HERITAGE COMMERCE CORP
Form 10-Q
August 09, 2007

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

FORM 10-Q

[X] 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	**77-0469558**
(State or Other Jurisdiction of Incorporation or Organization)	(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 [X] 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 [X] 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 [X]

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, 2007		December 31, 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

Heritage Commerce Corp
Consolidated Income Statements (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Interest income:	(Dollars in thousands, except per share data)			
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

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

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

	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholder's Equity	Comprehensive 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 minium 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

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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)
Redempton (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:		

Cash and cash equivalents	$	41,807	$	-
Scurities 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 dividends (3)	1.00%	0.87%

(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.

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 June 30,		Six Months Ended 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 June 30,		Six Months Ended 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 June 30,	
	2007	2006	2007	2006
	(Dollars in thousands)			
Components of net periodic benefits cost				
Service cost	$ 184	$ 200	$ 368	$ 400
Interest cost	155	138	310	276
Prior service cost	9	9	18	18
Amortization of loss	17	36	34	72
Net periodic cost	$ 365	$ 383	$ 730	$ 766

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7) Commitments and Contingencies

Financial Instruments with Off-Balance Sheet Risk

HBC is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its clients. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk, in excess of the amounts recognized in the balance sheets.

Heritage Bank of Commerce's exposure to credit loss in the event of non-performance of the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. HBC uses the same credit policies in making commitments and conditional obligations as it does for loans. Credit risk is the possibility that a loss may occur because a party to a transaction fails to perform according to the terms of the contract. HBC controls the credit risk of these transactions through credit approvals, limits, and monitoring procedures. Management does not anticipate any significant losses as a result of these transactions.

Commitments to extend credit as of June 30, 2007 and December 31, 2006 were as follows:

	June 30, 2007	December 31, 2006
	(Dollars in thousands)	
Commitments to extend credit	$ 436,650	$ 310,200
Standby letters of credit	12,154	12,020
	$ 448,804	$ 322,220

Generally, commitments to extend credit as of June 30, 2007 are at variable rates, typically based on the prime rate (with a margin). Commitments generally expire within one year.

Commitments to extend credit are agreements to lend to a client as long as there is no violation of conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses. Since some of the commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. HBC evaluates each client's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by HBC upon the extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies but may include cash, marketable securities, accounts receivable, inventory, property, plant and equipment, income-producing commercial properties, and/or residential properties. Fair value of these instruments is not material.

Standby letters of credit are written with conditional commitments issued by HBC to guarantee the performance of a client to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to clients.

8) Acquisition

The Company completed its acquisition of Diablo Valley Bank on June 20, 2007. The transaction was valued at approximately $65 million, including payments for cancellation of options for Diablo Valley Bank common stock. The merger consideration consisted of approximately $24 million in cash and the issuance of 1,732,298 shares of the Company's common stock in exchange for all outstanding Diablo Valley Bank shares and stock options. Prior to closing, Diablo Valley Bank redeemed all of its outstanding Series A Preferred Stock for an aggregate of approximately $6.7 million in cash (including dividend payments). The unaudited consolidated financial statements of the Company for the three and six months ended June 30, 2007 include preliminary purchase accounting adjustments to record the assets and liabilities of Diablo Valley Bank at their estimated fair values. The purchase accounting adjustments are subject to further refinement as more information becomes available.

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

Cash and cash equivalents	$	41,807
Securities available-for-sale		12,214
Net loans		203,673
Goodwill		43,172
Core deposit intangible asset		5,049
Premises and equipment		6,847
Corporate owned life insurance		1,025
Federal Home Loan Bank Stock		717
Other assets, net		2,301
Total assets acquired		316,805
Deposits		(248,646)
Other liabilities		(1,712)
Total liabilities		(250,358)
Net assets acquired	$	66,447

The Company’s cost to acquire Diablo Valley Bank is summarized as follows:

