share plus accrued dividends)	50,385	
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at June 30, 2010 and none at December 31, 2009 (liquidation preference of \$1,000 per share plus accrued dividends)	19,599	
Common stock, no par value; 60,000,000 shares authorized; 11,820,509 shares issued and outstanding	80,810	80,222
Retained earnings / (Accumulated deficit)	(3,012)	56,389
Accumulated other comprehensive loss	(569)	(2,554)
 Total shareholders' equity	 185,644	 172,305
 Total liabilities and shareholders' equity	 \$ 1,303,760	 \$ 1,363,870

See notes to consolidated financial statements

Table of Contents**Heritage Commerce Corp****Consolidated Statements of Operations (Unaudited)**

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>(Dollars in thousands, except per share data)</b>				
<b>Interest income:</b>				
Loans, including fees	\$ 12,737	\$ 14,862	\$ 25,911	\$ 29,892
Securities, taxable	1,459	954	2,622	1,949
Securities, non-taxable		4		8
Interest-bearing deposits in other financial institutions	16	4	26	8
<b>Total interest income</b>	<b>14,212</b>	<b>15,824</b>	<b>28,559</b>	<b>31,857</b>
<b>Interest expense:</b>				
Deposits	2,157	3,394	4,521	7,424
Subordinated debt	468	487	934	987
Repurchase agreements	113	227	244	469
Short-term borrowings	46	27	63	54
Note payable				82
<b>Total interest expense</b>	<b>2,784</b>	<b>4,135</b>	<b>5,762</b>	<b>9,016</b>
<b>Net interest income before provision for loan losses</b>	<b>11,428</b>	<b>11,689</b>	<b>22,797</b>	<b>22,841</b>
<b>Provision for loan losses</b>	<b>18,600</b>	<b>10,704</b>	<b>23,695</b>	<b>21,124</b>
<b>Net interest income (loss) after provision for loan losses</b>	<b>(7,172)</b>	<b>985</b>	<b>(898)</b>	<b>1,717</b>
<b>Noninterest income:</b>				
Service charges and fees on deposit accounts	579	537	1,128	1,108
Servicing income	425	408	846	828
Increase in cash surrender value of life insurance	413	415	822	827
Gain on sale of loans	163		277	
Other	298	241	489	461
<b>Total noninterest income</b>	<b>1,878</b>	<b>1,601</b>	<b>3,562</b>	<b>3,224</b>
<b>Noninterest expense:</b>				

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Salaries and employee benefits	5,491	5,643	11,373	12,101
Professional fees	1,144	1,229	2,421	2,142
FDIC deposit insurance premiums	1,019	1,220	2,210	1,959
Occupancy and equipment	983	972	1,942	1,888
Insurance expense	269	131	525	190
Software subscription	252	217	486	413
Data processing	219	260	430	489
Low income housing investment losses	133	210	358	424
Other real estate owned expense	69	107	488	170
Impairment of goodwill	43,181		43,181	
Other	1,792	2,091	3,337	3,666

Total noninterest expense	54,552	12,080	66,751	23,442
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Loss before income taxes	(59,846)	(9,494)	(64,087)	(18,501)
Income tax benefit	(5,753)	(4,113)	(5,874)	(9,165)

Net loss	(54,093)	(5,381)	(58,213)	(9,336)
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Dividends and discount accretion on preferred stock	(1,009)	(591)	(1,600)	(1,176)
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Net loss allocable to common shareholders	\$ (55,102)	\$ (5,972)	\$ (59,813)	\$ (10,512)
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Loss per common share:

Basic	\$ (4.66)	\$ (0.51)	\$ (5.06)	\$ (0.89)
Diluted	\$ (4.66)	\$ (0.51)	\$ (5.06)	\$ (0.89)

See notes to consolidated financial statements

Table of Contents**Heritage Commerce Corp****Consolidated Statements of Changes in Shareholders' Equity (Unaudited)****Six Months Ended June 30, 2010 and 2009**

	Preferred Stock			Common Stock		Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity	Comprehensive Income
	Shares	Amount	Discount	Shares	Amount	(Accumulated Deficit)	(Loss)		(Loss)
(Dollars in thousands, except share data)									
<b>Balance, January 1, 2009</b>	40,000	\$ 39,846	\$ (1,946)	11,820,509	\$ 78,854	\$ 67,804	\$ (291)	\$ 184,267	
Net loss						(9,336)		(9,336)	\$ (9,336)
Net change in unrealized gain on securities available-for-sale and interest-only strips, net of deferred income taxes							157	157	157
Net increase in pension and other postretirement obligations, net of deferred income taxes							66	66	66
<b>Total comprehensive loss</b>									<b>\$ (9,113)</b>
Amortization of restricted stock award					76			76	
Cash dividends accrued on Series A preferred stock						(1,006)		(1,006)	
Accretion of discount on Series A preferred stock			170			(170)			
Cash dividend declared on common stock, \$0.02 per share						(236)		(236)	
Stock option expense					663			663	
Income tax effect of restricted stock award vesting					(69)			(69)	
<b>Balance, June 30, 2009</b>	40,000	\$ 39,846	\$ (1,776)	11,820,509	\$ 79,524	\$ 57,056	\$ (68)	\$ 174,582	
<b>Balance, January 1, 2010</b>	40,000	\$ 39,846	\$ (1,598)	11,820,509	\$ 80,222	\$ 56,389	\$ (2,554)	\$ 172,305	
Net loss						(58,213)		(58,213)	\$ (58,213)
Net change in unrealized gain/loss on securities available-for-sale and interest-only strips, net of deferred income taxes							1,848	1,848	1,848
Net increase in pension and other							137	137	137



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postretirement  
obligations, net of  
deferred income taxes

Total comprehensive loss										\$ (56,228)
Issuance of Series B mandatorily convertible cumulative perpetual preferred stock, net of issuance costs	53,996	50,385								50,385
Issuance of Series C convertible perpetual preferred stock, net of issuance costs	21,004	19,599								19,599
Amortization of restricted stock award					77					77
Cash dividends accrued on Series A preferred stock						(1,005)				(1,005)
Accretion of unearned discount on Series A preferred stock			183			(183)				
Stock option expense					586					586
Income tax effect of restricted stock award vesting					(75)					(75)
<b>Balance, June 30, 2010</b>	115,000	\$ 109,830	\$ (1,415)	11,820,509	\$ 80,810	\$ (3,012)	\$ (569)	\$		185,644

See notes to consolidated financial statements

Table of Contents**Heritage Commerce Corp****Consolidated Statements of Cash Flows (Unaudited)**

	Six Months Ended June 30,	
	2010	2009
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$ (58,213)	\$ (9,336)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	402	400
Provision for loan losses	23,695	21,124
Stock option expense	586	663
Amortization of other intangible assets	287	321
Amortization of restricted stock award	77	76
Amortization (accretion) of discounts and premiums on securities	(137)	81
Writedowns and losses (gains) on sale of foreclosed assets, net	416	(62)
Gain on sale of SBA loans	(277)	
Proceeds from sale of SBA loans	5,504	
Net change in SBA loans originated held-for-sale	(9,167)	
Increase in cash surrender value of life insurance	(822)	(827)
Goodwill impairment	43,181	
Effect of changes in:		
Accrued interest receivable and other assets	(2,821)	(8,189)
Accrued interest payable and other liabilities	(1,349)	(1,940)
Net cash provided by operating activities	1,362	2,311
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net change in loans	91,493	47,859
Net change in loans previously transferred to held-for-sale	(630)	
Purchases of securities available-for-sale	(39,351)	(24,993)
Maturities/Paydowns/Calls of securities available-for-sale	10,333	27,769
Purchase of premises and equipment	(122)	(195)
Redemption (Purchase) of restricted stock and other investments	155	(618)
Proceeds from sale of SBA loans transferred to held-for-sale	1,079	
Proceeds from sale of foreclosed assets	1,270	1,011
Changes in company owned life insurance	308	
Net cash provided by investing activities	64,535	50,833
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	(51,860)	9,497
Issuance of preferred stock, net of offering costs	69,984	
Income tax effect of restricted stock award vesting	(75)	(69)
Payment of cash dividends common stock		(236)
Payment of cash dividends preferred stock		(967)
Net change in short-term borrowings	(16,008)	(40,000)
Net change in note payable		(15,000)
Net change in securities sold under agreement to repurchase	(5,000)	(5,000)
Net cash used in financing activities	(2,959)	(51,775)
Net increase in cash and cash equivalents	62,938	1,369
Cash and cash equivalents, beginning of period	45,562	30,096

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Cash and cash equivalents, end of period	\$ 108,500	\$ 31,465
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## Supplemental disclosures of cash flow information:

Cash paid during the period for:		
Interest paid	\$ 4,864	\$ 9,092
Income taxes paid	\$	\$ 1,250

## Supplemental schedule of non-cash investing and financing activities:

Transfer from portfolio loans to loans held-for-sale	\$ 17,079	\$ 20,506
Transfer from loans held-for-sale to the loan portfolio	\$ 1,942	\$
Loans transferred to foreclosed assets	\$	\$ 3,867

See notes to consolidated financial statements

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**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements**

**June 30, 2010**

**(Unaudited)**

**1) Basis of Presentation**

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company") and its wholly owned subsidiary, Heritage Bank of Commerce (sometimes referred to as "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, 2009. The Company has also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III which are Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities.

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

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

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

The results for the three and six months ended June 30, 2010 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2010.

***Adoption of New Accounting Standards***

In June 2009, the FASB amended previous guidance relating to transfers of financial assets and eliminates the concept of a qualifying special purpose entity. This guidance must be applied as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. This guidance must be applied to transfers occurring on or after the effective date. Additionally, on and after the effective date, the concept of a qualifying special purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special purpose entities should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance. The disclosure provisions were also amended and apply to transfers that occurred both before and after the effective date of this guidance. See Note 3 to the consolidated financial statements for the impact of the adoption of this guidance.

