HERITAGE COMMERCE CORP
Form 10-Q
November 07, 2012

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended September 30, 2012

OR

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

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

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

California	**77-0469558**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
150 Almaden Boulevard, San Jose, California	**95113**
(Address of Principal Executive Offices)	(Zip Code)

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

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

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

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

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

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

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

The Registrant had 26,320,184 shares of Common Stock outstanding on October 31, 2012.

HERITAGE COMMERCE CORP
QUARTERLY REPORT ON FORM 10-Q
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Cautionary Note Regarding Forward-Looking Statements

This Report on Form 10-Q contains various statements that may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Any statements about our expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and may be forward- looking. These forward-looking statements often can be, but are not always, identified by the use of words such as "assume," "expect," "intend," "plan," "project," "believe," "estimate," "predict," "anticipate," "may," "might," "should," "could," "goal," "potential" and similar expressions. We base these forward-looking statements on our current expectations and projections about future events, our assumptions regarding these events and our knowledge of facts at the time the statements are made. These statements include statements relating to our projected growth, anticipated future financial performance, and management's long-term performance goals, as well as statements relating to the anticipated effects on results of operations and financial condition.

These forward-looking statements are subject to various risks and uncertainties that may be outside our control and our actual results could differ materially from our projected results. In addition, our past results of operations do not necessarily indicate our future results. The forward-looking statements could be affected by many factors, including but not limited to:

- Competition for loans and deposits and failure to attract or retain deposits and loans;
- Local, regional, and national economic conditions and events and the impact they may have on us and our customers, and our assessment of that impact on our estimates including, the allowance for loan losses;
- Risks associated with concentrations in real estate related loans;
- Changes in the level of nonperforming assets and charge-offs and other credit quality measures, and their impact on the adequacy of the Company's allowance for loan losses and the Company's provision for loan losses;
- The effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Federal Open Market Committee of the Federal Reserve Board;
- Stability of funding sources and continued availability of borrowings;
- Our ability to raise capital or incur debt on reasonable terms;
- Regulatory limits on Heritage Bank of Commerce's ability to pay dividends to the Company;
- Continued volatility in credit and equity markets and its effect on the global economy;
- The impact of reputational risk on such matters as business generation and retention, funding and liquidity;
- Oversupply of inventory and continued deterioration in values of California commercial real estate;

A prolonged slowdown in construction activity;

The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities, and executive compensation) which we must comply, including but not limited to, the Dodd-Frank Act of 2010;

The effects of security breaches and computer viruses that may affect our computer systems;

Changes in consumer spending, borrowings and saving habits;

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

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

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

The ability to increase market share and control expenses; 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.

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Part I FINANCIAL INFORMATION

ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HERITAGE COMMERCE CORP

CONSOLIDATED BALANCE SHEETS (Unaudited)

	September 30, 2012	December 31, 2011
	(Dollars in thousands)	
Assets		
Cash and due from banks	$ 23,345	$ 20,861
Interest-bearing deposits in other financial institutions	8,165	52,011
Total cash and cash equivalents	31,510	72,872
Securities available-for-sale, at fair value	410,756	380,455
Securities held-to-maturity, at amoritized cost (fair value of $25,655 at September 30, 2012)	25,592	
Loans held-for-sale SBA, at lower of cost or fair value, including deferred costs	1,476	753
Loans held-for-sale other, at lower of cost or fair value, including deferred costs		413
Loans, including deferred costs	799,393	764,591
Allowance for loan losses	(19,124)	(20,700)
Loans, net	780,269	743,891
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	10,901	9,925
Company owned life insurance	47,929	46,388
Premises and equipment, net	7,627	7,980
Intangible assets	2,123	2,491
Accrued interest receivable and other assets	37,857	41,026
Total assets	$ 1,356,040	$ 1,306,194
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Demand, noninterest-bearing	$ 405,880	$ 344,303
Demand, interest-bearing	159,361	134,119
Savings and money market	281,579	282,478
Time deposits under $100	26,513	28,557
Time deposits $100 and over	170,430	168,874
Time deposits CDARS	5,098	6,371
Time deposits brokered	89,172	84,726
Total deposits	1,138,033	1,049,428
Subordinated debt	9,279	23,702
Accrued interest payable and other liabilities	39,727	35,233
Total liabilities	1,187,039	1,108,363
Shareholders' equity:		

