

HERITAGE COMMERCE CORP
Form 10-Q
August 09, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2007

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
Number)

150 Almaden Boulevard
San Jose, California 95113

(Address of Principal Executive Offices including Zip Code)

(408) 947-6900

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file reports), and (2) has been subject to such filing requirements for the past 90 days. 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 Accelerated filer Non-accelerated filer

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 13,375,163 shares of Common Stock outstanding on July 25, 2007.

Heritage Commerce Corp and Subsidiaries
Quarterly Report on Form 10-Q
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Part I -- FINANCIAL INFORMATION
ITEM 1 - CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Heritage Commerce Corp
Consolidated Balance Sheets (Unaudited)

	June 30,	December 31,
	2007	2006
	(Dollars in thousands)	
Assets		
Cash and due from banks	\$ 45,881	\$ 34,285
Federal funds sold	57,810	15,100
Total cash and cash equivalents	103,691	49,385
Securities available-for-sale, at fair value	169,498	172,298
Loans held for sale, at lower of cost or market	6,095	17,234
Loans, net of deferred origination costs	939,667	725,754
Allowance for loan losses	(11,104)	(9,279)
Loans, net	928,563	716,475
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	6,334	6,113
Company owned life insurance	37,900	36,174
Premises and equipment, net	9,186	2,539
Goodwill	43,172	-
Core deposit intangible asset	5,031	-
Accrued interest receivable and other assets	37,461	36,920
Total assets	\$ 1,346,931	\$ 1,037,138
 Liabilities and Shareholders' Equity		
Liabilities:		
Deposits		
Demand, noninterest bearing	\$ 266,404	\$ 231,841
Demand, interest bearing	162,003	133,413
Savings and money market	448,528	307,266
Time deposits, under \$100	33,735	31,097
Time deposits, \$100 and over	143,544	111,017
Brokered deposits, \$100 and over	65,439	31,959
Total deposits	1,119,653	846,593
Notes payable to subsidiary grantor trusts	23,702	23,702
Securities sold under agreement to repurchase	10,900	21,800
Accrued interest payable and other liabilities	22,522	22,223
Total liabilities	1,176,777	914,318
 Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized; none outstanding	-	-
Common Stock, no par value; 30,000,000 shares authorized; shares outstanding: 13,375,163 at June 30, 2007 and 11,656,943 at December 31, 2006	103,498	62,363
Retained earnings	69,102	62,452
Accumulated other comprehensive loss	(2,446)	(1,995)
Total shareholders' equity	170,154	122,820
Total liabilities and shareholders' equity	\$ 1,346,931	\$ 1,037,138

See notes to consolidated financial statements

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Heritage Commerce Corp
Consolidated Income Statements (Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
	(Dollars in thousands, except per share data)			
Interest income:				
Loans, including fees	\$ 15,589	\$ 15,344	\$ 30,259	\$ 30,065
Securities, taxable	1,940	1,932	3,848	3,678
Securities, non-taxable	42	45	86	91
Interest bearing deposits in other financial institutions	40	42	73	60
Federal funds sold	706	1,029	1,285	1,758
Total interest income	18,317	18,392	35,551	35,652
Interest expense:				
Deposits	5,221	5,033	10,006	9,352
Notes payable to subsidiary grantor trusts	583	575	1,164	1,137
Repurchase agreements and other	120	158	257	346
Total interest expense	5,924	5,766	11,427	10,835
Net interest income	12,393	12,626	24,124	24,817
Provision for loan losses	-	(114)	(236)	(603)
Net interest income after provision for loan losses	12,393	12,740	24,360	25,420
Noninterest income:				
Gain on sale of loans	695	842	1,706	2,339
Servicing income	534	441	1,050	909
Increase in cash surrender value of life insurance	353	360	697	707
Service charges and fees on deposit accounts	336	327	610	654
Other	344	287	713	542
Total noninterest income	2,262	2,257	4,776	5,151
Noninterest expense:				
Salaries and employee benefits	4,685	4,653	9,573	9,762
Occupancy	770	774	1,535	1,551
Professional fees	401	334	738	847
Advertising and promotion	390	347	602	557
Client services	247	242	476	542
Data processing	197	161	401	342
Low income housing investment losses and writedowns	118	213	355	477
Furniture and equipment	119	148	229	257
Intangible amortization	18	-	18	-
Other	1,555	1,620	2,873	2,918
Total noninterest expense	8,500	8,492	16,800	17,253
Income before income taxes	6,155	6,505	12,336	13,318