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**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**June 30, 2010**

**(Unaudited)**

**1) Basis of Presentation (Continued)**

In January 2010, the FASB issued guidance clarifying the accounting for shareholder distributions where the shareholder has the ability to elect to have his or her distribution in the form of cash (up to a pre-determined maximum), stock or a combination of the two. The amendments of the update provide that the stock portion of a distribution where the shareholder had the ability to elect the distribution as stock or cash (up to a pre-determined maximum) should be accounted for as a share issuance and thereby eliminate diversity in practice. The provisions of this update became effective for financial statements dated on or after December 15, 2009. The adoption of this standard did not have a material impact on the Company's financial statements.

In January 2010, the FASB issued guidance requiring increased fair value disclosures. There are two components to the increased disclosure requirements set forth in the update: (1) a description of, as well as the disclosure of, the dollar amount of transfers in or out of level one or level two (2) in the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances and settlements (that is, gross amounts shall be disclosed as opposed to a single net figure). Increased disclosures regarding the transfers in or out of level one and two are required for interim and annual periods beginning after December 15, 2009. The adoption of this portion of the standard did not have a material impact on the Company's financial statements. Increased disclosures regarding the level three fair value reconciliation are required for fiscal years beginning after December 15, 2010.

***Newly Issued, but not yet Effective Accounting Standards***

In July 2010, the FASB updated disclosure requirements with respect to the credit quality of financing receivables and the allowance for credit losses. According to the guidance there are two levels of detail at which credit information will be presented the portfolio segment and class levels. The portfolio segment level is defined as the level where financing receivables are aggregated in developing a Company's systematic method for calculating its allowance for credit losses. The class level is the second level at which credit information will be presented and represents the categorization of financing related receivables at a slightly less aggregated level than the portfolio segment level. Companies will now be required to provide the following disclosures as a result of this update: a rollforward of the allowance for credit losses at the portfolio segment level with the ending balances further categorized according to impairment method along with the balance reported in the related financing receivables at period end; additional disclosure of nonaccrual and impaired financing receivables by class as of period end; credit quality and past due/ aging information by class as of period end; information surrounding the nature and extent of loan modifications and troubled-debt restructurings and their effect on the allowance for credit losses during the period; and detail of any significant purchases or sales of financing receivables during the period. The increased period-end disclosure requirements become effective for periods ending on or after December 15, 2010. The increased disclosures for activity within a reporting period become effective for periods beginning on or after December 15, 2010. The provisions of this update will expand the Company's current disclosures with respect to the allowance for loan losses.

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****June 30, 2010****(Unaudited)****2) Securities**

The amortized cost and estimated fair value of securities at June 30, 2010 and December 31, 2009 were as follows:

<b>June 30, 2010</b>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
<b>(Dollars in thousands)</b>				
<b>Securities available-for-sale:</b>				
U.S. Government Sponsored Entities	\$ 2,000	\$ 2	\$	\$ 2,002
Mortgage-Backed Securities Residential	132,355	4,337		136,692
Collateralized Mortgage Obligations Residential	3,384	134		3,518
<b>Total securities available-for-sale</b>	<b>\$ 137,739</b>	<b>\$ 4,473</b>	<b>\$</b>	<b>\$ 142,212</b>

<b>December 31, 2009</b>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
<b>(Dollars in thousands)</b>				
<b>Securities available-for-sale:</b>				
U.S. Government Sponsored Entities	\$ 2,000	\$	\$ (27)	\$ 1,973
Mortgage-Backed Securities Residential	101,356	1,653	(463)	102,546
Collateralized Mortgage Obligations Residential	5,227	220		5,447
<b>Total securities available-for-sale</b>	<b>\$ 108,583</b>	<b>\$ 1,873</b>	<b>\$ (490)</b>	<b>\$ 109,966</b>

Securities classified as U.S. Government Sponsored Entities as of June 30, 2010 and December 31, 2009 were issued by the Federal National Mortgage Association ("Fannie Mae"). At June 30, 2010 and December 31, 2009, all mortgage backed securities and collateralized mortgage obligations were issued by Fannie Mae, Freddie Mac, or the Government National Mortgage Association ("Ginnie Mae").

At June 30, 2010 and December 31, 2009, 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.

There were no securities with unrealized losses at June 30, 2010. Securities with unrealized losses at December 31, 2009, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

<b>December 31, 2009</b>	<b>Less Than 12 Months Fair Value</b>	<b>Unrealized Losses</b>	<b>12 Months or More Fair Value</b>	<b>Unrealized Losses</b>	<b>Total Fair Value</b>	<b>Unrealized Losses</b>
<b>(Dollars in thousands)</b>						
U.S. Government Sponsored Entities	\$ 1,973	\$ (27)	\$	\$	\$ 1,973	\$ (27)
Mortgage-Backed Securities Residential	43,600	(463)			43,600	(463)

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Total	\$	45,573	\$	(490)	\$		\$	45,573	\$	(490)
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Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****June 30, 2010****(Unaudited)****2) Securities (Continued)**

At December 31, 2009, the Company held 75 securities, of which 23 had fair values below amortized cost. No securities have been carried with an unrealized loss for over 12 months. The Company did not consider these securities to be other-than-temporarily impaired at December 31, 2009.

**3) Loans**

Loans were as follows:

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
	<b>(Dollars in thousands)</b>	
<b>Loans held-for-sale:</b>		
Loans held-for-sale SBA	\$ 12,291	\$ 10,742
Loans held-for-sale Other	17,079	
<b>Total loans held-for-sale</b>	<b>\$ 29,370</b>	<b>\$ 10,742</b>
<b>Loans held for investment:</b>		
Commercial	\$ 388,471	\$ 427,177
Real estate mortgage	373,000	400,731
Real estate land and construction	110,194	182,871
Home equity	52,419	51,368
Consumer	12,837	7,181
<b>Loans</b>	<b>936,921</b>	<b>1,069,328</b>
Deferred loan origination costs and fees, net	852	785
<b>Loans, including deferred costs</b>	<b>937,773</b>	<b>1,070,113</b>
Allowance for loan losses	(26,753)	(28,768)
<b>Loans, net</b>	<b>\$ 911,020</b>	<b>\$ 1,041,345</b>

At June 30, 2010, included in the balance of loans held-for-sale are \$3,992,000 of SBA loans that have been transferred to third parties. However, these loans are subject to a SBA warranty for a period of 90 days, which under new accounting guidance requires the Company to treat these as secured borrowings during the warranty period. The secured borrowings are classified as "short-term borrowings" on the consolidated balance sheets. The warranty period for these loans expires in the following quarter. Provided the loans remain current through the end of the warranty period all elements necessary to record the sale will have been met. The Company has deferred gains of \$230,000 associated with these loans, which are included in other liabilities on the consolidated balance sheets.

During the second quarter of 2010, the Company identified \$31,005,000 of real estate loans classified as substandard or substandard-nonaccrual that it intends to sell. The sale is expected to be completed in the third quarter of 2010. These loans were written down to \$17,079,000, to reflect the estimated market value of the loans and this amount was transferred to loans held-for-sale. The





Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****June 30, 2010****(Unaudited)****3) Loans (Continued)**

write-down of these real estate loans resulted in net charge-offs of \$13,926,000 in the second quarter of 2010. The following table shows the detail of the real estate loans we intend to sell at June 30, 2010:

	<b>June 30, 2010</b>		
	<b>Balance Prior to Transfer</b>	<b>Amount Charged-off</b>	<b>Balance Transferred to Loans Held-for-Sale</b>
	<b>(Dollars in thousands)</b>		
Real estate-mortgage	\$ 9,893	\$ (2,781)	\$ 7,112
Real estate-land and construction	21,112	(11,145)	9,967
<b>Total</b>	<b>\$ 31,005</b>	<b>\$ (13,926)</b>	<b>\$ 17,079</b>

Changes in the allowance for loan losses were as follows:

	<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
	<b>(Dollars in thousands)</b>	
Balance, beginning of period	\$ 28,768	\$ 25,007
Loans charged-off	(26,383)	(15,254)
Recoveries	673	521
Net charge-offs	(25,710)	(14,733)
Provision for loan losses	23,695	21,124
Balance, end of period	\$ 26,753	\$ 31,398

Impaired loans were as follows:

	<b>June 30,</b>		<b>December 31,</b>
	<b>2010</b>	<b>2009</b>	<b>2009</b>
	<b>(Dollars in thousands)</b>		
Period-end loans with no allocated allowance for loan losses	\$ 17,127	\$ 6,099	\$ 13,202
Period-end loans with allocated	42,458	49,706	49,173

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allowance for loan  
losses

Total	\$	59,585	\$	55,805	\$	62,375
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Amount of the  
allowance for loan  
losses allocated to  
above at  
period-end

\$	9,756	\$	11,638	\$	9,103
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[Table of Contents](#)**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****June 30, 2010****(Unaudited)****3) Loans (Continued)**

Nonperforming loans include both smaller dollar balance homogeneous loans that are collectively evaluated for impairment and individually classified loans. Nonperforming loans were as follows:

	<b>Six Months Ended</b>		
	<b>June 30,</b>	<b>2009</b>	<b>December 31,</b>
	<b>2010</b>		<b>2009</b>
	<b>(Dollars in thousands)</b>		
Nonaccrual loans held-for-sale portfolio	\$ 9,806	\$	\$
Restructured and loans past due over 90 days still on accrual	2,516	786	2,895
Nonaccrual loans held-for-investment portfolio	47,263	57,889	59,480
Total	\$ 59,585	\$ 58,675	\$ 62,375

**4) Private Placement**

The Company entered into a securities purchase agreement, dated June 18, 2010, with various institutional investors, pursuant to which the investors purchased for an aggregate of \$75,000,000 newly issued shares of Series B Mandatorily Convertible Cumulative Perpetual Preferred Stock ("Series B Preferred Stock") and Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). On June 21, 2010, the Company issued to the investors (i) an aggregate of 53,996 shares of Series B Preferred Stock, each of which will automatically convert into 266.67 shares of our Common Stock (an aggregate of 14,399,000 shares of Common Stock) based on the initial conversion price of \$3.75, upon approval of the conversion by the Company's shareholders, and (ii) an aggregate of 21,004 shares of Series C Preferred Stock, each of which will automatically convert into 266.67 shares of our Common Stock (an aggregate of 5,601,000 shares of Common Stock) based on the initial conversion price of \$3.75, following both approval of the conversion by the Company's shareholders and, thereafter, a subsequent transfer of the Series C Preferred Stock to third parties not affiliated with the holder in a widely dispersed offering.