Preferred stock, no par value; 10,000,000 shares authorized				
Series A fixed rate cumulative preferred stock, 40,000 shares issued and outstanding (liquidation preference of $40,250) at December 31, 2011				39,846
Discount on Series A preferred stock				(833)
Series C convertible perpetual preferred stock, 21,004 shares issued and outstanding at September 30, 2012 and December 31, 2011 (liquidation preference of $21,004 at September 30, 2012 and December 31, 2011)		19,519		19,519
Common stock, no par value; 60,000,000 shares authorized; 26,320,184 shares issued and outstanding at September 30, 2012 and 26,295,001 shares issued and outstanding at December 31, 2011		131,615		131,172
Retained earnings		13,052		7,172
Accumulated other comprehensive income		4,815		955
Total shareholders' equity		169,001		197,831
Total liabilities and shareholders' equity	$	1,356,040	$	1,306,194

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Dollars in thousands, except per share data)			
Interest income:				
Loans, including fees	$ 10,146	$ 10,530	$ 30,754	$ 32,205
Securities	2,686	2,457	8,758	6,697
Interest-bearing deposits in other financial institutions	30	33	95	119
Total interest income	12,862	13,020	39,607	39,021
Interest expense:				
Deposits	690	852	2,144	3,191
Subordinated debt	346	468	1,293	1,400
Other	2		3	62
Total interest expense	1,038	1,320	3,440	4,653
Net interest income before provision for loan losses	11,824	11,700	36,167	34,368
Provision for loan losses	1,200	1,515	2,115	3,239
Net interest income after provision for loan losses	10,624	10,185	34,052	31,129
Noninterest income:				
Gain on sales of securities	1,105		1,164	
Service charges and fees on deposit accounts	575	605	1,766	1,759
Increase in cash surrender value of life insurance	434	426	1,292	1,270
Servicing income	429	434	1,336	1,280
Gain on sales of SBA loans	221	268	633	1,124
Other	184	179	570	566
Total noninterest income	2,948	1,912	6,761	5,999
Noninterest expense:				
Salaries and employee benefits	5,336	5,000	16,380	15,504
Occupancy and equipment	1,041	1,012	3,004	3,082
Premium on redemption of subordinated debt	601		601	
Professional fees	587	707	2,268	2,002
Software subscriptions	275	256	878	785
Low income housing investment losses	264	617	795	820
Data processing	252	234	744	653
FDIC deposit insurance premiums	248	167	675	1,074
Insurance expense	198	232	645	718
Other real estate owned expense	9	84	229	231
Other	1,336	1,500	4,238	4,843
Total noninterest expense	10,147	9,809	30,457	29,712
Income before income taxes	3,425	2,288	10,356	7,416
Income tax expense (benefit)	939	(2,529)	3,116	(1,068)

Net income		2,486		4,817		7,240		8,484
Dividends and discount accretion on preferred stock				(532)		(1,206)		(1,732)
Net income available to common shareholders	$	2,486	$	4,285	$	6,034	$	6,752
Earnings per common share:								
Basic	$	0.08	$	0.13	$	0.19	$	0.21
Diluted	$	0.08	$	0.13	$	0.19	$	0.21

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Dollars in thousands)			
Net income	$ 2,486	$ 4,817	$ 7,240	$ 8,484
Net unrealized holding gains on available-for-sale securities and I/O strips	3,915	7,733	7,685	11,607
Reclassification adjustment for (gains) realized in income	(1,105)		(1,164)	
Deferred income taxes	(1,180)	(3,248)	(2,739)	(4,875)
Change in unrealized gains on available-for-sale securities and I/O strips, net of deferred income taxes	1,630	4,485	3,782	6,732
Net pension and other benefit plan liability adjustment	38	2,034	134	2,229
Deferred income taxes	(16)	(1,498)	(56)	(1,579)
Change in pension and other benefit plan liability, net of deferred income taxes	22	536	78	650
Other comprehensive income	1,652	5,021	3,860	7,382
Total comprehensive income	$ 4,138	$ 9,838	$ 11,100	$ 15,866