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Income tax expense	2,140	2,316	4,288	4,753
Net income	\$ 4,015	\$ 4,189	\$ 8,048	\$ 8,565
Earnings per share:				
Basic	\$ 0.34	\$ 0.35	\$ 0.69	\$ 0.72
Diluted	\$ 0.33	\$ 0.35	\$ 0.68	\$ 0.71

See notes to consolidated financial statements

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Heritage Commerce Corp
Consolidated Statements of Shareholders' Equity (Unaudited)
Six Months Ended June 30, 2007 and 2006

	Common Stock		Retained Earnings		Accumulated Other Comprehensive Loss	Total Shareholder' Equity	Comprehensive Income
	Shares	Amount	Earnings	Loss	Equity	Income	
	(Dollars in thousands, except share data)						
Balance, January 1, 2006	11,807,649	\$ 66,799	\$ 47,539	\$ (2,721)	\$ 111,617		
Net Income	-	-	8,565	-	8,565	\$	8,565
Net change in unrealized gain/loss on securities available-for-sale and Interest-Only strips, net of reclassification adjustment and deferred income taxes	-	-	-	(1,143)	(1,143)		(1,143)
Decrease in minimum pension liability, net of deferred income taxes	-	-	-	183	183		183
Total comprehensive income						\$	7,605
Amortization of restricted stock award	-	76	-	-	76		
Cash dividend declared on common stock, \$0.10 per share	-	-	(1,182)	-	(1,182)		
Common stock repurchased	(72,000)	(1,676)	-	-	(1,676)		
Stock options expense	-	335	-	-	335		
Stock options exercised	84,914	1,192	-	-	1,192		
Balance, June 30, 2006	11,820,563	\$ 66,726	\$ 54,922	\$ (3,681)	\$ 117,967		
Balance, January 1, 2007	11,656,943	\$ 62,363	\$ 62,452	\$ (1,995)	\$ 122,820		
Net Income	-	-	8,048	-	8,048	\$	8,048
Net change in unrealized gain/loss on securities available-for-sale and Interest-Only strips, net of reclassification adjustment and deferred income taxes	-	-	-	(482)	(482)		(482)
Decrease in minimum pension liability, net of deferred income taxes	-	-	-	31	31		31
Total comprehensive income						\$	7,597
Issuance of 1,732,298 shares to acquire Diablo Valley Bank	1,732,298	41,397	-	-	41,397		
Amortization of restricted stock award	-	76	-	-	76		

Cash dividend declared on common stock, \$0.12 per share	-	-	(1,398)	-	(1,398)
Common stock repurchased	(60,200)	(1,497)	-	-	(1,497)
Stock options expense	-	483	-	-	483
Stock options exercised	46,122	676	-	-	676
Balance, June 30, 2007	13,375,163	\$ 103,498	\$ 69,102	\$ (2,446)	\$ 170,154

See notes to consolidated financial statements

Heritage Commerce Corp
Consolidated Statements of Cash Flows (Unaudited)