The Series B Preferred Stock is non-voting except in the case of certain transactions that affect the rights of the holders of the Series B Preferred Stock or applicable law. The initial conversion price of \$3.75 per share is subject to possible adjustments in the future under certain circumstances, including failure to obtain shareholder approval for the conversion by December 21, 2010, which would decrease the conversion price by 10%. Prior to shareholder approval, the holders of the Series B Preferred Stock will be entitled to receive cumulative cash dividends which shall accrue and be payable at a per annum rate equal to 20%, payable semi-annually in arrears commencing on December 21, 2010; provided, however, if shareholder approval is obtained before December 21, 2010, then no accrued dividends shall be payable. The Series B Preferred Stock is not redeemable by the Company or by the holders and carries a liquidation preference of \$1,000 per share, plus the right to participate in any liquidation distribution to holders of common stock on an as-converted basis.

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 initial conversion price of \$3.75 per share is subject to possible adjustments in the future under certain circumstances,

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**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**June 30, 2010**

**(Unaudited)**

**4) Private Placement (Continued)**

including the failure to obtain shareholder approval for the conversion by December 21, 2010, which would decrease the conversion price by 10%. Prior to shareholder approval, the holders of the Series C Preferred Stock will be entitled to receive cumulative cash dividends which shall accrue and be payable at a per annum rate equal to 20%, payable semi-annually in arrears commencing on December 21, 2010; provided, however, if shareholder approval is obtained on or before December 21, 2010, then no accrued dividends shall be payable. Following shareholder approval, holders of Series C Preferred Stock will receive dividends if and only to the extent dividends are paid to holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and carries a liquidation preference of \$1,000 per share, plus prior to shareholder approval, the right to participate in any liquidation distribution to holders of common stock on an as-converted basis. Following shareholder approval, upon a liquidation of the Company, holders of Series C Preferred Stock will be entitled to a liquidation preference of \$1,000 per share.

The Series B Preferred Stock and the Series C Preferred Stock rank senior to the Company's common stock and rank on parity with the Company's Series A Fixed Rate Cumulative Preferred Stock ("Series A Preferred Stock").

Dividends and discount accretion on preferred stock on the consolidated statements of operations include dividends on the Series B Preferred Stock and Series C Preferred Stock totaling \$411,000 for the three months and six months ended June 30, 2010.

The Company has scheduled a Special Shareholder Meeting for September 15, 2010, to approve the conversion of the Series B Preferred Stock and the Series C Preferred Stock for purposes of the NASDAQ Listing Rules and the California General Corporation Law (the "Shareholder Approvals"). There is no assurance the Company's shareholders will approve the conversion of the Series B Preferred Stock and Series C Preferred Stock before December 21, 2010 or thereafter. The failure of the Company's shareholders to approve the conversion of the Series B Preferred Stock and the Series C Preferred Stock would have potentially adverse consequences for the Company and its shareholders.

**5) Goodwill and Intangible Assets**

***Goodwill***

Goodwill resulted from the acquisition of Diablo Valley Bank in June 2007 and represented 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, as of November 30, for impairment with the assistance of an independent valuation firm. Goodwill impairment exists when a reporting unit's carrying value exceeds its fair value, which is determined through a two-step impairment test. Step 1 includes the determination of the carrying value of the Company's single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting

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**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**June 30, 2010**

**(Unaudited)**

**5) Goodwill and Intangible Assets (Continued)**

unit goodwill exceeds the implied fair value of that goodwill, an impairment loss will be recognized in an amount equal to that excess.

Because of concerns about the Company's stock price and banking industry in general, goodwill was tested for impairment in the first quarter of 2010 with the assistance of an independent valuation firm. Based on the assessment, management concluded that there was no impairment of goodwill at March 31, 2010.

Due to concerns about the Company's stock price, the condition of the banking industry in general, and the pricing of the closed private placement of convertible preferred stock, goodwill was tested for impairment in the second quarter of 2010, with the assistance of an independent valuation firm. Due to the continued depressed economic conditions and the length of time and amount by which the Company's book value exceeded market value per share, and the Company's closing of the private placement at a conversion price of \$3.75 per share, the Company determined goodwill related to the acquisition of Diablo Valley Bank of \$43,181,000 was fully impaired during the second quarter of 2010. The method for estimating the value of the reporting unit included a weighted average of the discounted cash flows income approach and publicly traded company approach.

***Intangible Assets***

Intangible assets consist of core deposit and customer relationship intangible assets arising from the acquisition of Diablo Valley Bank in June 2007. These assets are amortized over their estimated useful lives. Impairment testing of these 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 June 30, 2010.

**6) Income Taxes**

Under generally accepted accounting principles, a valuation allowance is required if it is "more likely than not" 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. At June 30, 2010, the Company determined a partial valuation allowance on the state of California net deferred tax asset was necessary, primarily because of the Company's cumulative loss in the most recent three-year period caused by the provision for loan losses recorded during the period.

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****June 30, 2010****(Unaudited)****6) Income Taxes (Continued)**

The \$5,874,000 income tax benefit for the six months ended June 30, 2010 is net of \$3,700,000 of income tax expense to establish the partial valuation allowance. Management is required to re-evaluate the deferred tax asset and the related valuation allowance quarterly.

The net recorded deferred tax asset, after the partial valuation allowance of \$3,700,000, was \$24,569,000 at June 30, 2010. The net deferred tax asset was \$22,401,000 at December 31, 2009. The net deferred tax asset includes California and Federal net operating loss carryforwards that will begin to expire in 2019 and 2030, respectively, if not utilized to reduce future taxable income. The remaining deferred tax asset was supported by available tax planning strategies and projected future taxable income.

**7) Supplemental Retirement Plan**

The Company has a supplemental retirement plan covering current and former key executives and directors. The Plan is a nonqualified defined benefit plan. Benefits are unsecured as there are no Plan assets. The following table presents the amount of periodic cost recognized for the three and six months ended June 30, 2010 and 2009:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
	<b>(Dollars in thousands)</b>			
Components of net periodic benefits cost				
Service cost	\$ 244	\$ 241	\$ 488	\$ 482
Interest cost	209	191	418	382
Prior service cost	9	9	18	18
Amortization of loss	17	48	34	96
Net periodic cost	\$ 479	\$ 489	\$ 958	\$ 978

**8) 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).

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****June 30, 2010****(Unaudited)****8) Fair Value (Continued)**

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

***Financial Assets and Liabilities Measured on a Recurring Basis***

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

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

	Balance	Fair Value Measurements Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
			Significant Unobservable Inputs (Level 3)
(Dollars in thousands)			
<b>Assets at June 30, 2010:</b>			
Available-for-sale securities			
U.S. Government Sponsored Entities	\$ 2,002		\$ 2,002
Mortgage-Backed Securities Residential	136,692		136,692
Collateralized Mortgage Obligations Residential	3,518		3,518
I/O strip receivables	2,059		2,059
<b>Assets at December 31, 2009:</b>			
Available-for-sale securities			
U.S. Government Sponsored Entities	\$ 1,973		\$ 1,973
Mortgage-Backed Securities Residential	102,546		102,546
Collateralized Mortgage Obligations Residential	5,447		5,447
I/O strip receivables	2,116		2,116

***Assets and Liabilities Measured on a Non-Recurring Basis***

The fair value of loans held-for-sale is based upon binding contracts or quotes from third party investment banker valuations, resulting in Level 2 classification of inputs for determining fair value.

The fair value of impaired loans held for investment with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals, brokers' opinion of value, letters of intent, purchase and sale agreements, financial statements and equipment evaluations. Real estate



Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****June 30, 2010****(Unaudited)****8) Fair Value (Continued)**

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.

Nonrecurring adjustments to certain commercial and residential estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

		Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Balance	(Dollars in thousands)		
Assets at June 30, 2010:				
Loans held-for-sale:				
Real estate mortgage	\$ 7,112		\$ 7,112	
Real estate land and construction	9,967		9,967	
Total	\$ 17,079		\$ 17,079	
Impaired loans held for investment:				
Commercial	\$ 8,166			\$ 8,166
Real estate mortgage	11,891			11,891
Real estate land and construction	16,863			16,863
Consumer	208			208
Total	\$ 37,128			\$ 37,128
Other real estate owned	\$ 555			\$ 555
Assets at December 31, 2009:				
Impaired loans held for investment	\$ 48,410			\$ 48,410

Other real estate owned	\$	812	\$	812
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Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****June 30, 2010****(Unaudited)****8) 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:

	June 30, 2010	December 31, 2009
	(Dollars in thousands)	
Impaired loans held for investment:		
Book value of impaired loans held for investment carried at fair value	\$ 46,884	\$ 57,513
Book value of impaired loans held for investment carried at cost	2,895	4,862
 Total impaired loans held for investment	 \$ 49,779	 \$ 62,375
Impaired loans held for investment carried at fair value:		
Book value of impaired loans held for investment carried at fair value	\$ 46,884	\$ 57,513
Specific valuation allowance	(9,756)	(9,103)
 Impaired loans held for investment carried at fair value, net	 \$ 37,128	 \$ 48,410

Of the total provision for loan losses during the six months ended June 30, 2010 and the year ended December 31, 2009, \$12,764,000 and \$16,574,000 was a result of the decline in the fair value of impaired loans held for investment that were carried at fair value at June 30, 2010 and December 31, 2009, respectively.

Total other real estate owned, consisting of one property, had a fair value of \$555,000 at June 30, 2010.

Total other real estate owned, consisting of two properties, had a carrying value of \$2,241,000 at December 31, 2009. One property is carried at fair value, less costs to sell, of \$812,000 at December 31, 2009. The other property is carried at cost as of December 31, 2009. There were no impairment write downs subsequent to acquisition in 2009.