Cash paid to Diablo Valley Bank common shareholders and stock option holders	$ 24,000
Common stock issued to Diablo Valley Bank shareholders	41,397
Total consideration	65,397
Professional fees and other acquisition costs	1,050
Net assets acquired	$ 66,447

The results of operations of Diablo Valley Bank for the ten day period starting on June 21, 2007 to June 30, 2007 are included in the income statement of the combined entity. Diablo Valley Bank was acquired by the Company for several reasons. Diablo Valley Bank was a profitable and fast growing bank in a geographic area where the Company wanted to expend. Diablo Valley Bank had experienced staff and the acquisition also enhanced the Company’s position in the East Bay area in the cities of Danville and Pleasanton. The Company believes it can achieve significant cost savings from merging Diablo Valley Bank into Heritage Bank of Commerce.

The following table presents pro forma information for the periods ended June 30 as if the acquisition had occurred at the beginning of the period presented. The pro forma financial information is not necessarily indicative of the results of operations as they would have been had the transaction been effected on the assumed date and is not intended to be a projection of future results.

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2007	**2006**	**2007**	**2006**
	(Dollars in thousands, except per share data)			
Net interest income	$ 14,651	$ 14,724	$ 28,778	$ 28,875
Net income	$ 4,486	$ 4,347	$ 8,845	$ 8,895
Net income per share - basic	$ 0.34	$ 0.32	$ 0.66	$ 0.66
Net income per share - diluted	$ 0.33	$ 0.32	$ 0.65	$ 0.65

ITEM 2 - MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION ANDRESULTS OF OPERATIONS

Discussions of certain matters in this Report on Form 10-Q 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 (the “Exchange Act”), and as such, may involve risks and uncertainties. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies, and expectations, are generally identifiable by the use of words such as “believe”, “expect”, “intend”, “anticipate”, “estimate”, “project”, “assume”, “plan” “forecast” or similar expressions. These forward-looking statements relate to, among other things, expectations of the business environment in which the Company operates, projections of future performance, potential future performance, potential future credit experience, perceived opportunities in the market, and statements regarding the Company's mission and vision. The Company's actual results, performance, and achievements may differ materially from the results, performance, and achievements expressed or implied in such forward-looking statements due to a wide range of factors. These factors include, but are not limited to, consummation of the acquisition of Diablo Valley Bank and the successful integration of its business, customers, employees and operations with the Company, changes in interest rates, reducing interest margins or increasing interest rate risk, general economic conditions nationally or, in the State of California, legislative and regulatory changes adversely affecting the business in which the Company operates, monetary and fiscal policies of the US Government, real estate valuations, the availability of sources of liquidity at a reasonable cost, competition in the financial services industry, and other risks. All of the Company's operations and most of its customers are located in California. In addition, acts and threats of terrorism or the impact of military conflicts have increased the uncertainty related to the national and California economic outlook and could have an effect on the future operations of the Company or its customers, including borrowers. See "Item 1A – Risk Factors" in this Report on Form 10-Q and in Item 1-A- Risk Factors" in our Annual Report on Form 10-K for the Year ended December 31, 2006 for further discussions of factors that could cause actual result to differ from forward looking statements. The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

EXECUTIVE SUMMARY

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

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

The merger with Diablo Valley Bank was completed on June 20, 2007 for approximately $65 million payable in approximately $24 million in cash and 1,732,298 shares of the Company's common stock. The unaudited consolidated financial statements of the Company for the three and six months ended June 30, 2007 includes preliminary purchase accounting adjustments to record the assets and liabilities of Diablo Valley Bank at their estimated fair values. The Company recorded goodwill in connection with the transaction of $43,172,000 and a core deposit intangible asset of $5,049,000. The 10 day period from the closing date to June 30, 2007 did not result in a material effect on the Company's revenues and expenses, net interest margin, or net income.