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

	Nine Months Ended September 30, 2012 and 2011							
	Preferred Stock			Common Stock		Retained Earnings/ (Accumulated Defecit)	Accumulated Other Comprehensive Income / (Loss)	Total Shareholders' Equity
	Shares	Amount	Discount	Shares	Amount			
	(Dollars in thousands)							
Balance, January 1, 2011	61,004	$ 59,365	$ (1,227)	26,233,001	$ 130,531	$ (1,866)	$ (4,651)	$ 182,152
Net income						8,484		8,484
Net change in unrealized gain/(loss) on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes							6,732	6,732
Net change in pension and other benefit plan liability, net of deferred income taxes							650	650
Issuance of restricted stock awards				62,000				
Amortization of restricted stock awards, net of forfeitures and taxes					27			27
Cash dividends accrued on Series A preferred stock						(1,439)		(1,439)
Accretion of discount on Series A preferred stock			293			(293)		
Stock option expense, net of fortfeitures and taxes					457			457
Balance, September 30, 2011	61,004	$ 59,365	$ (934)	26,295,001	$ 131,015	$ 4,886	$ 2,731	$ 197,063
Balance, January 1, 2012	61,004	$ 59,365	$ (833)	26,295,001	$ 131,172	$ 7,172	$ 955	$ 197,831
Net income						7,240		7,240
Net change in unrealized gain/(loss) on securities available-for-sale and interest-only strips, net of reclassification adjustment and deferred income taxes							3,782	3,782
Net change in pension and other benefit plan liability, net of deferred income taxes							78	78
Repurchase of Series A preferred stock	(40,000)	(40,000)						(40,000)
Series A preferred stock capitalized offering costs		154				(154)		
Issuance (forfeitures) of restricted stock awards, net				21,500				
Amortization of restricted stock awards, net of forfeitures and taxes					86			86
Cash dividends accrued on Series A preferred stock						(373)		(373)
Accretion of discount on Series A preferred stock			833			(833)		
Stock option expense, net of fortfeitures and taxes					340			340
Stock options exercised				3,683	17			17
Balance, September 30, 2012	21,004	$ 19,519	$	26,320,184	$ 131,615	$ 13,052	$ 4,815	$ 169,001

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 7,240	$ 8,484
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of discounts and premiums on securities	1,781	920
Gain on sales of securities available-for-sale	(1,164)	
Gain on sales of SBA loans	(633)	(1,124)
Proceeds from sale of SBA loans originated for sale	8,792	12,347
Net change in SBA loans originated for sale	(8,882)	(5,864)
Write-downs on other loans held-for-sale	87	29
Provision for loan losses	2,115	3,239
Increase in cash surrender value of life insurance	(1,292)	(1,270)
Depreciation and amortization	569	579
Amortization of intangible assets	368	392
Gains on sale of foreclosed assets, net	(135)	(67)
Stock option expense, net	340	457
Amortization of restricted stock awards, net	86	27
Effect of changes in:		
Accrued interest receivable and other assets	1,871	(173)
Accrued interest payable and other liabilities	481	(8,390)
Net cash provided by operating activities	11,624	9,586
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of securities available-for-sale	(148,107)	(95,841)
Purchase of securities held-to-maturity	(6,821)	
Maturities/paydowns/calls of securities available-for-sale	82,766	26,432
Proceeds from sale of securities available-for-sale	26,357	
Net change in other loans transferred to held-for-sale		70
Net change in loans	(40,360)	59,719
Change in Federal Home Loan Bank and Federal Reserve Bank stock	(976)	(747)
Purchase of premises and equipment	(216)	(201)
Proceeds from sale of foreclosed assets	574	2,465
Proceeds from sale of other loans transferred to held-for-sale	220	1,769
(Purchases) redemption of company owned life insurance	(249)	(250)
Net cash (used in) investing activities	(86,812)	(6,584)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	88,605	12,216
Repayment of preferred stock	(40,000)	
Redemption of subordinated debt	(14,423)	
Payment of cash dividends preferred stock	(373)	(4,172)
Exercise of stock options	17	
Net change in securities sold under agreement to repurchase		(5,000)
Net change in short-term borrowings		(2,445)
Net cash provided by financing activities	33,826	599
Net increase (decrease) in cash and cash equivalents	(41,362)	3,601
Cash and cash equivalents, beginning of period	72,872	72,177
Cash and cash equivalents, end of period	$ 31,510	$ 75,778

Supplemental disclosures of cash flow information:				
Interest paid	$	3,927	$	7,054
Income taxes paid		2,230		490
Supplemental schedule of non-cash investing activity:				
Due to broker for securities purchased	$	9,353	$	
Loans transferred to foreclosed assets		1,973		2,252
Transfer securities from available-for-sale to held-to-maturity		15,498		
Transfer of loans held-for-sale to loan portfolio		87		

See notes to consolidated financial statements

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(Unaudited)

1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the "Company" or "HCC") and its wholly owned subsidiary, Heritage Bank of Commerce (sometimes referred to as the "Bank" or "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, 2011. The Company has also established following the 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. During the third quarter of 2012 the Company dissolved the Heritage Statutory Trust I and the Heritage Capital Trust I.