Table of Contents**HERITAGE COMMERCE CORP****Notes to Consolidated Financial Statements (Continued)****June 30, 2010****(Unaudited)****8) Fair Value (Continued)**

The carrying amounts and estimated fair values of the Company's financial instruments, at June 30, 2010 and December 31, 2009 were as follows:

	June 30, 2010		December 31, 2009	
	Carrying Amounts	Estimated Fair Value	Carrying Amounts	Estimated Fair Value
	(Dollars in thousands)			
<b>Assets</b>				
Cash and cash equivalents	\$ 108,500	\$ 108,500	\$ 45,562	\$ 45,562
Securities available-for-sale	142,212	142,212	109,966	109,966
Loans (including loans held-for-sale), net	940,390	854,678	1,052,087	955,242
FHLB and FRB stock	8,299	N/A	8,454	N/A
Accrued interest receivable	3,194	3,194	3,472	3,472
Loan servicing rights and I/O strips receivables	3,016	5,044	3,183	4,972
<b>Liabilities</b>				
Time deposits	\$ 353,616	\$ 355,618	\$ 386,213	\$ 389,027
Other deposits	683,809	683,809	703,072	703,072
Securities sold under agreement to repurchase	20,000	20,165	25,000	25,341
Short-term borrowings	3,992	3,992	20,000	20,000
Subordinated debt	23,702	18,585	23,702	14,938
Accrued interest payable	2,092	2,092	1,194	1,194

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

***Cash and Cash Equivalents and Accrued Interest Receivable and Payable***

The carrying amount approximates fair value because of the short maturities of these instruments.

***Loans***

Loans with similar financial characteristics are grouped together for purposes of estimating their fair value. Loans are segregated by type such as commercial, term real estate, construction and land development, and consumer. Each loan category is further segmented into fixed and adjustable rate interest terms.

The fair value of performing, fixed rate loans is calculated by discounting scheduled future cash flows using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The fair value of variable rate loans approximates the carrying amount as these loans generally reprice within 90 days.

The fair value of loans held-for-sale is based on estimated market values from third party investors.

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**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**June 30, 2010**

**(Unaudited)**

**8) Fair Value (Continued)**

***FHLB and FRB Stock***

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

***Deposits***

The fair value of deposits with no stated maturity, such as demand deposits, savings, and money market accounts, approximates the amount payable on demand. The carrying amount approximates the fair value of time deposits with a remaining maturity of less than 90 days. The fair value of all other time deposits is calculated based on discounting the future cash flows using rates currently offered for time deposits with similar remaining maturities.

***Subordinated debt and Securities Sold Under Agreement to Purchase***

The fair values of subordinated debt and securities sold under agreement to repurchase were determined based on the current market value for like kind instruments of a similar maturity and structure.

***Short-term Borrowings and Note Payable***

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

***Off-Balance Sheet Items***

The fair value of off-balance sheet items, such as commitments to extend credit, is not considered material and therefore is not included in the table above.

***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.

**9) Regulatory Matters**

On February 17, 2010, the Company and HBC entered into a written agreement ("Written Agreement") with the Federal Reserve Bank of San Francisco ("FRB") and the California Department of Financial Institutions ("DFI"). Under the terms of the Written Agreement, the Company must obtain the prior written approval of the Federal Reserve and DFI before it may (i) declare or pay any dividends, (ii) make any distributions of principal or interest on the Company's outstanding trust

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**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements (Continued)**

**June 30, 2010**

**(Unaudited)**

**9) Regulatory Matters (Continued)**

preferred securities and related subordinated debt, (iii) incur, increase or guarantee any debt, (iv) redeem any outstanding stock, or (v) take dividends or any other form of payment that represents a reduction in capital from HBC. The Written Agreement also requires the Company to (i) submit a written plan to strengthen credit risk management practices, (ii) submit a written capital plan for sufficient capitalization of both the Company and HBC, (iii) submit a written business plan for 2010 to improve the Company's earnings and overall financial condition, (iv) comply with notice and approval requirements related to the appointment of directors and senior executive officers or change in the responsibility of any current senior executive officer, (v) comply with restrictions on paying or agreeing to pay certain indemnification and severance payments without prior written approval, (vi) submit a written plan to improve management of the Company's liquidity position and funds management practices, (vii) notify the Federal Reserve and DFI no more than 30 days after the end of any quarter in which the capital ratios of the Company or HBC fall below approved capital plan's minimum ratios, together with an acceptable written plan to increase capital ratios to or above the approved capital plan's minimum levels, (viii) comply with specified procedures for board (or a committee of the board) approval for the extension, renewal or restructure of any "criticized loan", (ix) submit plans to improve the Company's position on outstanding past due and other problem loans in excess of \$2 million, (x) maintain policies and procedures and submit a plan for the maintenance of an adequate allocation for loan losses, and (xi) provide quarterly progress reports to the Federal Reserve and DFI.

Prior to entering into the Written Agreement in February 2010, the Company had already ceased paying dividends on its common stock (in the second quarter of 2009), suspended interest payments on its trust preferred securities and related subordinated debt (in the fourth quarter of 2009), and suspended dividend payments on its preferred stock (also in the fourth quarter of 2009).

The Company is addressing the requirements of the Written Agreement. The Company submitted specific plans to the FRB and DFI relating to improving asset quality and credit risk management, improving profitability and liquidity management and these plans were accepted as satisfactory by the FRB and DFI. The Company submitted its capital plan and it is being reviewed by the FRB and DFI.

Failure to comply with the Written Agreement may subject the Company and HBC to additional supervisory actions and orders.

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

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

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, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or Exchange Act, 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. Please see our most recent Annual Report on Form 10-K for the year ended December 31, 2009 and our subsequent Quarterly Reports on Form 10-Q and the other information contained in this Report on Form 10-Q for a further discussion of these and other risks and uncertainties applicable to our business. The forward looking statements could be affected by many factors, including but not limited to:

Our ability to attract new deposits and loans;

Local, regional, and national economic conditions and events and the impact they may have on us and our customers;

Risks associated with concentrations in real estate related loans;

Increasing levels of classified assets, including nonperforming assets, which could adversely affect our earnings and liquidity;

Market interest rate volatility;

Stability of funding sources and continued availability of borrowings;

Changes in legal or regulatory requirements or the results of regulatory examinations that could restrict growth and constrain our activities, including the terms of our Written Agreement entered into by the Company, the Board of Governors of the Federal Reserve System and the Department of Financial Institutions;

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Changes in accounting standards and interpretations;

Our ability to raise capital or incur debt on reasonable terms;

Regulatory limits on the HBC's ability to pay dividends to the Company;

Effectiveness of the Emergency Economic Stabilization Act of 2008, the American Recovery and Reinvestment Act of 2009 and other legislative and regulatory efforts to help stabilize the U.S. financial markets;

Future legislative or administrative changes to the U.S. Treasury Capital Purchase Program enacted under the Emergency Economic Stabilization Act of 2008;

The impact of the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009 and related rules and regulations on our business operations and competitiveness, including the impact of executive compensation restrictions, which may affect our ability to retain and recruit executives in competition with other firms who do not operate under those restrictions;

The impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act signed by President Obama on July 21, 2010; and

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

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

### **EXECUTIVE SUMMARY**

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

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

#### ***Performance Overview***

For the three months ended June 30, 2010, the net loss was \$54.1 million. The net loss allocable to common shareholders was \$55.1 million, or \$(4.66) per common share for the three months ended June 30, 2010, which included a \$43.2 million charge for impairment of goodwill, an \$18.6 million provision for loan losses, and a \$3.7 million partial valuation allowance on the deferred tax asset. In the three months ended June 30, 2009, the net loss was \$5.4 million. The net loss allocable to common shareholders was \$6.0 million, or \$(0.51) per common share, including a provision for loan losses of \$10.7million.

For the six months ended June 30, 2010, the net loss was \$58.2 million. The net loss allocable to common shareholders was \$59.8 million, or \$(5.06) per common share, which included a \$43.2 million





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charge for impairment of goodwill, a \$23.7 million provision for loan losses, and a \$3.7 million partial valuation allowance on the deferred tax asset. In the six months ended June 30, 2009, the net loss was \$9.3 million. The net loss allocable to common shareholders was \$10.5 million, or \$(0.89) per common share, including a provision for loan losses of \$21.1 million.

During the second quarter of 2010, there were several significant events that impacted the Company's financial condition and operations. First, the Company completed a private placement of convertible preferred stock for \$75 million which significantly improved the Company's regulatory capital ratios. Second, the Company identified \$31.0 million of real estate loans classified as substandard or substandard-nonaccrual that it intends to sell in the third quarter of 2010. The loans were transferred to the held-for-sale portfolio and the Company recorded a \$13.9 million of related loan charge-offs in the second quarter of 2010. In addition, due to the continued depressed economic conditions and amount by which the Company's book value exceeded the market value per common share, and the Company's closing of a private placement at a conversion price of \$3.75 per share, the Company determined that goodwill related to the acquisition of Diablo Valley Bank of \$43.2 million was fully impaired. Also, after an analysis in the second quarter of 2010 of both the positive and negative evidence regarding the realization of the deferred tax asset, the Company recorded a \$3.7 million partial valuation allowance on the Company's deferred tax asset.

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

The net interest margin increased 33 basis points to 3.88% for the second quarter of 2010, compared with 3.55% for the second quarter of 2009, and increased 7 basis points to 3.88% compared to 3.81% for the first quarter of 2010. The Company's net interest margin increased to 3.85% for the six months ended June 30, 2010, compared to 3.45% for the first six months of 2009.

The provision for loan losses was \$18.6 million for the second quarter of 2010, compared to \$10.7 million for the second quarter of 2009. The provision for loan losses for the six months ended June 30, 2010 was \$23.7 million, compared to \$21.1 million for the same period a year ago.

Noninterest income increased 17% to \$1.9 million in the second quarter of 2010 from \$1.6 million in the second quarter of 2009, and increased 10% to \$3.6 million in the first six months of 2010 from \$3.2 million in the first six months of 2009.

A \$43.2 million non-cash charge was recorded during the second quarter of 2010 to reflect an impairment of goodwill related to a prior acquisition.

Noninterest expense, including the \$43.2 million impairment of goodwill, was \$54.6 million for the second quarter of 2010, compared to \$12.1 million in the second quarter of 2009. In the first six months of 2010, noninterest expense including the \$43.2 million impairment of goodwill was \$66.8 million, compared to \$23.4 million in the first six months a year ago.