	Six Months Ended	
	June 30,	
	2007	2006
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 8,048	\$ 8,565
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	307	343
Provision for loan losses	(236)	(603)
Stock option expense	483	335
Amortization of core deposit intangible	18	-
Amortization of restricted stock award	76	76
Amortization (accretion) of discounts and premiums on securities	51	(436)
Gain on sale of loans	(1,706)	(2,339)
Change in loans held for sale	12,845	42,161
Increase in cash surrender value of life insurance	(697)	(707)
Effect of changes in:		
Accrued interest receivable and other assets	2,539	4,234
Accrued interest payable and other liabilities	(1,411)	1,640
Net cash provided (used in) by operating activities	20,317	53,269
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net increase in loans	(8,666)	(25,509)
Purchases of securities available-for-sale	(9,322)	(49,098)
Maturities/paydowns/calls of securities available-for-sale	23,536	54,786
Purchase of premises and equipment	(107)	(208)
Redemption (purchase) of other investments	496	(124)
Cash received in bank acquisition, net of cash paid	16,757	-
Net cash provided by (used in) investing activities	22,694	(20,153)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	24,414	(31,272)
Payment of other liability	-	(1,348)
Exercise of stock options	676	1,192
Common stock repurchased	(1,497)	(1,676)
Payment of dividends	(1,398)	(1,182)
Net decrease in securities sold under agreement to repurchase	(10,900)	(10,900)
Net cash provided by (used in) financing activities	11,295	(45,186)
Net increase in cash and cash equivalents	54,306	(12,070)
Cash and cash equivalents, beginning of period	49,385	98,460
Cash and cash equivalents, end of period	\$ 103,691	\$ 86,390
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	\$ 11,302	\$ 10,833
Income taxes	\$ 2,287	\$ -
Supplemental schedule of non-cash investing and financing activities:		
Loans transferred to foreclosed assets	\$ 487	\$ -
Summary of assets acquired, and liabilities assumed through acquisition:		

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Cash and cash equivalents	\$	41,807	\$	-
Securities available-for-sale	\$	12,214	\$	-
Net loans	\$	203,673	\$	-
Goodwill and other intangible asset	\$	48,221	\$	-
Premises and equipment	\$	6,847	\$	-
Corporate owned life insurance	\$	1,025	\$	-
Federal Home Loan Bank Stock	\$	717	\$	-
Other assets, net	\$	2,301	\$	-
Deposits	\$	(248,646)	\$	-
Other liabilities	\$	(1,712)	\$	-
Common stock issued to acquire Diablo Valley Bank	\$	41,397	\$	-

See notes to consolidated financial statements

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HERITAGE COMMERCE CORP
Notes to Consolidated Financial Statements
June 30, 2007
(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 (“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, 2006. 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.

Certain amounts reported in previous consolidated financial statements have been reclassified to conform to the 2007 presentation.

The results for the three and six months ended June 30, 2007 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2007.

Adoption of New Accounting Standards

In February, 2006, FASB issued Statement 155, *Accounting for Certain Hybrid Instruments*. This standard amended the guidance in Statement 133, *Accounting for Derivative Instruments and Hedging Activities*, and Statement 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Statement 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation and clarifies which interest-only and principal-only strips are not subject to the requirements of Statement 133. Statement 155 is effective for all financial instruments acquired or issued after the beginning of an entity’s first fiscal year that begins after September 15, 2006. The adoption of this standard did not have a material impact on the Company’s financial statements.

In March, 2006, FASB issued Statement 156, *Accounting for Servicing of Financial Assets - An Amendment of FASB Statement No. 140*. This standard amends the guidance in Statement 140, with respect to the accounting for separately recognized servicing assets and servicing liabilities. Among other requirements, Statement 156 requires an entity to

recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations, including a transfer of loans with servicing retained that meets the requirements for sale accounting. Statement 156 is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of this standard did not have a material impact on the Company's financial statements.

In June 2006, FASB issued FASB Interpretation ("FIN") 48, *Accounting for Uncertainty in Income Taxes*. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement 109, *Accounting for Income Taxes*. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006.

The Company adopted FIN 48 as of January 1, 2007. Under FIN 48, a tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The adoption of this standard did not have a material impact on the Company's financial statements.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of the State of California. The Company is no longer subject to examination by taxing authorities for years before 2003. The Company does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense. The Company did not have any amounts accrued for interest and penalties at June 30, 2007.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-5, *Accounting for Purchases of Life Insurance - Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4 (Accounting for Purchases of Life Insurance)*. This issue requires that a policyholder consider contractual terms of a life insurance policy in determining the amount that could be realized under the insurance contract. It also requires that if the contract provides for a greater surrender value if all individual policies in a group are surrendered at the same time, that the surrender value be determined based on the assumption that policies will be surrendered on an individual basis. Lastly, the issue discusses whether the cash surrender value should be discounted when the policyholder is contractually limited in its ability to surrender a policy. This issue is effective for fiscal years beginning after December 15, 2006. The adoption of this issue did not have a material impact on the financial statements.

