HERITAGE FINANCIAL CORP /WA/
Form 10-Q
April 30, 2013
Table of Contents

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 March 31, 2013

OR

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

Commission File Number 0-29480

HERITAGE FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Washington	**91-1857900**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
201 Fifth Avenue SW, Olympia, WA	**98501**
(Address of principal executive offices)	**(Zip Code)**

(360) 943-1500

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the last practicable date:

As of April 17, 2013 there were 15,148,304 common shares outstanding, with no par value, of the registrant.

Table of Contents

HERITAGE FINANCIAL CORPORATION

FORM 10-Q

INDEX

FORWARD LOOKING STATEMENT

2

Table of Contents

Forward Looking Statements

Safe Harbor statement under the Private Securities Litigation Reform Act of 1995: This Form 10-Q contains forward-looking statements that are subject to risks and uncertainties, including, but not limited to: our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired including the Northwest Commercial Bank, Cowlitz Bank and Pierce Commercial Bank transactions, or may in the future acquire, into our operations, and our ability to realize related revenue synergies and cost savings within expected time frames or at all, and any goodwill charges related thereto and costs or difficulties relating to the integration matters, including but not limited to customer and employee retention, which might be greater than expected; the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets, which may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses no being adequate to cover actual losses, and require us to increase our allowance for loan losses; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Federal Reserve and of our bank subsidiaries by the Federal Deposit Insurance Corporation (the FDIC), the Washington State Department of Financial Institutions, Division of Banks (the Washington DFI) or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules as a result of Basel III; our ability to control operating costs and expenses; the impact of the Dodd-Frank Act and implementing the regulations; further increases in premiums for deposit insurance; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our condensed consolidated statement of financial condition; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; failure or security breach of computer systems on which we depend; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our expansion strategy of pursuing acquisitions and de novo branching; increased competitive pressures among financial service companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services; and other risks detailed from time to time in our filings with the Securities and Exchange Commission.

The Company cautions readers not to place undue reliance on any forward-looking statements. Moreover, you should treat these statements as speaking only as of the date they are made and based only on information then actually known to the Company. The Company does not undertake and specifically disclaims any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements. These risks could cause our actual results for the remainder of 2013 and beyond to differ materially from those expressed in any forward-looking statements by, or on behalf of, us, and could negatively affect the Company s operating and stock price performance.

As used throughout this report, the terms we , our , us , or the Company refer to Heritage Financial Corporation and its consolidated subsidiaries, unless the context otherwise requires.

Table of Contents

ITEM 1. HERITAGE FINANCIAL CORPORATION

HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Dollars in thousands)

(Unaudited)

	March 31, 2013	December 31, 2012
ASSETS		
Cash on hand and in banks	$ 34,129	$ 37,180
Interest earning deposits	112,105	69,906
Cash and cash equivalents	146,234	107,086
Investment securities available for sale	147,148	144,293
Investment securities held to maturity (fair value of $11,808 and $11,010)	10,933	10,099
Loans held for sale	729	1,676
Originated loans receivable, net	887,111	874,485
Less: Allowance for loan losses	(17,912)	(19,125)
Originated loans receivable, net of allowance for loan losses	869,199	855,360
Purchased covered loans receivable, net of allowance for loan losses of ($4,710 and $4,352)	81,375	83,978
Purchased non-covered loans receivable, net of allowance for loan losses of ($4,925 and $5,117)	104,916	59,006
Total loans receivable, net	1,055,490	998,344
Federal Deposit Insurance Corporation (FDIC) indemnification asset	5,353	7,100
Other real estate owned ($367 and $260 covered by FDIC loss share, respectively)	5,263	5,666
Premises and equipment, net	25,962	24,755
Federal Home Loan Bank (FHLB) stock, at cost	5,533	5,495
Accrued interest receivable	4,721	4,821
Prepaid expenses and other assets	8,846	8,288
Deferred income taxes, net	16,729	13,819
Other intangible assets, net	1,127	1,086
Goodwill	13,012	13,012
Total assets	$ 1,447,080	$ 1,345,540
LIABILITIESANDSTOCKHOLDERS EQUITY		
Deposits	$ 1,225,112	$ 1,117,971
Securities sold under agreement to repurchase	12,029	16,021
Accrued expenses and other liabilities	9,431	12,610
Total liabilities	1,246,572	1,146,602
Stockholders equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at March 31, 2013 and December 31, 2012		
Common stock, no par value, 50,000,000 shares authorized; 15,148,304 and 15,117,980 shares issued and outstanding at March 31, 2012 and December 31, 2012, respectively	122,054	121,832
Retained earnings	77,038	75,362
Accumulated other comprehensive income, net	1,416	1,744