The income tax benefit for the quarter ended June 30, 2010 was \$5.8 million, which included \$3.7 million of additional income tax expense to establish a partial valuation allowance on the Company's net deferred tax asset. The income tax benefit was \$4.1 million in the second quarter a year ago, and \$120,000 in the first quarter of 2010. In the first six months of 2010, the income tax benefit was \$5.9 million, compared to \$9.2 million in the first six months a year ago. The negative effective income tax rates are due to the loss before income taxes. The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes, and tax credits related to investments in low income housing limited partnerships.

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

Cash and securities increased to \$250.7 million at June 30, 2010, from \$133.3 million at June 30, 2009, and \$155.5 million at December 31, 2009.

Classified assets will be reduced as a result of the planned sale of \$17.1 million of real estate loans classified as substandard or substandard-nonaccrual assets.

Total loans, excluding loans held-for-sale, decreased \$224,000, or 19%, to \$937.8 million at June 30, 2010, compared to \$1.16 billion at June 30, 2009, and decreased \$132.3 million, or 12%, from December 31, 2009. Land and construction loans decreased \$120.6 million, or 52%, to \$110.2 million at June 30, 2010, compared to \$230.8 million at June 30, 2009, and decreased \$72.7 million, or 40%, from \$182.9 million at December 31, 2009.

The allowance for loan losses at June 30, 2010 was \$26.8 million, or 2.85% of total loans, and represented 44.90% of nonperforming loans, and 53.74% of nonperforming loans excluding nonaccrual loans in the loans held-for-sale portfolio. The allowance for loan losses a year ago was \$31.4 million, or 2.70% of total loans and 53.51% of nonperforming loans. The allowance for loan losses at December 31, 2009, was \$28.8 million, or 2.69% of total loans and 46.12% of nonperforming loans.

Nonperforming assets decreased to \$60.1 million, or 4.61% of total assets at June 30, 2010, which included \$9.8 million of real estate loans classified as substandard or substandard-nonaccrual transferred to the loans held-for-sale portfolio. Excluding the loans held-for-sale, nonperforming assets were \$50.3 million, or 3.86% of total assets at June 30, 2010. Nonperforming assets were \$61.7 million, or 4.30% of total assets at June 30, 2009, and \$64.6 million, or 4.74% of total assets at December 31, 2009.

Net charge-offs were \$18.4 million in the second quarter of 2010, of which \$13.9 million related to substandard and substandard-nonaccrual real estate loans transferred to the loans held-for-sale portfolio, and \$4.5 million related to the remaining loan portfolio. Net charge-offs were \$3.2 million in the second quarter of 2009, and \$5.9 million in the fourth quarter of 2009.

Brokered deposits decreased to \$163.7 million at June 30, 2010, compared to \$212.8 million at June 30, 2009, and \$178.0 million at December 31, 2009.

The ratio of noncore funding (which consists of time deposits \$100,000 and over, CDARS deposits, brokered deposits, securities under agreement to repurchase, notes payable and short-term borrowings) to total assets was 26% at June 30, 2010, compared to 31% at June 30, 2009, and 29% at December 31, 2009.

The loan to deposit ratio improved to 90.39% at June 30, 2010, compared to 99.84% at June 30, 2009, and 98.24% at December 31, 2009.

The \$75 million of new capital raised in June 2010 increased tangible equity to \$182.3 million at June 30, 2010, from \$127.5 million at June 30, 2009, and \$125.5 million at December 31, 2009.

HCC downstreamed \$40 million of the proceeds from the June 2010 private placement to the capital of HBC.

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On a consolidated basis, the Company's capital ratios continue to exceed regulatory well-capitalized standards with a leverage ratio of 8.65%, a Tier 1 risk-based capital ratio of 10.73%, and a total risk-based capital ratio of 18.66% at June 30, 2010.

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HBC's capital ratios continue to exceed regulatory well-capitalized standards with a leverage ratio of 11.68%, a Tier 1 risk-based capital ratio of 14.49%, and a total risk-based capital ratio of 15.75% at June 30, 2010.

***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. The Company had \$163.7 million in brokered deposits at June 30, 2010, compared to \$212.8 million at June 30, 2009, and \$178.0 million at December 31, 2009. 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 at June 30, 2010 were \$1.04 billion, compared to \$1.16 billion at June 30, 2009, and \$1.09 billion at December 31, 2009.

HBC is a member of the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program allows customers with deposits in excess of FDIC insured limits to obtain coverage on time deposits through a network of banks within the CDARS program. Deposits gathered through this program are considered brokered deposits under regulatory guidelines. Deposits in the CDARS program totaled \$18.2 million at June 30, 2010, compared to \$11.9 million at June 30, 2009 and \$38.2 million at December 31, 2009.

HBC is a participant in the FDIC's Transaction Account Guarantee Program ("TAGP"), which provides HBC's depositors with unlimited FDIC insurance coverage for certain noninterest-bearing transaction accounts. Unless extended by the FDIC, the TAGP will expire on December 31, 2010, at which time the amount of coverage for each depositor will be limited to \$250,000. The impact of the TAGP expiration in December 2010 could have an adverse effect on HBC's deposit base.

***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. We believe that our liquidity position is more than sufficient to meet our operating expenses, borrowing needs and other obligations for 2010. At June 30, 2010, we had \$108.5 million in cash and cash equivalents and approximately \$198.1 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 \$88.1 million in unpledged securities available at June 30, 2010. The loan to deposit ratio improved to 90.39% at June 30, 2010, compared to 99.84% at June 30, 2009, and 98.24% at December 31, 2009.

***Lending***

Our lending business originates primarily through our branch offices located in our primary market. The Company also has SBA loan production offices in Sacramento, Oakland and Santa Rosa, California. As a result of the weakened economy in our primary service area throughout 2009 and the first half of 2010 and loan payoffs, we have seen a contraction in our loan portfolio during the first six months of 2010. At June 30, 2010, commercial and industrial loans accounted for 41% of the total loan portfolio. Commercial real estate loans accounted for another 40% of the total loan portfolio at June 30, 2010, of which 51% were owner occupied by businesses. Land and construction loans continued to decrease and accounted for 12% of the total loan portfolio, and consumer and home equity loans accounted for the remaining 7% of total loans at June 30, 2010.

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***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).

Because of our focus on commercial lending to closely held businesses, the Company will continue to have a high percentage of floating rate loans and other assets. Given the current volume, mix and repricing characteristics of our interest-bearing liabilities and interest-earning assets, we believe our interest rate spread is expected to increase in a rising rate environment, and decrease in a declining interest rate environment.

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*.

From January 22, 2008 through December 16, 2008, the Board of Governors of the Federal Reserve System reduced short-term interest rates by 325 basis points. This decrease in short-term rates immediately affected the rates applicable to the majority of the Company's loans. While the decrease in interest rates also lowered the cost of interest bearing deposits, which represents the Company's primary funding source, these deposits tend to price more slowly than floating rate loans, which resulted in compression of the Company's net interest margin. The Company's net interest margin expanded in the first half of 2010, as the costs of deposits and borrowings have continued to decline.

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

***Management of Credit Risk***

We continue to proactively identify, quantify, and manage our problem loans. Early identification of problem loans and potential future losses helps enable us to resolve credit issues with potentially less risk and ultimate losses. We maintain an allowance for loan losses in an amount that we believe is adequate to absorb probable incurred losses in the portfolio. While we strive to carefully manage and monitor credit quality and to identify loans that may be deteriorating, circumstances can change at any time for loans included in the portfolio that may result in future losses, that as of the date of the financial statements have not yet been identified as potential problem loans. Through established credit practices, we adjust the allowance for loan losses accordingly. However, because future events are uncertain, there may be loans that deteriorate some of which could occur in an accelerated time frame. As a result, future additions to the allowance 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, such as have resulted due to the current, and potentially worsening, economic conditions. 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*."

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***Noninterest Income***

While net interest income remains the largest single component of total revenues, noninterest income is an important component. Prior to the third quarter of 2007, a significant percentage of the Company's noninterest income was 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. From the third quarter of 2007 through the second quarter of 2009, the Company retained its SBA production. In the third quarter of 2009, the Company began to again sell loans in the secondary market. During the first quarter of 2010, \$3.9 million of SBA loans were transferred to third parties, which were subject to a 90 day SBA warranty. The Company adopted new accounting guidance in the first quarter of 2010 that requires the Company to treat the SBA loans sold as secured borrowings during the warranty period. The warranty period for loans transferred in the first quarter of 2010 expired in the second quarter of 2010, and resulted in a gain on sale of loans of \$163,000. Additionally, \$4.0 million of SBA loans have been transferred to third parties during the second quarter of 2010. Provided the loans remain current through the end of the warranty period, all elements necessary to record the sale will have been met. The Company has deferred gains of \$230,000 associated with these loans, which are included in other liabilities on the consolidated balance sheet. We expect to continue to sell loans in the secondary market in 2010 to enhance liquidity and improve noninterest income. Other sources of noninterest income include loan servicing fees, service charges and fees, and cash surrender value from company owned life insurance policies.

***Noninterest Expense***

Management considers the control of operating expenses to be a critical element of the Company's performance. Over the last several quarters the Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. Nonetheless, noninterest expense increased in the second quarter of 2010 compared to the second quarter of 2009, as a result of the goodwill impairment. Noninterest expense, including the \$43.2 million impairment of goodwill, was \$54.6 million for the second quarter of 2010, compared to \$12.1 million in the second quarter of 2009.

***Capital Management***

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

On June 21, 2010, the Company issued Series B Mandatorily Convertible Cumulative Perpetual Preferred Stock ("Series B Preferred Stock") and Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock") to a limited number of institutional investors for an aggregate amount of \$75.0 million. HCC downstreamed \$40 million of the proceeds from the private placement to the capital of HBC.

