

HERITAGE COMMERCE CORP
Form 10-Q
November 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 September 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 13,130,798 shares of Common Stock outstanding on November 1, 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)

September 30,
2007

December 31,
2006

(Dollars in thousands)

Assets				
Cash and due from banks	\$	51,627	\$	34,285
Federal funds sold		42,600		15,100
Total cash and cash equivalents		94,227		49,385
Securities available-for-sale, at fair value		150,116		172,298
Loans held for sale, at lower of cost or market		-		17,234
Loans, net of deferred origination costs		954,658		725,754
Allowance for loan losses		(11,472)		(9,279)
Loans, net		943,186		716,475
Federal Home Loan Bank and Federal Reserve				
Bank stock, at cost		7,653		6,113
Company owned life insurance		38,270		36,174
Premises and equipment, net		9,441		2,539
Goodwill		42,996		-
Core deposit intangible asset		4,863		-
Accrued interest receivable and other assets		35,667		36,920
Total assets	\$	1,326,419	\$	1,037,138
Liabilities and Shareholders' Equity				
Liabilities:				
Deposits				
Demand, noninterest bearing	\$	263,244	\$	231,841
Demand, interest bearing		146,410		133,413
Savings and money market		468,263		307,266
Time deposits, under \$100		32,341		31,097
Time deposits, \$100 and over		138,327		111,017
Brokered deposits, \$100 and over		52,179		31,959
Total deposits		1,100,764		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		22,678		22,223
Total liabilities		1,158,044		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: 13,123,396 at September 30, 2007 and 11,656,943 at December 31, 2006		98,093		62,363
Retained earnings		71,540		62,452
Accumulated other comprehensive loss		(1,258)		(1,995)

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Total shareholders' equity		168,375		122,820
Total liabilities and shareholders' equity	\$	1,326,419	\$	1,037,138

See notes to consolidated financial statements

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Heritage Commerce Corp
Consolidated Income Statements (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(Dollars in thousands, except per share data)			
Interest income:				
Loans, including fees	\$ 19,282	\$ 15,958	\$ 49,541	\$ 46,023
Securities, taxable	1,881	1,968	5,729	5,646
Securities, non-taxable	38	45	124	136
Interest bearing deposits in other financial institutions	31	36	104	96
Federal funds sold	873	561	2,158	2,319
Total interest income	22,105	18,568	57,656	54,220
Interest expense:				
Deposits	7,663	5,027	17,669	14,379
Notes payable to subsidiary grantor trusts	585	587	1,749	1,724
Repurchase agreements and other	76	140	333	486
Total interest expense	8,324	5,754	19,751	16,589
Net interest income	13,781	12,814	37,905	37,631
Provision for loan losses	(500)	-	(736)	(603)
Net interest income after provision for loan losses	14,281	12,814	38,641	38,234
Noninterest income:				
Gain on sale of Capital Group loan portfolio	-	-	-	671
Gain on sale of SBA loans	60	832	1,766	2,500
Servicing income	546	412	1,596	1,321
Increase in cash surrender value of life insurance	374	363	1,071	1,070
Service charges and fees on deposit accounts	344	354	954	1,008
Other	315	338	1,028	880
Total noninterest income	1,639	2,299	6,415	7,450
Noninterest expense:				
Salaries and employee benefits	5,840	4,941	15,413	14,703
Occupancy	969	773	2,504	2,324
Professional fees	751	442	1,489	1,289
Advertising and promotion	206	206	808	763
Data processing	252	156	653	498
Client services	155	230	631	772
Low income housing investment losses and writedowns	233	257	588	734
Furniture and equipment	200	140	429	397
Core deposit intangible amortization	167	-	185	-
Other	1,745	1,167	4,618	4,085
Total noninterest expense	10,518	8,312	27,318	25,565
Income before income taxes	5,402	6,801	17,738	20,119
Income tax expense	2,162	2,448	6,450	7,201

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Net income	\$	3,240	\$	4,353	\$	11,288	\$	12,918
Earnings per share:								
Basic	\$	0.24	\$	0.37	\$	0.92	\$	1.09
Diluted	\$	0.24	\$	0.36	\$	0.91	\$	1.08