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

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

The results for the three months and nine months ended September 30, 2012 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2012.

Reclassifications

Certain reclassifications of prior year balances have been made to conform to the current year presentation. These reclassifications had no impact on the Company's consolidated financial position, results of operations or net change in cash and cash equivalents.

Adoption of New Accounting Standards

In May 2011, the FASB issued an accounting standards update to improve the comparability between U.S. GAAP fair value accounting and reporting requirements and International Financial Reporting Standards ("IFRS") fair value accounting and reporting requirements. Additional disclosures required by the update include: (i) disclosure of quantitative information regarding the unobservable

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

1) Basis of Presentation (Continued)

inputs used in any fair value measurement classified as Level 3 in the fair value hierarchy in addition to an explanation of the valuation techniques used in valuing Level 3 items and information regarding the sensitivity in the valuation of Level 3 items to changes in the values assigned to unobservable inputs; (ii) categorization by level within the fair value hierarchy of items not recognized on the Statement of Financial Position at fair value but for which fair values are required to be disclosed; and (iii) instances where the fair values disclosed for non-financial assets were based on a highest and best use assumption when in fact the assets are not being utilized in that capacity. The amendments in the update are effective for interim and annual periods beginning on or after December 15, 2011. The effect of adopting this standard did not have a material effect on the Company's operating results or financial condition, but the additional disclosures are included in Note 8.

In June 2011, the FASB issued an accounting standards update to increase the prominence of items included in Other Comprehensive Income and facilitate the convergence of U.S. GAAP with IFRS. The update prohibits continued presentation of Other Comprehensive Income in the statement of stockholders' equity. The update requires that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but continuous statements. The amendments in the update are effective for interim and annual periods beginning on or after December 15, 2011. The adoption of this amendment changed the presentation of the statement of comprehensive income for the Company to two consecutive statements, instead of presented as part of the consolidated statements of shareholders' equity.

2) Earnings Per Share

Basic earnings per common share is computed by dividing net income, less dividends and discount accretion on preferred stock, by the weighted average common shares outstanding. On June 21, 2010, the Company issued to various institutional investors 21,004 shares of Series C Convertible Perpetual Preferred Stock ("Series C Preferred Stock"). The Series C Preferred Stock is convertible into 5,601,000 shares of common stock when transferred in accordance with its terms. The Series C Preferred Stock participate in the earnings of the Company and, therefore, the shares issued on the conversion of the Series C Preferred Stock are considered outstanding under the two-class method of computing basic earnings per common share during periods of earnings. Diluted earnings per share reflect potential dilution from outstanding stock options and common stock warrants, using the treasury stock method. The common stock warrant was antidilutive at September 30, 2012 and 2011. A

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

2) Earnings Per Share (Continued)

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

	For the Three Months Ended September 30, 2012	For the Three Months Ended September 30, 2011	For the Nine Months Ended September 30, 2012	For the Nine Months Ended September 30, 2011
	(Dollars in thousands, except per share data)			
Net income available to common shareholders	$ 2,486	$ 4,285	$ 6,034	$ 6,752
Less: net income allocated to Series C Preferred Stock	436	752	1,059	1,187
Net income allocated to common shareholders	$ 2,050	$ 3,533	$ 4,975	$ 5,565
Weighted average common shares outstanding for basic earnings per common share	26,312,263	26,295,001	26,297,359	26,257,112
Dilutive effect of stock options oustanding, using the the treasury stock method	30,776	2,274	27,096	4,443
Shares used in computing diluted earnings per common share	26,343,039	26,297,275	26,324,455	26,261,555
Basic earnings per share	$ 0.08	$ 0.13	$ 0.19	$ 0.21
Diluted earnings per share	$ 0.08	$ 0.13	$ 0.19	$ 0.21

3) Securities

The amortized cost and estimated fair value of securities at September 30, 2012 and December 31, 2011 were as follows:

September 30, 2012	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
	(Dollars in thousands)			
Securities available-for-sale:				
Agency mortgage-backed securities	$ 321,977	$ 12,934	$	$ 334,911
Corporate bonds	53,795	1,265	(24)	55,036
Trust preferred securities	20,723	101	(15)	20,809
Total	$ 396,495	$ 14,300	$ (39)	$ 410,756
Securities held-to-maturity:				
Agency mortgage-backed securities	$ 15,756	$ 36	$	$ 15,792
Municipals tax exempt	9,836	46	(19)	9,863
Total	$ 25,592	$ 82	$ (19)	$ 25,655