Performance Overview

For the three months and six months ended June 30, 2007, consolidated net income was $4.0 million and $8.0 million, compared to $4.2 million and $8.6 million for the three and six months ended June 30, 2006, a decrease of 4% and 6%, respectively. Earnings per diluted share were $0.33 and $0.68 for the three and six months ended June 30, 2007, compared to $0.35 and $0.71 for the three and six months ended June 30, 2006, a decrease of 6% and 4%, respectively. The Company's return on average assets and return on average equity for the three months ended June 30, 2007 were 1.50% and 12.17%, compared to 1.50% and 14.35%, for the same period in 2006, respectively. Returns on average assets and average equity for the first six months of 2006 were 1.53% and 12.63%, compared to 1.55% and 14.93% for the first six months of 2006, respectively.

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

- Net interest income decreased 2% to $12.4 million for the three months ended June 30, 2007, compared to $12.7 million for the three months ended June 30, 2006 and decreased 3% for the six months ended June 30, 2007 compared to 2006, primarily due to a decrease in average interest earning assets.

- Noninterest income remained at $2.3 million for the three months ended June 30, 2007 compared to the three months ended June 30, 2006. Year-to-date noninterest income decreased 7% for the six months ended June 30, 2007 from 2006 primarily due to a decrease of 27% in 2007 in gain on sale of loans, or $633,000, compared to 2006. The six month period in 2006 also benefited from a $671,000 nonrecurring gain on the sale of the Capital Group loan portfolio in the first quarter of 2006.

- The efficiency ratio was 58.00% and 58.13% for the three and six months ended June 30, 2007 compared to 57.06% and 57.57% for the three and six months ended June 30, 2006, respectively.

- No provision for loan losses was recorded in the second quarter of 2007 compared to a reverse provision for loan losses of $114,000 in the second quarter of 2006. The year-to-date reverse provision for loan losses was $236,000 in 2007 compared to a reverse provision of $603,000 a year ago. The reverse provision in 2007 was due to continued improvement in credit quality.

- Nonperforming assets at June 30, 2007 increased to $6.3 million, or 290%, from June 30, 2006 levels. Nonperforming assets increased by $2.0 million, or 46%, compared to December 31, 2006. Approximately $3.7 million of the nonperforming assets were acquired in the Diablo Valley Bank merger.

Deposits

Growth in deposits is an important metric management uses to measure market share. The Company's depositors are primarily located in its primary market area. Depending on loan demand and other funding requirements, the Company occasionally obtains deposits from wholesale sources including deposit brokers. The Company had $65 million in brokered deposits at June 30, 2007. The Company also seeks deposits from title insurance companies and real estate exchange facilitators. The Company has a policy to monitor all deposits that may be sensitive to interest rate changes to help assure that liquidity risk does not become excessive due to concentrations. As a result of the merger with Diablo Valley Bank, deposits increased $257 million.

Lending

Our lending business originates primarily through our branch offices. The economy in our primary service area has continued to stabilize in 2007. Commercial loans increased for the period ended June 30, 2007 from June 30, 2006, primarily from increased loan demand reflecting the improving economy in our primary service area. Commercial real estate mortgage loans increased for the period ended June 30, 2007 from June 30, 2006, primarily due to general improvements in commercial income property markets. We will continue to use and improve existing products to expand market share at current locations. As a result of the merger with Diablo Valley Bank, loans increased $214 million.

Net Interest Income

The management of interest income and interest expense is fundamental to the performance of the Company. Net interest income, the difference between interest income and interest expense, is the largest component of the Company’s total revenue. Management closely monitors both net interest income and the net interest margin (net interest income divided by average earning assets).