At June 30, 2010, HBC's total risk-based capital ratio was 15.75%, compared to the 10% regulatory requirement for well-capitalized banks under the regulatory framework for prompt corrective actions. HBC's Tier 1 risk-based capital ratio of 14.49% and our leverage ratio of 11.68% at June 30, 2010 also exceeded regulatory guidelines for well-capitalized banks under the prompt corrective actions framework. On a consolidated basis, the Company has a leverage ratio of 8.65%, a Tier 1 risk-based capital ratio of 10.73%, and a total risk-based capital ratio of 18.66% at June 30, 2010.

Under the Written Agreement we are required to obtain the prior approval of the Federal Reserve Bank of San Francisco and the Director of the Division of Banking Supervision and Regulation of the Federal Reserve to make any interest payments on our outstanding trust preferred securities and related subordinate debt, or to any dividends on our common stock or preferred stock.

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Under the terms of the Capital Purchase Program with the U.S. Treasury, so long as our Series A Preferred Stock is outstanding, we are prohibited from increasing quarterly dividends on our common stock in excess of \$0.08 per share, and from making certain repurchases of equity securities, including our common stock, without the U.S. Treasury consent until the third anniversary of the U.S. Treasury investment or until the U.S. Treasury has transferred all of the Series A Preferred Stock it purchased under the Capital Purchase Program to third parties. As long as the Series A Preferred Stock is outstanding, dividend payments and repurchases or redemptions relating to certain equity securities, including our common stock, the Series B Preferred Stock and the Series C Preferred Stock, are also prohibited until all accrued and unpaid dividends are paid on such preferred stock, subject to certain limited exceptions. On November 6, 2009, we suspended dividend payments on our Series A Preferred Stock. So long as dividends on the Series A Preferred Stock remain suspended, we may not, among other things and with limited exceptions, pay cash dividends on or repurchase our common stock or preferred stock.

We have supported our growth through the issuance of trust preferred securities from special purpose trusts and accompanying sales of subordinated debt to these trusts. The subordinated debt that we issued to the trusts is senior to our shares of common stock, Series A Preferred Stock, Series B Preferred Stock and Series C Preferred Stock. As a result, we must make payments on the subordinated debt before any dividends can be paid on our common stock, Series A Preferred Stock, Series B Preferred Stock and Series C Preferred Stock. Under the terms of the subordinated debt, we may defer interest payments for up to five years. On November 6, 2009, we exercised our right to defer regularly scheduled interest payments on our outstanding \$23.7 million of subordinated debt relating to our trust preferred securities. So long as interest payments remain deferred, we may not pay cash dividends on or repurchase our common stock or preferred stock.

We may not pay dividends on our common stock until all accrued and unpaid dividends have been paid on our Series B Preferred Stock. The Series B Preferred stock will convert automatically and no longer be outstanding upon shareholder approval of the conversion of the Series B Preferred Stock. Prior to the shareholder approval of the conversion of the Series C Preferred Stock, we may not pay dividends on our common stock until all accrued and unpaid dividends have been paid on our Series C Preferred Stock.

At such time as we become current with the dividends payable on our preferred stock and interest payments on our trust preferred securities and related subordinated debt, the decision whether to pay dividends will be made by our board of directors in light of conditions then existing, including factors such as our results of operations, financial condition, business conditions, regulatory capital requirements and covenants under any applicable contractual arrangements, including agreements with regulatory authorities.

## **RESULTS OF OPERATIONS**

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

### ***Net Interest Income and Net Interest Margin***

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



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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.

### Distribution, Rate and Yield

NET INTEREST INCOME AND NET INTEREST MARGIN	For the Three Months Ended June 30, 2010			For the Three Months Ended June 30, 2009		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
(Dollars in thousands)						
<b>Assets:</b>						
Loans, gross(1)	\$ 1,002,987	\$ 12,737	5.09%	\$ 1,206,479	\$ 14,862	4.94%
Securities	151,875	1,459	3.85%	107,158	958	3.59%
Federal funds sold	100		0.00%	139		0.00%
Interest-bearing deposits in other financial institutions	26,970	16	0.24%	6,828	4	0.23%
Total interest earning assets	1,181,932	14,212	4.82%	1,320,604	15,824	4.81%
Cash and due from banks	34,875			23,090		
Premises and equipment, net	8,825			9,380		
Goodwill and other intangible assets	46,088			47,189		
Other assets	61,207			56,899		
Total assets	\$ 1,332,927			\$ 1,457,162		
<b>Liabilities and shareholders' equity:</b>						
<b>Deposits:</b>						
Demand, interest-bearing	\$ 150,565	83	0.22%	\$ 134,141	79	0.24%
Savings and money market	294,628	363	0.49%	346,847	662	0.77%
Time deposits under \$100	38,514	133	1.39%	44,612	259	2.33%
Time deposits \$100 and over	132,062	470	1.43%	169,954	718	1.69%
Time deposits CDARS	18,849	48	1.02%	12,124	42	1.39%
Time deposits brokered	177,184	1,060	2.40%	187,531	1,634	3.49%
Subordinated debt	23,702	468	7.92%	23,702	487	8.24%
Securities sold under agreement to repurchase	20,000	113	2.27%	30,000	227	3.03%
Short-term borrowings	5,393	46	3.42%	43,099	27	0.25%
Total interest-bearing liabilities	860,897	2,784	1.30%	992,010	4,135	1.67%
Demand, noninterest bearing	258,902			255,011		
Other liabilities	34,961			28,745		
Total liabilities	1,154,760			1,275,766		
Shareholders' equity	178,167			181,396		
Total liabilities and shareholders' equity	\$ 1,332,927			\$ 1,457,162		
Net interest income / margin		\$ 11,428	3.88%		\$ 11,689	3.55%

(1)

Includes loans held-for-sale. Yields and amounts earned on loans include loan fees and costs. Nonaccrual loans are included in the average balance calculation above.

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	For the Six Months Ended June 30, 2010			For the Six Months Ended June 30, 2009		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
(Dollars in thousands, unaudited)						
<b>Assets:</b>						
Loans, gross(1)	\$ 1,033,270	\$ 25,911	5.06%	\$ 1,221,329	\$ 29,892	4.94%
Securities	138,190	2,622	3.83%	108,655	1,957	3.63%
Federal funds sold	101		0.00%	157		0.00%
Interest-bearing deposits in other financial institutions	22,286	26	0.24%	6,021	8	0.27%
Total interest earning assets	1,193,847	28,559	4.82%	1,336,162	31,857	4.81%
Cash and due from banks	27,977			23,786		
Premises and equipment, net	8,891			9,424		
Goodwill and other intangible assets	46,400			47,269		
Other assets	66,286			54,141		
Total assets	\$ 1,343,401			\$ 1,470,782		
<b>Liabilities and shareholders' equity:</b>						
<b>Deposits:</b>						
Demand, interest-bearing	\$ 149,966	169	0.23%	\$ 135,223	178	0.27%
Savings and money market	298,111	762	0.52%	346,851	1,454	0.85%
Time deposits under \$100	39,036	281	1.45%	45,356	555	2.47%
Time deposits \$100 and Over	132,215	968	1.48%	173,377	1,592	1.85%
Time deposits CDARS	19,110	101	1.07%	11,479	89	1.56%
Time deposits brokered	177,301	2,240	2.55%	190,312	3,556	3.77%
Subordinated debt	23,702	934	7.95%	23,702	987	8.40%
Securities sold under agreement to repurchase	21,354	244	2.30%	31,354	469	3.02%
Note payable			N/A	5,110	82	3.24%
Short-term borrowings	13,064	63	0.97%	41,370	54	0.26%
Total interest-bearing liabilities	873,859	5,762	1.33%	1,004,134	9,016	1.81%
Demand, noninterest bearing	256,671			254,250		
Other liabilities	36,882			28,997		
Total liabilities	1,167,412			1,287,381		
Shareholders' equity	175,989			183,401		
Total liabilities and shareholders' equity	\$ 1,343,401			\$ 1,470,782		
Net interest income / margin		\$ 22,797	3.85%		\$ 22,841	3.45%

(1)

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Includes loans held-for-sale. Yields and amounts earned on loans include loan fees and costs. Nonaccrual loans are included in the average balance calculation above.

### 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

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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 June 30, 2010 vs. 2009 Increase (Decrease) Due to Change In:			
	Average Volume	Average Rate	Net Change
(Dollars in thousands)			
Income from interest earning assets:			
Loans, gross	\$ (2,573)	\$ 448	\$ (2,125)
Securities	430	71	501
Federal funds sold			
Interest-bearing deposits in other financial institutions	12		12
Total interest income from interest earnings assets	\$ (2,131)	\$ 519	\$ (1,612)
Expense on interest-bearing liabilities:			
Demand, interest-bearing	\$ 9	\$ (5)	\$ 4
Savings and money market	(61)	(238)	(299)
Time deposits under \$100	(22)	(104)	(126)
Time deposits \$100 and over	(136)	(112)	(248)
Time deposits CDARS	17	(11)	6
Time deposits brokered	(62)	(512)	(574)
Subordinated debt		(19)	(19)
Securities sold under agreement to repurchase	(57)	(57)	(114)
Short-term borrowings	(321)	340	19
Total interest expense on interest-bearing liabilities	\$ (633)	\$ (718)	\$ (1,351)
Net interest income	\$ (1,498)	\$ 1,237	\$ (261)

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Six Months Ended June 30, 2010 vs. 2009 Increase (Decrease) Due to Change In:			
	Average Volume	Average Rate	Net Change
(Dollars in thousands)			
Income from interest earning assets:			
Loans, gross	\$ (4,735)	\$ 754	\$ (3,981)
Securities	558	107	665
Federal funds sold			
Interest-bearing deposits in other financial institutions	19	(1)	18
Total interest income from interest earnings assets	\$ (4,158)	\$ 860	\$ (3,298)
Expense on interest-bearing liabilities:			
Demand, interest-bearing	\$ 15	\$ (24)	\$ (9)
Savings and money market	(132)	(560)	(692)
Time deposits under \$100	(45)	(229)	(274)
Time deposits \$100 and over	(304)	(320)	(624)
Time deposits CDARS	40	(28)	12
Time deposits brokered	(167)	(1,149)	(1,316)
Subordinated debt		(53)	(53)
Securities sold under agreement to repurchase	(114)	(111)	(225)
Note payable		(82)	(82)
Short-term borrowings	(136)	145	9
Total interest expense on interest-bearing liabilities	\$ (843)	\$ (2,411)	\$ (3,254)
Net interest income	\$ (3,315)	\$ 3,271	\$ (44)

The Company's net interest margin, expressed as a percentage of average earning assets, increased to 3.88% and 3.85% for the second quarter and six months ended June 30, 2010 compared to 3.55% and 3.45% for the same periods in 2009, respectively. A substantial portion of the Company's earning assets are variable-rate loans that re-price when the Company's prime lending rate is changed, versus 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.