See notes to consolidated financial
statements

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Heritage Commerce Corp
Consolidated Statements of Shareholders' Equity (Unaudited)
Nine Months Ended September 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	-	-	12,918	-	12,918	\$	12,918
Net change in unrealized gain/loss on securities available-for-sale and Interest-Only strips, net of reclassification adjustment and deferred income taxes	-	-	-	211	211		211
Decrease in minimum pension liability, net of deferred income taxes	-	-	-	204	204		204
Total comprehensive income						\$	13,333
Amortization of restricted stock award	-	115	-	-	115		
Cash dividend declared on common stock, \$0.15 per share	-	-	(1,774)	-	(1,774)		
Common stock repurchased	(282,900)	(6,660)	-	-	(6,660)		
Stock options expense	-	550	-	-	550		
Stock options exercised, including related tax benefits	156,548	2,155	-	-	2,155		
Balance, September 30, 2006	11,681,297	\$ 62,959	\$ 58,683	\$ (2,306)	\$ 119,336		
Balance, January 1, 2007	11,656,943	\$ 62,363	\$ 62,452	\$ (1,995)	\$ 122,820		
Net Income	-	-	11,288	-	11,288	\$	11,288
Net change in unrealized gain/loss on securities available-for-sale and Interest-Only strips, net of reclassification adjustment and deferred income taxes	-	-	-	691	691		691
Decrease in pension liability, net of deferred income taxes	-	-	-	46	46		46
Total comprehensive income						\$	12,025
Issuance of 1,732,298 shares to acquire Diablo Valley Bank, net of offerings costs of \$214	1,732,298	41,183	-	-	41,183		
Amortization of restricted stock award	-	115	-	-	115		
	-	-	(2,200)	-	(2,200)		

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Cash dividend declared on common stock, \$0.18 per share					
Common stock repurchased	(339,700)	(7,476)	-	-	(7,746)
Stock options expense, including related tax benefits	-	813	-	-	813
Stock options exercised	73,855	1,095	-	-	1,095
Balance, September 30, 2007	13,123,396	\$ 98,093	\$ 71,540	\$ (1,258)	\$ 168,375

See notes to consolidated financial statements

Heritage Commerce Corp
Consolidated Statements of Cash Flows (Unaudited)

	Nine Months Ended September 30,	
	2007	2006
	(Dollars in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 11,288	\$ 12,918
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	535	507
Provision for loan losses	(736)	(603)
Stock option expense	813	550
Amortization of core deposit intangible	186	-
Amortization of restricted stock award	115	115
Amortization (accretion) of discounts and premiums on securities	(22)	(872)
Gain on sale of Capital Group loan portfolio	-	(671)
Gain on sale of SBA loans	(1,766)	(2,500)
Proceeds from sales of SBA loans held for sale	35,529	48,703
Originations of loans held for sale	(21,372)	(28,640)
Maturities/paydowns/payoffs of loans held for sale	338	833
Increase in cash surrender value of life insurance	(1,071)	(1,070)
Effect of changes in:		
Accrued interest receivable and other assets	3,822	6,097
Accrued interest payable and other liabilities	(1,004)	891
Net cash provided by operating activities	26,655	36,258
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net increase in loans	(18,164)	(28,578)
Proceeds from sales of Capital Group loan portfolio	-	30,047
Net decrease in Capital Group loan portfolio prior to sale	-	2,681
Purchases of securities available-for-sale	(9,322)	(49,098)
Maturities/paydowns/calls of securities available-for-sale	45,008	75,530
Purchase of premises and equipment	(596)	(460)
Redemption (purchase) of other investments	(823)	(184)
Cash received in bank acquisition, net of cash paid	16,407	-
Net cash provided by investing activities	32,510	29,938
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in deposits	5,525	(63,661)
Payment of other liability	(153)	(1,378)
Exercise of stock options, including related tax benefits	1,095	2,155
Common stock repurchased	(7,476)	(6,660)