Total stockholders equity	200,508	198,938
Total liabilities and stockholders equity	$ 1,447,080	$ 1,345,540

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands, except for per share amounts)

(Unaudited)

	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012
Interest income:		
Interest and fees on loans	$ 16,719	$ 17,018
Taxable interest on investment securities	373	652
Nontaxable interest on investment securities	335	256
Interest on interest earning deposits	57	63
Total interest income	17,484	17,989
Interest expense:		
Deposits	937	1,277
Other borrowings	9	18
Total interest expense	946	1,295
Net interest income	16,538	16,694
Provision for loan losses on originated loans	495	
Provision for loan losses on purchased loans	363	(109)
Net interest income after provision for loan losses	15,680	16,803
Noninterest income:		
Bargain purchase gain on bank acquisition	399	
Service charges and other fees	1,353	1,326
Merchant Visa income, net	172	170
Change in FDIC indemnification asset	(267)	(176)
Other income	625	588
Total noninterest income	2,282	1,908
Noninterest expense:		
Impairment loss on investment securities, net	2	36
Compensation and employee benefits	7,589	7,198
Occupancy and equipment	1,920	1,785
Data processing	1,136	591
Marketing	326	403
Professional services	1,030	554
State and local taxes	279	310
Federal deposit insurance premium	233	275
Other real estate owned, net	(104)	256
Other expense	1,308	1,190
Total noninterest expense	13,719	12,598

Income before income taxes		4,243		6,113
Income tax expense		1,358		1,943
Net income	$	2,885	$	4,170
Basic earnings per common share	$	0.19	$	0.27
Diluted earnings per common share	$	0.19	$	0.27
Dividends declared per common share	$	0.08	$	0.06

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in thousands)

(Unaudited)

Comprehensive Income	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012
Net income	$ 2,885	$ 4,170
Change in fair value of securities available for sale, net of tax of $(184) and $(176)	(342)	(327)
Accretion of other-than-temporary impairment on securities held to maturity, net of tax of $7 and $14	14	26
Other comprehensive loss	$ (328)	$ (301)
Comprehensive income	$ 2,558	$ 3,869

See accompanying Notes to Condensed Consolidated Financial Statements.

6

Table of Contents

HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY FOR THE THREE MONTHS ENDED

MARCH 31, 2013

(Dollars and shares in thousands, except for per share amounts)

(Unaudited)

	Number of common shares	Common stock	Retained earnings	Accumulated other comprehensive income, net	Total stock holders equity
Balance at December 31, 2012	15,118	$ 121,832	$ 75,362	$ 1,744	$ 198,938
Restricted stock awards issued, net of forfeitures	36				
Stock option compensation expense		22			22
Exercise of stock options (including excess tax benefits from nonqualified stock options)	2	20			20
Restricted stock compensation expense		251			251
Excess tax benefits from restricted stock		47			47
Common stock repurchased and retired	(8)	(118)			(118)
Net income			2,885		2,885
Other comprehensive loss, net of tax				(328)	(328)
Cash dividends declared on common stock ($0.08 per share)			(1,209)		(1,209)
Balance at March 31, 2013	15,148	$ 122,054	$ 77,038	$ 1,416	$ 200,508

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the three months ended March 31, 2013 and 2012

(Dollars in thousands)

(Unaudited)

	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012
Cash flows from operating activities:		
Net income	$ 2,885	$ 4,170
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,292	878
Changes in net deferred loan fees (costs), net of amortization	148	(55)
Provision for loan losses	858	(109)
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities	(1,622)	(431)
Recognition of compensation related to ESOP shares and share based payment	251	226
Stock option compensation expense	22	42
Tax provision realized from stock options exercised, share based payment and dividends on unallocated ESOP shares	(47)	(46)
Amortization of intangible assets	115	107
Deferred income tax	139	34
Bargain purchase gain on bank acquisition	(399)	
Impairment loss on investment of securities	2	36
Origination of loans held for sale	(4,143)	(3,260)
Gain on sale of loans	(81)	(63)
Proceeds from sale of loans	5,171	4,033
Valuation adjustment on other real estate owned	(107)	331
(Gain) loss on other real estate owned, net	(172)	12
Loss on sale of premises and equipment, net		1
Net cash provided by operating activities	4,312	5,906
Cash flows from investing activities:		
Loans originated, net of principal payments	(6,393)	9,448
Maturities of investment securities available for sale	16,109	10,803
Maturities of investment securities held to maturity	338	389
Purchase of investment securities available for sale	(17,490)	(10,344)
Purchase of investment securities held to maturity	(1,157)	
Purchase of premises and equipment	(1,527)	(498)
Proceeds from sales of other real estate owned	2,711	101
Proceeds from redemption of FHLB stock	50	
Net cash received from acquisitions	748	
Net cash (used in) provided by investing activities	(6,611)	9,899
Cash flows from financing activities:		
Net increase in deposits	46,699	3,493
Common stock cash dividends paid	(1,209)	(927)
Net decrease in securities sold under agreement to repurchase	(3,992)	(2,305)