Newly Issued but not yet Effective Accounting Standards

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. This issue requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants' employment or retirement. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. This issue is effective for fiscal years beginning after December 15, 2007. Adoption of EITF Issue 06-4 is not expected to have a material effect on the Company's financial statements. In 2005, the Company began recognizing the cost of continuing life insurance coverage under split-dollar arrangements. The recorded liability for split-dollar life insurance coverage was \$1,277,000 and \$1,113,000 at June 30, 2007 and 2006, respectively.

In September 2006, FASB issued Statement 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The adoption of this standard is not expected to have a material impact on the Company's financial statements.

In February 2007, FASB issued Statement 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This statement provides companies with an option to report selected financial assets and liabilities at fair value. The Standard's objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. The standard requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company's choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. Statement 159 does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in Statements 157, *Fair Value Measurements*, and 107, *Disclosures about Fair Value of Financial Instruments*. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company has not completed its evaluation of Statement 159's potential effects on its financial statements.

2) Securities Available-for-Sale

The following table shows the gross unrealized losses and fair value of the Company's securities with unrealized losses aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2007:

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(Dollars in thousands)						
U.S. Treasury	\$ 4,895	\$ 6	\$ -	\$ -	\$ 4,895	\$ 6
U.S. Government Agencies	28,738	47	23,573	179	52,311	226
Mortgage-Backed	21,816	506	63,904	3,296	85,720	3,802
Municipals - Tax Exempt	-	-	6,877	112	6,877	112
Collateralized Mortgage Obligations	-	-	2,994	144	2,994	144
Total	\$ 55,449	\$ 559	\$ 97,348	\$ 3,731	\$ 152,797	\$ 4,290

As of June 30, 2007, the Company held 103 securities, of which 81 had fair values below amortized cost. Fifty-four securities have been carried with an unrealized loss for over 12 months. Unrealized losses were primarily due to higher interest rates. No security sustained a downgrade in credit rating. 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. Because the Company has the ability and intent to hold these securities until a recovery of fair value, which may be maturity, the Company does not consider these securities to be other-than-temporarily impaired at June 30, 2007.

Securities classified as U.S. Government Agencies as of June 30, 2007 and December 31, 2006 was issued by the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and the Federal Home Loan Bank.

The securities portfolio of the Company is also used as collateral to meet requirements imposed as a condition of deposit by some depositors such as political subdivisions (public funds) bankruptcy trustees and other contractual obligations such as repurchase agreements. Securities with fair value of \$46,365,000 and \$57,909,000 as of June 30, 2007 and 2006 were pledged to secure public and certain other deposits as required by law or contract and other contractual obligations. A portion of these deposits can only be secured by U.S. Treasury securities. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or to otherwise mitigate interest rate risk.

3) Stock-Based Compensation

The Company has a stock option plan (the "Plan") for directors, officers, and key employees. The Plan provides for the grant of incentive and non-qualified stock options. The Plan provides that the option price for both incentive and non-qualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally, options vest over four years. All options expire no later than ten years from the date of grant. As of June 30, 2007, there are 244,308 shares available for future grants under the Plan. Option activity under the Plan is as follows:

Total Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Options Outstanding at January 1, 2007	752,983	\$ 16.56		
Granted	194,500	\$ 24.01		
Exercised	(46,122)	\$ 8.81		
Forfeited or expired	(23,323)	\$ 20.93		
Options Outstanding at June 30, 2007	878,038	\$ 18.50	7.5	\$ 4,635,000
Exercisable at June 30, 2007	433,373	\$ 14.41	6.0	\$ 4,026,000

Information related to the stock option plan during the six months ended June 30, 2007 and 2006 follows:

	2007	2006
Intrinsic value of options exercised	\$ 715,000	\$ 1,188,000
Cash received from option exercise	\$ 406,000	\$ 785,000
Tax benefit realized from option exercises	\$ 270,000	\$ 407,000
Weighted average fair value of options granted	\$ 6.74	\$ 7.63

As of June 30, 2007, there was approximately \$3,216,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Company's stock plan. That cost is expected to be recognized over a weighted-average period of approximately 2.5 years.