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Stock offering costs		(214)		-
Payment of dividends		(2,200)		(1,774)
Net decrease in securities sold under agreement to repurchase		(10,900)		(10,900)
Net cash used in financing activities		(14,323)		(82,218)
Net increase (decrease) in cash and cash equivalents		44,842		(16,022)
Cash and cash equivalents, beginning of period		49,385		98,460
Cash and cash equivalents, end of period	\$	94,227	\$	82,438
Supplemental disclosures of cash flow information:				
Cash paid during the period for:				
Interest	\$	20,041	\$	16,919
Income taxes	\$	3,687	\$	780
Supplemental schedule of non-cash investing and financing activities:				
Transfer of portfolio loans to loans held for sale	\$	-	\$	7,797
Transfer of loans held for sale to portfolio loans	\$	4,505	\$	4,383
Loans transferred to foreclosed assets	\$	487	\$	-
Summary of assets acquired, and liabilities assumed through acquisition:				
Cash and cash equivalents	\$	41,807	\$	-
Securities available-for-sale	\$	12,214	\$	-
Net loans	\$	203,793	\$	-
Goodwill and core deposit intangible asset	\$	48,045	\$	-
Premises and equipment	\$	6,841	\$	-
Corporate owned life insurance	\$	1,025	\$	-
Federal Home Loan Bank Stock	\$	717	\$	-
Other assets, net	\$	2,686	\$	-
Deposits	\$	(248,646)	\$	-
Other liabilities	\$	(1,685)	\$	-
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
September 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 nine months ended September 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 2004. 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 significant amounts accrued for interest and penalties at September 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 \$1,305,000 and \$1,145,000 at September 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 September 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. Government Agencies	\$ 4,745	\$ 7	\$ 4,912	\$ 70	\$ 9,657	\$ 77
Mortgage-Backed Municipals - Tax Exempt	18,390	198	62,387	2,041	80,777	2,239
Collateralized Mortgage Obligations	-	-	5,984	68	5,984	68
Total	\$ 23,135	\$ 205	\$ 76,263	\$ 2,291	\$ 99,398	\$ 2,496

As of September 30, 2007, the Company held 91 securities, of which 55 had fair values below amortized cost. Forty-two 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 September 30, 2007.

Securities classified as U.S. Government Agencies as of September 30, 2007 and December 31, 2006 were 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) and bankruptcy trustees, and other contractual obligations such as repurchase agreements. Securities with fair value of \$32,887,000 and \$53,283,000 as of September 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 September 30, 2007, there are 120,555 shares available for future grants under the Plan. Option activity under the Plan is as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Total Stock Options				
Options Outstanding at January 1, 2007	752,983	\$ 16.56		
Granted	321,500	\$ 23.02		
Exercised	(73,855)	\$ 9.56		
Forfeited or expired	(27,105)	\$ 21.10		
Options Outstanding at September 30, 2007	973,523	\$ 19.10	7.6	\$ 2,015,000
Exercisable at September 30, 2007	451,611	\$ 15.30	6.0	\$ 2,651,000

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

	2007	2006
Intrinsic value of options exercised	\$ 1,005,000	2,078,000
Cash received from option exercise	\$ 706,000	1,572,000
Tax benefit realized from option exercises	\$ 389,000	583,000
Weighted average fair value of options granted	\$ 6.52	7.57

As of September 30, 2007, there was approximately \$3,657,000 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 nine months ended September 30, 2007 and 2006, respectively:

	2007	2006
Expected life in months ⁽¹⁾	72	84

Volatility ⁽¹⁾	22%	21%
Risk-free interest rate ⁽²⁾	4.65%	4.84%
Expected dividends ⁽³⁾	1.05%	0.86%

- (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 was \$115,000 in each of the nine month periods ended September 30, 2007 and 2006, respectively.

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 536,553 and 215,093 stock options for three months ended September 30, 2007 and 2006 and 359,822 and 128,905 for nine months ended September 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 September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Weighted average common shares outstanding - used in computing basic earnings per share	13,235,087	11,781,135	12,211,945	11,812,718
Dilutive effect of stock options outstanding, using the treasury stock method	152,897	176,089	171,740	192,214
Shares used in computing diluted earnings per share	13,387,984	11,957,224	12,383,685	12,004,932

5) Loans and the Allowance for Loan Losses

Loans at period-end were as follows:

	September 30, 2007	December 31, 2006
	(Dollars in thousands)	
Commercial	\$ 378,777	\$ 300,611
Real estate - mortgage *	325,327	239,041
Real estate - land and construction	205,925	143,834
Home equity	39,771	38,976
Consumer	4,131	2,422
Total loans	953,931	724,884
Deferred loan costs	727	870
Allowance for loan losses	(11,472)	(9,279)
Loans, net	\$ 943,186	\$ 716,475

* Real estate mortgage loans are primarily secured by mortgages on commercial property.

Changes in allowance for loan losses were as follows:

**For the Nine Months Ended
September 30,**

	2007	2006
	(Dollars in thousands)	
Balance, beginning of period	\$ 9,279	\$ 10,224
Net		