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

3) Securities (Continued)

December 31, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(Dollars in thousands)		
Securities available-for-sale:				
Agency mortgage-backed securities	$ 341,901	$ 8,484	$ (37)	$ 350,348
Trust preferred securities	29,947	194	(34)	30,107
Total	$ 371,848	$ 8,678	$ (71)	$ 380,455

The investment securities available-for-sale portfolio totaled $410,756,000 at September 30, 2012, an increase of $30,301,000 from $380,455,000 at December 31, 2011. Mortgage-backed securities decreased $15,437,000 to $334,911,000 at September 30, 2012, from $350,348,000 at December 31, 2011. At September 30, 2012 and December 31, 2011, all agency mortgage-backed securities were issued by the Federal National Mortgage Association ("Fannie Mae") the Federal Home Loan Mortgage Corporation ("Freddie Mac"), or the Government National Mortgage Association ("Ginnie Mae"). The Company sold $22,596,000 of agency mortgage-backed securities for a gain on the sale of securities of $1,105,000 during the third quarter of 2012, compared to no gain on the sale of securities during the third quarter of 2011.

At September 30, 2012, the investment securities available-for-sale portfolio included $55,036,000 of corporate bonds, compared to no corporate bonds in the investment portfolio at December 31, 2011. At September 30, 2012, the Company's available-for-sale portfolio included two issues of single entity issue trust preferred securities with a carrying value of $20,723,000 and market value of $20,809,000 compared to a carrying value of $29,947,000 and a market value of $30,107,000 of single entity issue trust preferred securities at December 31, 2011.

During the third quarter of 2012, the Company reclassified, at fair value, approximately $16,373,000 in available-for-sale mortgage-backed securities to the held-to-maturity category. The related unrealized after-tax gains of approximately $505,000 remained in accumulated other comprehensive income and will be amortized over the remaining life of the securities as an adjustment of yield, offsetting the related amortization of the premium or accretion of the discount on the transferred securities. No gains or losses were recognized at the time of reclassification. At September 30, 2012, mortgage-backed securities held-to-maturity, at amortized cost, were $15,756,000. During the third quarter of 2012, the Company purchased $9,836,000 of tax-exempt municipal bonds, which are also classified as held-to-maturity. At September 30, 2012, total investment securities held-to-maturity at amortized cost were $25,592,000, compared to no investment securities held-to-maturity at December 31, 2011. Management considers the held-to-maturity classification of these investment securities to be appropriate based on the Company's intent and ability to hold these securities to maturity.

There were no holdings of securities of any one issuer, other than the U.S. Government and its sponsored entities, in an amount greater than 10% of shareholders' equity. At September 30, 2012, the Company held 213 securities (176 available-for-sale and 37 held-to-maturity), of which 11 had fair values below amortized cost. No securities had been carried with an unrealized loss for over 12 months.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

3) Securities (Continued)

Unrealized losses were due to higher interest rates. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. The Company does not intend to sell any securities with an unrealized loss and does not believe that it is more likely than not that the Company will be required to sell a security in an unrealized loss position prior to recovery in value. The Company does not consider these securities to be other-than-temporarily impaired at September 30, 2012.

At December 31, 2011, the Company held 165 securities, of which five had fair values below amortized cost. No securities had 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, 2011.

The amortized cost and estimated fair values of securities as September 30, 2012, by contractual maturity, are shown below. The expected maturities will differ from contractual maturities if borrowers have the right to call or pre-pay obligations with or without call or pre-payment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-sale	
	Amortized Cost	**Estimated Fair Value**
	(Dollars in thousands)	
Due after one through five years	$ 914	$ 934
Due after five through ten years	52,881	54,102
Due after ten years	20,723	20,809
Agency mortgage-backed securities	321,977	334,911
Total	$ 396,495	$ 410,756

	Held-to-maturity	
	Amortized Cost	**Estimated Fair Value**
	(Dollars in thousands)	
Due after five through ten years	$ 4,687	$ 4,725
Due after ten years	5,149	5,138
Agency mortgage-backed securities	15,756	15,792
Total	$ 25,592	$ 25,655

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

4) Loans

Loans were as follows:

	September 30, 2012	December 31, 2011
	(Dollars in thousands)	
Loans held-for-investment:		
Commercial	$ 377,520	$ 366,590
Real estate:		
Commercial and residential	336,573	311,479
Land and construction	24,068	23,016
Home equity	45,565	52,017
Consumer	15,649	11,166
Loans	799,375	764,268
Deferred loan origination costs and fees, net	18	323
Loans, including deferred costs	799,393	764,591
Allowance for loan losses	(19,124)	(20,700)
Loans, net	$ 780,269	$ 743,891

Changes in the allowance for loan losses were as follows:

	Three Months Ended September 30, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 13,378	$ 6,539	$ 106	$ 20,023
Charge-offs	(916)	(1,334)		(2,250)
Recoveries	149	2		151
Net charge-offs	(767)	(1,332)		(2,099)
Provision for loan losses	661	525	14	1,200
Balance, end of period	$ 13,272	$ 5,732	$ 120	$ 19,124

	Three Months Ended September 30, 2011			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 13,992	$ 8,162	$ 1,013	$ 23,167
Charge-offs	(3,042)	(901)		(3,943)
Recoveries	283	25	2	310

Net (charge-offs)/recoveries	(2,759)	(876)	2	(3,633)
Provision/(credit) for loan losses	1,809	554	(848)	1,515
Balance, end of period	$ 13,042	$ 7,840	$ 167	$ 21,049

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

4) Loans (Continued)

	Nine Months Ended September 30, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 13,215	$ 7,338	$ 147	$ 20,700
Charge-offs	(3,106)	(1,480)		(4,586)
Recoveries	670	225		895
Net charge-offs	(2,436)	(1,255)		(3,691)
Provision/(credit) for loan losses	2,493	(351)	(27)	2,115
Balance, end of period	$ 13,272	$ 5,732	$ 120	$ 19,124

	Nine Months Ended September 30, 2011			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 13,952	$ 10,363	$ 889	$ 25,204
Charge-offs	(5,841)	(2,497)	(8)	(8,346)
Recoveries	513	436	3	952
Net charge-offs	(5,328)	(2,061)	(5)	(7,394)
Provision/(credit) for loan losses	4,418	(462)	(717)	3,239
Balance, end of period	$ 13,042	$ 7,840	$ 167	$ 21,049

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment, based on the impairment method as of September 30, 2012 and December 31, 2011:

	September 30, 2012			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 2,469	$ 803	$ 24	$ 3,296
Collectively evaluated for impairment	10,803	4,929	96	15,828
Total ending allowance balance	$ 13,272	$ 5,732	$ 120	$ 19,124
Loans:				
Individually evaluated for impairment	$ 11,153	$ 8,517	$ 152	$ 19,822

Collectively evaluated for impairment	366,367	397,689	15,497	779,553
Total ending loan balance	$ 377,520	$ 406,206	$ 15,649	$ 799,375

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

4) Loans (Continued)

	December 31, 2011			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 2,249	$ 76	$ 2	$ 2,327
Collectively evaluated for impairment	10,966	7,262	145	18,373
Total ending allowance balance	$ 13,215	$ 7,338	$ 147	$ 20,700
Loans:				
Individually evaluated for impairment	$ 11,954	$ 5,948	$ 12	$ 17,914
Collectively evaluated for impairment	354,636	380,564	11,154	746,354
Total ending loan balance	$ 366,590	$ 386,512	$ 11,166	$ 764,268

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

4) Loans (Continued)

The following table presents loans held-for-investment individually evaluated for impairment by class of loans as of September 30, 2012 and December 31, 2011. The recorded investment included in the following table represents loan principal net of any partial charge-offs recognized on the loans. The unpaid principal balance represents the recorded balance prior to any partial charge-offs.

	September 30, 2012			December 31, 2011		
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
	(Dollars in thousands)					
With no related allowance recorded:						
Commercial	$ 6,222	$ 5,511	$	$ 7,644	$ 5,972	$
Real estate:						
Commercial and residential	1,059	1,059		2,916	2,057	
Land and construction	2,346	2,259		3,491	3,039	
Home Equity	299	299				
Consumer						
Total with no related allowance recorded	9,926	9,128		14,051	11,068	
With an allowance recorded:						
Commercial	6,042	5,642	2,469	6,526	5,982	2,249
Real estate:						
Commercial and residential	5,752	4,504	803	80	80	44
Land and construction				817	740	32
Home Equity	396	396		32	32	
Consumer	152	152	24	12	12	2
Total with an allowance recorded	12,342	10,694	3,296	7,467	6,846	2,327
Total	$ 22,268	$ 19,822	$ 3,296	$ 21,518	$ 17,914	$ 2,327