Proceeds from exercise of stock options	20	
Tax provision realized from stock options exercised, share based payment and dividends on unallocated ESOP shares	47	46
Repurchase of common stock	(118)	(114)
Net cash provided by financing activities	41,447	193
Net increase in cash and cash equivalents	39,148	15,998
Cash and cash equivalents at beginning of period	107,086	123,759
Cash and cash equivalents at end of period	$ 146,234	$ 139,757

8

Table of Contents

	2013	2012
Supplemental disclosures of cash flow information:		
Cash paid for interest	$ 952	$ 1,337
Cash paid for income taxes	2,612	650
Seller-financed sale of other real estate owned	250	
Loans transferred to other real estate owned		4,309
Assets acquired (liabilities assumed) in acquisitions:		
Investment securities available for sale	2,753	
Purchased non-covered loans receivable	51,509	
Other real estate owned	2,279	
Premises and equipment, net	214	
FHLB stock	88	
Accrued interest receivable	232	
Prepaid expenses and other assets	1,175	
Deferred income taxes, net	2,873	
Core deposit intangible	156	
Deposits	(60,442)	
Accrued expenses and other liabilities	(1,186)	

See accompanying Notes to Condensed Consolidated Financial Statements.

9

Table of Contents

HERITAGE FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Three Months Ended March 31, 2013 and 2012

(Unaudited)

(1) Description of Business and Basis of Presentation

(a) Description of Business

Heritage Financial Corporation (the Company) is a bank holding company incorporated in the State of Washington in August 1997. The Company is primarily engaged in the business of planning, directing and coordinating the business activities of its wholly owned subsidiaries: Heritage Bank and Central Valley Bank (the Banks). The Banks are Washington-chartered commercial banks and their deposits are insured by the FDIC under the Deposit Insurance Fund (DIF). Heritage Bank conducts business from its main office in Olympia, Washington and its twenty-seven branch offices located in western Washington and the greater Portland, Oregon area. Central Valley Bank conducts business from its main office in Toppenish, Washington and its five branch offices located in Yakima and Kittitas counties of Washington State.

The Company s business consists primarily of lending and deposit relationships with small businesses and their owners in its market areas and attracting deposits from the general public. The Company also makes real estate construction and land development loans and consumer loans and originates for sale or investment purposes first mortgage loans on residential properties located in western and central Washington State and the greater Portland, Oregon area.

Effective July 30, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Cowlitz Bank, a Washington state-chartered bank headquartered in Longview, Washington (the Cowlitz Acquisition). The Cowlitz Acquisition included nine branches of Cowlitz Bank, including its division Bay Bank, which opened as branches of Heritage Bank as of August 2, 2010. It also included the Trust Services Division of Cowlitz Bank. Effective November 5, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Pierce Commercial Bank, a Washington state-chartered bank headquartered in Tacoma, Washington (the Pierce Commercial Acquisition). The Pierce Commercial Acquisition included one branch, which opened as a branch of Heritage Bank as of November 8, 2010.

On September 14, 2012, the Company announced that it had entered into a definitive agreement along with its financial institution subsidiary, Heritage Bank, to acquire Northwest Commercial Bank (NCB) a full service commercial bank headquartered in Lakewood, Washington (the NCB Acquisition). NCB operated two branch locations in Washington State. The transaction closed on January 9, 2013, and NCB was merged with and into Heritage Bank. See Note 2, Business Combination.

The Cowlitz Acquisition, Pierce Commercial Acquisition and NCB Acquisition are collectively referred to as the Cowlitz, Pierce and NCB Acquisitions.

On March 11, 2013, the Company announced it had entered into a definitive agreement to acquire Valley Community Bancshares, Inc., headquartered in Puyallup, Washington. The transaction is subject to customary closing conditions, including the receipt of regulatory approvals, and is expected to be completed in the third quarter of 2013. See Note 14, Proposed Mergers and Acquisitions.

On April 8, 2013, the Company announced the proposed merger of its wholly-owned bank subsidiaries, with Central Valley Bank merging with and into Heritage Bank. Following the merger, Central Valley Bank will be operated as Heritage Bank dba Central Valley Bank. The merger is expected to be completed in the second quarter of 2013. See Note 14, Proposed Mergers and Acquisitions.