The following table presents the assumptions used to estimate the fair value of options granted during the three months periods ending June 30, 2007 and 2006, respectively:

	2007	2006
Expected life in months ⁽¹⁾	72	84
Volatility ⁽¹⁾	21%	22%
Risk-free interest rate ⁽²⁾	4.68%	4.87%

Expected 1.00% 0.87%
dividends ⁽³⁾

- (1) Estimate based on historical experience. Volatility is based on the historical volatility of the stock over the most recent period that is generally commensurate with the expected life of the option.
- (2) Based on the U.S. Treasury constant maturity interest rate with a term consistent with the expected life of the options granted.
- (3) The Company began paying cash dividends on common stock in 2006. Each grant's dividend yield is calculated by annualizing the most recent quarterly cash dividend and dividing that amount by the market price of the Company's common stock as of the grant date.

The Company estimates the impact of forfeitures based on the Company's historical experience with previously granted stock options in determining stock option expense. The Company issues new shares of common stock to satisfy stock option exercises.

The Company awarded 51,000 restricted shares of common stock to Walter T. Kaczmarek, President and Chief Executive Officer of the Company, pursuant to the terms of a Restricted Stock Agreement dated March 17, 2005. The grant price was \$18.15. Under the terms of the Restricted Stock Agreement, the restricted shares will vest 25% per year at the end of years three, four, five and six, provided Mr. Kaczmarek is still with the Company. Compensation cost associated with the restricted stock issued is measured based on the market price of the stock at the grant date and is expensed on a straight-line basis over the service period. Restricted stock compensation expense for the three and six months ended June 30, 2007 and 2006 were \$38,000 and \$76,000, respectively.

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4) Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted average common shares outstanding. Diluted earnings per share reflects potential dilution from outstanding stock options, using the treasury stock method. There were 337,174 and 92,174 stock options for three months ended June 30, 2007 and 2006 and 279,381 and 90,096 for six months ended June 30, 2007 and 2006, respectively, considered to be antidilutive and excluded from the computation of diluted earnings per share. For each of the periods presented, net income is the same for basic and diluted earnings per share. Reconciliation of weighted average shares used in computing basic and diluted earnings per share is as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Weighted average common shares outstanding - used in computing basic earnings per share	11,798,627	11,835,202	11,700,374	11,828,510
Dilutive effect of stock options outstanding, using the treasury stock method	187,608	195,844	198,605	202,751
Shares used in computing diluted earnings per share	11,986,235	12,031,046	11,898,979	12,031,261

5) Comprehensive Income

Comprehensive income includes net income and other comprehensive income, which represents the changes in net assets during the period from non-owner sources. The Company's sources of other comprehensive income are unrealized gains and losses on securities available-for-sale and I/O strips, which are treated like available-for-sale securities, and the liability related to the Company's supplemental retirement plan. The items in other comprehensive income are presented net of deferred income tax effects. Reclassification adjustments result from gains or losses on securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized gains and losses. The Company's comprehensive income was as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
	(Dollars in thousands)			
Net Income	\$ 4,015	\$ 4,189	\$ 8,048	\$ 8,565
Other comprehensive income (loss):				
Unrealized gains (losses) on available-for-sale of securities and I/O strips during the period	(1,293)	(784)	(830)	(1,833)
Deferred income tax	543	329	348	690
Net unrealized gains (losses) on available-for-sale				

securities and I/O strips, net of deferred income tax	(750)	(455)	(482)	(1,143)
Pension liability adjustment during the period	26	36	53	316
Deferred income tax	(11)	(15)	(22)	(133)
Pension liability adjustment, net of deferred income tax	15	21	31	183
Other comprehensive income (loss)	(735)	(434)	(451)	(960)
Comprehensive income	\$ 3,280	\$ 3,755	\$ 7,597	\$ 7,605

6) Supplemental Retirement Plan

The Company has a supplemental retirement plan covering current and former key executives and directors (“Plan”). 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 months ended June 30, 2007 and 2006:

Three Months Ended June 30,	Six Months Ended
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