Increases in short-term interest rates contributed to growth in net interest income since the interest rate earned on a majority of the Company’s loan portfolio adjusts with the prime rate. Approximately 76% of the Company’s loan portfolio is indexed to the prime rate. The Federal Open Market Committee (“FOMC”) increased short term rates in one quarter percent increments in January, March, May, and June of 2006. The prime rate increased from 7.25% in January of 2006 to 8.25% in June of 2006. The prime rate has remained at 8.25% since June of 2006. The improvement in net interest margin in the second quarter of 2007 from a year ago is largely attributable to the FOMC action. Because of its focus on commercial lending to closely held businesses, the Company continues to have a high percentage of floating rate loans and other assets. Given the current volume, mix and repricing characteristics of our interest-bearing liabilities and interest-earning assets, we believe our interest rate spread is expected to increase slightly in a rising rate environment, and decrease slightly in a declining interest rate scenario.

The Company, through its asset and liability policies and practices, seeks to maximize net interest income without exposing the Company to an excessive level of interest rate risk. Interest rate risk is managed by monitoring the pricing, maturity and repricing options of all classes of interest bearing assets and liabilities.

Management of Credit Risk

Because of its focus on business banking, loans to single borrowing entities are often larger than would be found in a more consumer oriented bank with many smaller, more homogenous loans. The average size of its relationships makes the Company more susceptible to larger losses. As a result of this concentration of larger risks, the Company has maintained an allowance for loan losses which is substantially higher than would be indicated by its actual historic loss experience.

Noninterest Income

While net interest income remains the largest single component of total revenues, noninterest income is an important component. A significant percentage of the Company's noninterest income is associated with its SBA lending activity, either as gains on the sale of loans sold in the secondary market or servicing income from loans sold with servicing retained. However, beginning in the third quarter of 2007, the Company decided to change its strategy regarding its SBA loan business. The Company will retain most new SBA production in lieu of selling it. As a result, the Company expects its noninterest income will be lower in the second half of 2007 compare to the second half of 2006.

Risks associated with the continuation of this level of noninterest income from SBA lending include the possibility that the federal government will eliminate or change SBA programs in a manner that becomes less attractive to the Company or to SBA borrowers. Further, change in the secondary market for SBA loans could reduce gains on sale. Higher than expected prepayments of SBA loans on which the Company has retained servicing could reduce the carrying value of the associated servicing asset and interest only strip.

Noninterest Expense

Management considers the control of operating expenses to be a critical element of the Company's performance. Over the last three years, the Company has undertaken several initiatives to reduce its noninterest expense and improve its efficiency. These initiatives included a reduction in staff and the consolidation of operations under the common Heritage Bank brand and restructuring each department. Management monitors progress in reducing noninterest expense through review of the Company's efficiency ratio. The Company's efficiency ratio was 58.00% in the second quarter of 2007 compared with 57.06% in the second quarter of 2006, and 58.13% for the six months ended June 30, 2007 compared to 57.57% in 2006.

Capital Management and Share Repurchases

Heritage Commerce Corp and Heritage Bank of Commerce meet the regulatory definition of "well capitalized" at June 30, 2007. As part of its asset and liability process, the Company continually assesses its capital position to take into consideration growth, expected earnings, risk profile and potential corporate activities that it may choose to pursue. On July 26, 2007, the Board of Directors authorized the repurchase of up to an additional $30 million of common stock over the next two years.

RESULTS OF OPERATIONS

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

Net Interest Income and Net Interest Margin

Net interest income is the largest component of the Company's total revenue. Net interest income is the difference between the interest and fees earned on loans and investments and interest expense on deposits and other liabilities. Net interest income depends on two factors: (1) the volume or balance of earning assets compared to the volume or balance of interest bearing deposits and liabilities, and (2) the interest rate earned on those interest earning assets compared with the interest rate on those interest bearing assets and liabilities. Net interest margin is net interest income expressed as a percentage of average earning assets. To maintain its net interest margin, the Company must manage the relationship between interest earned and paid.