Net interest income in the second quarter of 2010 decreased to \$11.4 million, or 2%, from \$11.7 million in the second quarter of 2009. The decrease in 2010 was primarily due to a decrease in average loan volume, including loans held-for-sale, of \$203.5 million. Net interest income in the first half of 2010 remained relatively the same as the first half of 2009 at \$22.8 million.

***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 shown in the statements of operations 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, 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.

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The Company had a provision for loan losses of \$18.6 million for the quarter ended June 30, 2010 and \$23.7 million for the six months ended June 30, 2010. The Company had a provision for loan losses of \$10.7 million for the quarter ended June 30, 2009 and \$21.1 million for the six months ended June 30, 2009.

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."

## 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 June 30,		Increase (decrease) 2010 versus 2009	
	2010	2009	Amount	Percent
(Dollars in thousands)				
Noninterest income:				
Service charges and fees on deposit accounts	\$ 579	\$ 537	\$ 42	8%
Servicing income	425	408	17	4%
Increase in cash surrender value of life insurance	413	415	(2)	0%
Gain on sale of loans	163		163	N/A
Other	298	241	57	24%
Total noninterest income	\$ 1,878	\$ 1,601	\$ 277	17%

	For the Six Months Ended June 30,		Increase (decrease) 2010 versus 2009	
	2010	2009	Amount	Percent
(Dollars in thousands)				
Noninterest income:				
Service charges and fees on deposit accounts	\$ 1,128	\$ 1,108	\$ 20	2%
Servicing income	846	828	18	2%
Increase in cash surrender value of life insurance	822	827	(5)	-1%
Gain on sale of loans	277		277	N/A
Other	489	461	28	6%
Total noninterest income	\$ 3,562	\$ 3,224	\$ 338	10%

The increase in noninterest income in the second quarter and first half of 2010 compared to the same periods in 2009 was primarily attributable to the gain on sale of loans. Other sources of noninterest income include loan servicing fees, service charges and fees, and the cash surrender value from company owned life insurance policies.

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. From the third quarter of 2007 through the second quarter of 2009, the Company changed its strategy regarding its SBA loan business by retaining new SBA production in lieu of selling the loans. Reflecting the strategic shift to retain SBA loan production, there were no gains from sales of loans during 2008 and for the first six months of 2009. During the first six months of 2010, loans were sold resulting in a gain on sale of \$277,000.

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The servicing assets that result from the sale 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.

The increase in cash surrender value of life insurance approximates a 3.94% after tax yield on the policies. To realize this tax advantaged yield, the policies must be held until death of the insured individuals, who are current and former officers and directors of the Company.

## 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 June 30,		Increase (decrease) 2010 versus 2009	
	2010	2009	Amount	Percent
	(Dollars in thousands)			
Noninterest Expense:				
Salaries and employee benefits	\$ 5,491	\$ 5,643	\$ (152)	-3%
Professional fees	1,144	1,229	(85)	-7%
FDIC deposit insurance premiums	1,019	1,220	(201)	-16%
Occupancy and equipment	983	972	11	1%
Insurance expense	269	131	138	105%
Software subscription	252	217	35	16%
Data processing	219	260	(41)	-16%
Low income housing investment losses	133	210	(77)	-37%
Other real estate owned expense	69	107	(38)	-36%
Impairment of goodwill	43,181		43,181	N/A
Other	1,792	2,091	(299)	-14%
Total noninterest expense	\$ 54,552	\$ 12,080	\$ 42,472	352%

	For the Six Months Ended June 30,		Increase (decrease) 2010 versus 2009	
	2010	2009	Amount	Percent
	(Dollars in thousands)			
Noninterest Expense:				
Salaries and employee benefits	\$ 11,373	\$ 12,101	\$ (728)	-6%
Professional fees	2,421	2,142	279	13%
FDIC deposit insurance premiums	2,210	1,959	251	13%
Occupancy and equipment	1,942	1,888	54	3%
Insurance expense	525	190	335	176%
Software subscription	486	413	73	18%
Data processing	430	489	(59)	-12%
Low income housing investment losses	358	424	(66)	-16%
Other real estate owned expense	488	170	318	187%
Impairment of goodwill	43,181		43,181	N/A
Other	3,337	3,666	(329)	-9%
Total noninterest expense	\$ 66,751	\$ 23,442	\$ 43,309	185%



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Salaries and employee benefits, the single largest component of noninterest expense, decreased \$152,000, or 3%, for the second quarter of 2010 and \$728,000, or 6%, for the first six months of 2010, compared to the same periods in 2009, primarily due to a reduction in workforce implemented in the fourth quarter of 2009. Full-time equivalent employees were 202 and 217 at June 30, 2010 and 2009, respectively.

Professional fees decreased \$85,000, or 7% for the quarter ended June 30, 2010 and increased \$279,000 or 13% for the six months ended June 30, 2010, from the same periods a year ago. The increase in professional fees in the first six months of 2010 compared to the same period in 2009 was primarily due to legal fees related to loan workouts and increased expenses for bank regulatory compliance.

FDIC deposit insurance premiums decreased \$201,000, or 16%, for the quarter ended June 30, 2010 compared to the same period in 2009, mainly due to a \$657,000 charge for the FDIC special assessment in the second quarter of 2009, partially offset by an increase in the FDIC deposit assessment rate. FDIC deposit insurance premiums increased \$251,000, or 13%, for the six months ended June 30, 2010 compared to the same period in 2009, primarily due to an increase in the FDIC deposit assessment rate.

Insurance expense increased \$138,000, or 105%, for the quarter ended June 30, 2010 and increased \$335,000, or 176%, for the six months ended June 30, 2010 from the same periods in 2009, primarily due to an increase in the directors and officers insurance premiums.

OREO expense decreased \$38,000, or 36% in the second quarter of 2010, compared to the same period in 2009. For the six months ended June 30, 2010, OREO expense increased \$318,000, or 187%, compared to the same period in 2009, primarily due to the write-down of an OREO property in the first quarter of 2010.

Due to the continued depressed economic conditions and the length of time and amount by which the Company's book value exceeded market value per share, and the Company's closing of the private placement at a conversion price of \$3.75 per share, the Company determined the entire \$43.2 million of goodwill related to the acquisition of Diablo Valley Bank was impaired during the second quarter of 2010.

### *Income Tax Expense*

The Company computes its provision for income taxes on a monthly basis. The effective tax rate is determined by applying the Company's statutory income tax rates to pre-tax book income as adjusted for permanent differences between pre-tax book income and actual taxable income. These permanent differences include, but are not limited to, tax-exempt interest income, increases in the cash surrender value of life insurance policies, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits.

The Company's Federal and state income tax benefit for the quarter and six months ended 2010 was \$5.8 million and \$5.9 million, respectively, which included \$3.7 million of additional income tax expense to establish a partial valuation allowance on the Company's net deferred tax asset. The income tax benefit was \$4.1 million and \$9.2 million for the same periods in 2009. The following table shows the effective income tax rates for the second quarter and first six months of 2010 and 2009:

	<b>For the Three Months Ended June 30,</b>		<b>For the Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Effective income tax rate	-9.6%	-43.3%	-9.2%	-49.5%

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The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of the Company's investment in life insurance policies whose earnings are not subject to taxes and tax credits related to investments in low income housing limited partnerships.

The Company has total investments of \$5.1 million in low-income housing limited partnerships as of June 30, 2010. These investments have generated annual tax credits of approximately \$1.1 million in each of the years ended December 31, 2009 and 2008.

Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles, leading to timing differences between the Company's actual tax liability and the amount accrued for this liability based on book income. These temporary differences comprise the "deferred" portion of the Company's tax expense or benefit, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as they reverse. At June 30, 2010, the Company had a net deferred tax asset of approximately \$24.6 million, compared to \$21.7 million at June 30, 2009, and \$22.4 million at December 31, 2009.

Realization of the Company's deferred tax assets is primarily dependent upon the Company generating sufficient taxable income to obtain benefit from the reversal of net deductible temporary differences and utilization of tax credit carryforwards and the net operating loss carryforwards for California state income tax purposes. The amount of deferred tax assets considered realizable is subject to adjustment in future periods based on estimates of future taxable income. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the 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. At June 30, 2010, the Company determined a partial valuation allowance on the state of California net deferred tax asset was necessary, largely based on the negative evidence represented by a cumulative loss in the Company's most recent three-year period caused by the loan loss provisions recorded during the periods. The \$5.9 million income tax benefit for the six months ended June 30, 2010 is net of \$3.7 million of income tax expense to establish the partial valuation allowance. Management is required to re-evaluate the deferred tax asset and the related valuation allowance quarterly.

The net recorded deferred tax asset, after the partial valuation allowance, was \$24.6 million at June 30, 2010. The remaining deferred tax asset was supported by available tax planning strategies and projected future taxable income.

**FINANCIAL CONDITION**

As of June 30, 2010, total assets were \$1.30 billion, compared to \$1.44 billion as of June 30, 2009 and \$1.36 billion as of December 31, 2009. Total securities available-for-sale (at fair value) were \$142.2 million, a increase of 40% from \$101.8 million the year before. The total loan portfolio (excluding loans held-for-sale) was \$937.8 million, a decrease of 19% from \$1.16 billion at June 30, 2009, and a decrease of 12% from \$1.07 billion at December 31, 2009. Total deposits decreased 11% to \$1.04 billion at June 30, 2010, from \$1.16 billion at June 30, 2009, and decreased 5% from \$1.09 billion at December 31, 2009. Securities sold under agreement to repurchase decreased \$10 million, or 33%, to \$20.0 million at June 30, 2010, from \$30.0 million at June 30, 2009 and decreased 20% from \$25.0 million at December 31, 2009. In addition, short-term borrowings decreased 73% to \$4.0 million at June 30, 2010, from \$15.0 million at June 30, 2009, and decreased 80% from \$20.0 million at December 31, 2009.