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

	Three Months Ended September 30, 2012					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 11,138	$ 3,329	$ 2,228	$ 546	$ 156	$ 17,397
Interest income during impairment	$	$	$	$	$	$
Cash-basis interest earned	$	$	$	$	$	$

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

4) Loans (Continued)

	Three Months Ended September 30, 2011					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 11,740	$ 1,297	$ 4,411	$ 3,317	$ 800	$ 21,565
Interest income during impairment	$	$	$	$	$ 2	$ 2
Cash-basis interest earned	$	$	$	$	$	$

	Nine Months Ended September 30, 2012					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 11,294	$ 3,051	$ 2,615	$ 281	$ 83	$ 17,324
Interest income during impairment	$	$ 1	$ 14	$	$	$ 15
Cash-basis interest earned	$	$ 1	$ 14	$	$	$ 15

	Nine Months Ended September 30, 2011					
		Real Estate				
	Commercial	Commercial and Residential	Land and Construction	Home Equity	Consumer	Total
	(Dollars in thousands)					
Average of impaired loans during the period	$ 12,777	$ 3,186	$ 6,213	$ 1,729	$ 848	$ 24,753
Interest income during impairment	$ 2	$	$	$ 1	$ 2	$ 5
Cash-basis interest earned	$	$	$	$ 1	$	$ 1

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

4) Loans (Continued)

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

	September 30, 2012	September 30, 2011	December 31, 2011
	(Dollars in thousands)		
Nonaccrual loans held-for-sale	$	$ 191	$ 186
Nonaccrual loans held-for-investment	17,396	16,419	14,353
Restructured and loans over 90 days past due and still accruing	1,722	1,343	2,291
Total nonperforming loans	$ 19,118	$ 17,953	$ 16,830
Other restructured loans	$ 704	$ 1,313	$ 1,270
Impaired loans, excluding loans held-for-sale	$ 19,822	$ 19,075	$ 17,914

Nonperforming loans were $19.1 million at September 30, 2012, compared to $18.0 million at September 30, 2011, and $16.8 million at December 30, 2011. The increase in nonperforming loans at September 30, 2012 from comparable prior periods was primarily due to a commercial loan and two real estate loans advanced to one customer which were previously included in classified assets but have been moved to nonperforming assets. The current recorded investment of the loans is approximately $5.5 million.

The following table presents the nonperforming loans by class as of September 30, 2012 and December 31, 2011:

	September 30, 2012			December 31, 2011		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	$ 8,727	$ 1,722	$ 10,449	$ 8,876	$ 1,803	$ 10,679
Real estate:						
Commercial and residential	5,564		5,564	2,137		2,137
Land and construction	2,259		2,259	3,514	456	3,970
Home equity	694		694		32	32
Consumer	152		152	12		12
Total	$ 17,396	$ 1,722	$ 19,118	$ 14,539	$ 2,291	$ 16,830

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

4) Loans (Continued)

The following table presents the aging of past due loans as of September 30, 2012 by class of loans:

	September 30, 2012					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 1,414	$ 535	$ 3,656	$ 5,605	$ 371,915	$ 377,520
Real estate:						
Commercial and residential			1,369	1,369	335,204	336,573
Land and construction			87	87	23,981	24,068
Home equity	892			892	44,673	45,565
Consumer		30		30	15,619	15,649
Total	$ 2,306	$ 565	$ 5,112	$ 7,983	$ 791,392	$ 799,375

The following table presents the aging of past due loans as of December 31, 2011 by class of loans:

	December 31, 2011					
	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
	(Dollars in thousands)					
Commercial	$ 1,999	$ 508	$ 3,394	$ 5,901	$ 360,689	$ 366,590
Real estate:						
Commercial and residential	2,293			2,293	309,186	311,479
Land and construction			1,532	1,532	21,484	23,016
Home equity	753		32	785	51,232	52,017
Consumer					11,166	11,166
Total	$ 5,045	$ 508	$ 4,958	$ 10,511	$ 753,757	$ 764,268

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

4) Loans (Continued)

Past due loans 30 days or greater totaled $7,983,000 and $10,511,000 at September 30, 2012 and December 31, 2011, respectively, of which $6,217,000 and $6,312,000 were on nonaccrual. At September 30, 2012, there were also $11,179,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. At December 31, 2011, there were also $8,041,000 loans less than 30 days past due included in nonaccrual loans held-for-investment. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued.