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

Average Balance, Rate and Yield

	For the Three Months Ended June 30, 2007			2006		
	Average Balance	Average Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate
	(Dollars in thousands)					
Assets:						
Loans, gross	$ 743,160	$ 15,589	8.41%	$ 735,311	$ 15,344	8.37%
Securities	171,896	1,982	4.62%	195,743	1,977	4.05%
Interest bearing deposits in other financial institutions	3,243	40	4.95%	2,728	42	6.18%
Federal funds sold	53,717	706	5.27%	83,508	1,029	4.94%
Total interest earning assets	972,016	$ 18,317	7.56%	1,017,290	$ 18,392	7.25%
Cash and due from banks	33,305			36,224		
Premises and equipment, net	3,111			2,393		
Other assets	66,839			64,201		
Total assets	$ 1,075,271			$1,120,108		
Liabilities and shareholders' equity:						
Deposits:						
Demand, interest bearing	$ 141,230	$ 780	2.22%	$ 148,635	$ 830	2.24%
Savings and money market	328,580	2,456	3.00%	373,697	2,698	2.90%
Time deposits, under $100	30,872	301	3.91%	32,264	251	3.12%
Time deposits, $100 and over	102,284	1,067	4.18%	111,024	929	3.36%
Brokered time deposits, $100 and over	53,698	617	4.61%	34,489	325	3.78%
Notes payable to subsidiary grantor trusts	23,702	583	9.87%	23,702	575	9.73%
Securities sold under agreement to repurchase	16,407	120	2.93%	25,722	158	2.46%
Total interest bearing liabilities	696,773	$ 5,924	3.41%	749,533	$ 5,766	3.09%
Demand, noninterest bearing	223,415			228,891		
Other liabilities	22,736			24,558		
Total liabilities	942,924			1,002,982		
Shareholders' equity	132,347			117,126		
Total liabilities and shareholders' equity	$ 1,075,271			$1,120,108		
Net interest income / margin		$ 12,393	5.11%		$ 12,626	4.98%

Note: Yields and amounts earned on loans include loan fees of $0 and $165,000 for the three month periods ended June 30, 2007 and 2006, respectively. Nonaccrual loans are included in the average balance calculation above.

	For the Six Months Ended June 30,					
	2007			2006		
	Average Balance	Average Income / Expense	Average Yield / Rate	Average Balance	Interest Income / Expense	Average Yield / Rate
Assets:			(Dollars in thousands)			
Loans, gross	$ 731,255	$ 30,259	8.34%	$ 737,840	$ 30,065	8.22%
Securities	172,603	3,934	4.60%	198,394	3,769	3.83%
Interest bearing deposits in other financial institutions	2,936	73	5.01%	2,783	60	4.35%
Federal funds sold	49,080	1,285	5.28%	74,583	1,758	4.75%
Total interest earning assets	955,874	$ 35,551	7.50%	1,013,600	$ 35,652	7.09%
Cash and due from banks	34,311			36,588		
Premises and equipment, net	2,807			2,435		
Other assets	64,691			64,570		
Total assets	$ 1,057,683			$1,117,193		
Liabilities and shareholders' equity:						
Deposits:						
Demand, interest bearing	$ 138,876	$ 1,545	2.24%	$ 153,288	$ 1,668	2.19%
Savings and money market	323,549	4,740	2.95%	360,983	4,779	2.67%
Time deposits, under $100	30,929	590	3.85%	33,232	497	3.02%
Time deposits, $100 and over	101,741	2,079	4.12%	109,656	1,750	3.22%
Brokered time deposits, $100 and over	47,600	1,052	4.46%	35,265	658	3.76%
Notes payable to subsidiary grantor trusts	23,702	1,164	9.90%	23,702	1,137	9.67%
Securities sold under agreement to repurchase	19,015	257	2.73%	29,119	346	2.40%
Total interest bearing liabilities	685,412	$ 11,427	3.36%	745,245	$ 10,835	2.93%
Demand, noninterest bearing	220,727			232,072		
Other liabilities	23,035			24,171		
Total liabilities	929,174			1,001,488		
Shareholders' equity	128,509			115,705		
Total liabilities and shareholders' equity	$ 1,057,683			$1,117,193		
Net interest income / margin		$ 24,124	5.09%		$	