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### Securities Portfolio

The following table reflects the estimated fair values for each category of securities at the dates indicated:

	June 30, 2010	June 30, 2009	December 31, 2009
(Dollars in thousands)			
Securities available-for-sale (at fair value)			
U.S. Treasury	\$	\$ 29,494	\$
U.S. Government Sponsored Entities	2,002	6,574	1,973
Mortgage-Backed Securities Residential	136,692	59,621	102,546
Municipals Tax Exempt		326	
Collateralized Mortgage Obligations Residential	3,518	5,822	5,447
Total	\$ 142,212	\$ 101,837	\$ 109,966

The following table summarizes the weighted average life and weighted average yields of securities at June 30, 2010:

		Weighted Average Life									
		Within One Year		After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
		Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
(Dollars in thousands)											
Securities available-for-sale (at fair value)											
U.S. Government Sponsored Entities											
		\$ 2,002	2.20%	\$		\$		\$		\$ 2,002	2.20%
Mortgage-Backed Securities Residential											
	8	5.89%	33,992	4.42%	99,434	3.68%	3,258	5.05%	136,692	3.90%	
Collateralized Mortgage Obligations Residential											
	1,645	5.12%	873	6.47%					3,518	5.46%	
Total		\$ 4,655	3.87%	\$ 34,865	4.47%	\$ 99,434	3.68%	\$ 3,258	5.05%	\$ 142,212	3.91%

The securities portfolio is the second largest component of the Company's interest-earning assets, and the structure and composition of this portfolio is important to any analysis of the financial condition of the Company. The portfolio serves the following purposes: (i) it provides a source of pledged assets for securing certain deposits and borrowed funds, as may be required by law or by specific agreement with a depositor or lender; (ii) it can be used as an interest rate risk management tool, since it provides a large base of assets, the maturity and interest rate characteristics of which can be changed more readily than the loan portfolio to better match changes in the deposit base and other funding sources of the Company; and (iii) it is an alternative interest-earning use of funds when loan demand is weak or when deposits grow more rapidly than loans.

The Company's securities are all currently classified under existing accounting rules as "available-for-sale" to allow flexibility for the management of the portfolio. Accounting requires available-for-sale securities to be marked to fair value with an offset to accumulated other comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available-for-sale securities.

The Company's portfolio is historically comprised primarily of: (i) U.S. Treasury securities and U.S. Government sponsored entities' debt securities for liquidity and pledging; (ii) mortgage-backed securities, which in many instances can also be used for pledging, and which generally enhance the yield of the portfolio; (iii) municipal obligations, which provide tax free income and limited pledging potential; and (iv) collateralized mortgage obligations, which generally enhance the yield of the portfolio.



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In the second quarter of 2010, the securities portfolio increased by \$40.4 million, or 40%, and increased to 11% of total assets at June 30, 2010 from 7% at June 30, 2009, and increased by \$32.2 million, or 29%, from December 31, 2009. U.S. Treasury and U.S. Government sponsored entity securities decreased to 1% of the portfolio at June 30, 2010 from 35% at June 30, 2009 and 2% at December 31, 2009. The Company increased its holding of mortgage-back securities by \$77.1 million to \$136.7 million at June 30, 2010, from \$59.6 million at June 30, 2009, and increased \$34.1 million from \$102.5 million at December 31, 2009 to take advantage of higher yields and offset a portion of the contraction in the loan portfolio. No securities of a single issuer exceeded 10% of shareholders' equity at June 30, 2010. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities to otherwise mitigate interest rate risk.

## Loans

The Company's loans represent the largest portion of invested assets, substantially greater than the securities portfolio or any other asset category, and the quality and diversification of the loan portfolio is an important consideration when reviewing the Company's financial condition.

Gross loans, excluding loans held-for-sale, represented 72% of total assets at June 30, 2010 and 81% at June 30, 2009 and represented 78% of total assets at December 31, 2009. The ratio of loans to deposits decreased to 90.39% at June 30, 2010 from 99.84% at June 30, 2009 and 98.24% at December 31, 2009. Demand for loans has weakened within the Company's markets due to the current economic environment.

During the second quarter of 2010, the Company identified \$31.0 million of real estate loans classified as substandard or substandard-nonaccrual that it intends to sell. The sale is expected to be finalized in the third quarter of 2010. These loans were written down to \$17.1 million to reflect the estimated market value of the loans and this amount was transferred to loans held-for-sale. The write-down of these real estate loans resulted in net charge-offs of \$13.9 million in the second quarter of 2010. The following table shows the detail of the real estate loans we intend to sell at June 30, 2010:

	Balance Prior to Transfer	Amount Charged-off	Balance Transferred to Loans Held-for-Sale
(Dollars in thousands)			
Realestate mortgage	\$ 9,893	\$ (2,781)	\$ 7,112
Real estate land and construction	21,112	(11,145)	9,967
Total	\$ 31,005	\$ (13,926)	\$ 17,079

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**Loan Distribution**

The Loan Distribution table that follows sets forth the Company's gross loans, excluding loans held-for-sale, outstanding and the percentage distribution in each category at the dates indicated:

	June 30, 2010		June 30, 2009		December 31, 2009	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
(Dollars in thousands)						
Commercial	\$ 388,471	41%	\$ 457,981	39%	\$ 427,177	40%
Real estate mortgage	373,000	40%	412,430	36%	400,731	37%
Real estate land and construction	110,194	12%	230,798	20%	182,871	17%
Home equity	52,419	6%	55,372	5%	51,368	5%
Consumer	12,837	1%	3,596	0%	7,181	1%
Total loans	936,921	100%	1,160,177	100%	1,069,328	100%
Deferred loan costs	852		1,489		785	
Loans, including deferred costs	937,773	100%	1,161,666	100%	1,070,113	100%
Allowance for loan losses	(26,753)		(31,398)		(28,768)	
Loans, net	\$ 911,020		\$ 1,130,268		\$ 1,041,345	

The Company's loan portfolio is concentrated in commercial loans, primarily manufacturing, wholesale, and services, and real estate mortgage loans, with the balance in land development, construction and home equity and consumer loans. The decrease in the Company's loan portfolio in 2010 is due to diminished loan demand, and loan payoffs exceeding draw downs of loan commitments. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 58% of its gross loans were secured by real property as of June 30, 2010, compared to 60% as of June 30, 2009, and 59% as of December 31, 2009. While no specific industry concentration is considered significant, the Company's lending operations are located in areas that are dependent on the technology and real estate industries and their supporting companies.

The Company's commercial loans are made for working capital, financing the purchase of equipment or for other business purposes. Commercial loans include loans with maturities ranging from thirty days to one year and "term loans" with maturities normally ranging from one to five years. Short-term business loans are generally intended to finance current transactions and typically provide for periodic principal payments, with interest payable monthly. Term loans normally provide for floating interest rates, with monthly payments of both principal and interest.

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such guaranteed loans (collectively referred to as "SBA loans"). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold, the Company retains the servicing rights for the sold portion. During the first six months of 2010, loans were sold resulting in a gain on sale of \$277,000.

As of June 30, 2010, real estate mortgage loans of \$373.0 million consist primarily of adjustable and fixed rate loans secured by deeds of trust on commercial property. The real estate mortgage loans at June 30, 2010 consist of \$192.0 million, or 51%, of owner occupied properties, and \$181.0 million, or 49%, of investment properties. Properties securing the commercial real estate mortgage loans are primarily located in the Company's primary market, which is the Greater San Francisco Bay Area.

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The Company's real estate mortgage loans consist primarily of loans based on the borrower's cash flow and are secured by deeds of trust on commercial and residential property to provide a secondary source of repayment. The Company generally restricts real estate term loans to generally 75%, or less, of the property's appraised value or the purchase price of the property during the initial underwriting of the credit, depending on the type of property and its utilization. The Company offers both fixed and floating rate loans. Maturities on real estate mortgage loans are generally between five and ten years (with amortization ranging from fifteen to twenty-five years and a balloon payment due at maturity); however, SBA and certain other real estate loans that can be sold in the secondary market may be granted for longer maturities.

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Land and construction loans decreased \$120.6 million to \$110.2 million, or 12% of total loans at June 30, 2010, from \$230.8 million, or 20% of total loans at June 30, 2009, and decreased \$72.7 million from \$182.9 million, or 17% of total loans at December 31, 2009.

The Company makes consumer loans for the purpose of financing automobiles, various types of consumer goods, and other personal purposes. Consumer loans generally provide for the monthly payment of principal and interest. Most of the Company's consumer loans are secured by the personal property being purchased or, in the instances of home equity loans or lines, real property.

Additionally, the Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten with a maximum 70% loan to value ratio. Home equity lines are reviewed at least semiannually, with specific emphasis on loans with a loan to value ratio greater than 70% and loans that were underwritten from mid-2005 through 2008, when real estate values were at the peak in the cycle. The Company takes measures to work with customers to reduce line commitments and minimize potential losses.

With certain exceptions, state chartered banks are permitted to make extensions of credit to any one borrowing entity up to 15% of the bank's capital and reserves for unsecured loans and up to 25% of the bank's capital and reserves for secured loans. For HBC, these lending limits were \$30.3 million and \$50.4 million at June 30, 2010, respectively.

***Loan Maturities***

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale) as of June 30, 2010. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall

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Street Journal. As of June 30, 2010, approximately 69% of the Company's loan portfolio consisted of floating interest rate loans.

	<b>Due in One Year or Less</b>	<b>Over One Year But Less than Five Years</b>	<b>Over Five Years</b>	<b>Total</b>
<b>(Dollars in thousands)</b>				
Commercial	\$ 346,938	\$ 40,737	\$ 796	\$ 388,471
Real estate mortgage	130,661	196,853	45,486	373,000
Real estate land and construction	96,104	14,090		110,194
Home equity	50,453		1,966	52,419
Consumer	12,141	696		12,837
Loans	\$ 636,297	\$ 252,376	\$ 48,248	\$