Credit Quality Indicators

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

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

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

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

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

4) Loans (Continued)

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

The following table provides a summary of the loan portfolio by loan type and credit quality classification at September 30, 2012 and December 31, 2011:

	September 30, 2012			December 31, 2011		
	Nonclassified	Classified	Total	Nonclassified	Classified	Total
	(Dollars in thousands)					
Commercial	$ 353,187	$ 24,333	$ 377,520	$ 333,506	$ 33,084	$ 366,590
Real estate:						
Commercial and residential	323,924	12,649	336,573	294,653	16,826	311,479
Land and construction	18,055	6,013	24,068	15,343	7,673	23,016
Home equity	44,626	939	45,565	51,368	649	52,017
Consumer	15,244	405	15,649	10,853	313	11,166
Total	$ 755,036	$ 44,339	$ 799,375	$ 705,723	$ 58,545	$ 764,268

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

During the three months and nine months ended September 30, 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included either one or both of the following: a reduction of the stated interest rate of the loan; or an extension of maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk.

The recorded investment of troubled debt restructurings at September 30, 2012 was $4,247,000, which included $1,821,000 of nonaccrual loans and $2,426,000 of accruing loans. The book balance of troubled debt restructurings at December 31, 2011 was $7,396,000, which included $4,323,000 of nonaccrual loans and $3,073,000 of accruing loans. Approximately $959,000 and $574,000 in specific reserves were established with respect to these loans as of September 30, 2012 and December 31, 2011, respectively. As of September 30, 2012 and December 31, 2011, the Company had no additional amounts committed on any loan classified as a troubled debt restructuring.

HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

4) Loans (Continued)

The following table presents loans by class modified as troubled debt restructurings during the three month period ended September 30, 2012 and 2011:

	During the Three Months Ended September 30, 2012		
Troubled Debt Restructurings:	**Number of Contracts**	**Pre-modification Outstanding Recorded Investment**	**Post-modification Outstanding Recorded Investment**
		(Dollars in thousands)	
Commercial	2	$ 91	$ 91
Total	2	$ 91	$ 91

	During the Three Months Ended September 30, 2011		
Troubled Debt Restructurings:	**Number of Contracts**	**Pre-modification Outstanding Recorded Investment**	**Post-modification Outstanding Recorded Investment**
		(Dollars in thousands)	
Commercial	6	$ 1,557	$ 1,370
Total	6	$ 1,557	$ 1,370

The troubled debt restructurings described above increased the allowance for loan losses by $21,000 through the allocation of specific reserves, and resulted in no net charge-offs during the three months period ended September 30, 2012.

The troubled debt restructurings described above increased the allowance for loan losses by $144,000 through the allocation of specific reserves, and resulted in net charge-offs of $174,000 during the three month period ended September 30, 2011.

The following table presents loans by class modified as troubled debt restructurings during the nine month period ended September 30, 2012 and 2011:

	During the Nine Months Ended September 30, 2012		
Troubled Debt Restructurings:	**Number of Contracts**	**Pre-modification Outstanding Recorded Investment**	**Post-modification Outstanding Recorded Investment**
		(Dollars in thousands)	
Commercial	3	$ 163	$ 163
Consumer	1	111	111
Total	4	$ 274	$ 274

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HERITAGE COMMERCE CORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2012

(Unaudited)

4) Loans (Continued)

	During the Nine Months Ended September 30, 2011		
Troubled Debt Restructurings:	**Number of Contracts**	**Pre-modification Outstanding Recorded Investment**	**Post-modification Outstanding Recorded Investment**
	(Dollars in thousands)		
Commercial	7	$ 2,249	$ 2,057
Total	7	$ 2,249	$ 2,057

The troubled debt restructurings described above increased the allowance for loan losses by $59,000 through the allocation of specific reserves, and resulted in no net charge-offs during the nine month period ended September 30, 2012.

The troubled debt restructurings described above increased the allowance for loan losses by $158,000 through the allocation of specific reserves, and resulted in net charge-offs of $174,000 during the nine months period ended September 30, 2011.

A loan is considered to be in payment default when it is 30 days contractually past due under the modified terms. There were no defaults on troubled debt restructurings, within twelve months following the modification, during the three month and nine month periods ended September 30, 2012.

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

5) Income Taxes

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

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