(b) Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with Generally Accepted Accounting Principles (GAAP), for interim financial information, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These Condensed Consolidated Financial Statements should be read with our December 31, 2012 audited Consolidated Financial

Statements and the accompanying Notes included in our Annual Report on Form 10-K (Form 10-K). In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three

10

Table of Contents

months ended March 31, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. In preparing the Condensed Consolidated Financial Statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates. Estimates related to the allowance for loan losses, other than temporary impairments in the fair value of investment securities, expected cash flows of purchased loans and related indemnification asset, fair value measurements, stock-based compensation, impairment of goodwill and other intangible assets and income taxes are particularly subject to change.

Certain prior period amounts have been reclassified to conform to the current year s presentation. Reclassifications had no effect on prior period net income or stockholders equity.

(c) Significant Accounting Policies

The significant accounting policies used in preparation of our Condensed Consolidated Financial Statements are disclosed in our 2012 Annual Form 10-K. There have not been any material changes in our significant accounting policies compared to those contained in our Form 10-K disclosure for the year ended December 31, 2012.

(d) Recently Issued Accounting Pronouncements

Financial Accounting Standards Board (FASB) Accounting Standards Updated (ASU) 2011-11, *Disclosures about Offsetting Assets and Liabilities*, was issued in December 2011 to require an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The adoption of the Update did not have a material effect on the Company s Condensed Consolidated Financial Statements at the date of adoption.

FASB ASU 2012-06, *Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution*, was issued in October 2012. The objective of the Update is to address the diversity in practice about how to interpret the terms on the same basis and contractual limitations when subsequently measuring an indemnification asset. This Update is effective for fiscal years and interim periods beginning on or after December 15, 2012. Early adoption was permitted, and adoption should be applied prospectively to indemnification assets existing as of the date of adoption. The adoption of this Update did not have a material effect on the Company s Condensed Consolidated Financial Statements at the date of adoption as the Company previously accounted for its indemnification asset in a manner consistent with the Update.

FASB ASU 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, was issued in February 2013. The Update requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component and to present either on the face of the statement where net income is presented, or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2012. The adoption of this Update did not have a material effect on the Company s Condensed Consolidated Financial Statements. The additional disclosures are included in Note 7, Accumulated Other Comprehensive Income.

(2) Business Combination

On September 14, 2012, the Company announced that it had entered into a definitive agreement along with its financial institution subsidiary, Heritage Bank, to acquire NCB headquartered in Lakewood, Washington. NCB was a full service commercial bank that operated two branch locations in Washington State. The transaction closed on January 9, 2013, and NCB was merged with and into Heritage Bank.

Pursuant to the agreement, the Company provided cash consideration of $3.0 million, or $5.50 per NCB share, which was paid out on January 9, 2013. Additionally, the NCB shareholders have the ability to potentially receive additional consideration based on an earn-out structure from the sale of an asset included in other real estate owned. The estimated additional consideration as of January 9, 2013 is approximately $533,000, or $0.99 per NCB share, and is included in accrued expenses and other liabilities. Prior to the closing of the transaction, NCB redeemed its outstanding preferred stock of approximately $2.0 million issued to the U.S. Department of Treasury in connection with its participation in the Troubled Asset Relief Program Capital Purchase Plan.

Table of Contents

The acquisition of the net assets constitutes a business acquisition as defined by FASB Accounting Standards Codification (ASC) 805, *Business Combinations*. The Business Combinations topic establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired and the liabilities assumed. Accordingly, the estimated fair values of the acquired assets, including the identifiable intangible assets, and the assumed liabilities in the acquisition were measured and recorded as of the acquisition date. A description of the methods used to determine the fair values of the significant assets and liabilities of the acquisition is included in Note 1, Description of Business and Basis of Presentation and Note 13, Fair Value Measurements.

A statement of the fair value of the assets acquired and liabilities assumed in the NCB Acquisition was as follows:

	Northwest Commercial Bank January 9, 2013 (In thousands)	
Assets		
Cash on hand and in banks	$	2,463
Interest earning deposits		1,252
Investment securities available for sale		2,753
Purchased non-covered loans receivable		51,509
Other real estate owned		2,279
Premises and equipment		214
FHLB stock		88
Accrued interest receivable		232
Core deposit intangible		156
Prepaid expenses and other assets		1,175
Deferred income taxes, net		2,873
Total assets acquired	$	64,994
Liabilities		
Deposits	$	60,442
Accrued expenses and other liabilities		1,186
Total liabilities assumed		61,628
Net assets acquired	$	3,366

The cost basis of net assets transferred to Heritage Bank was $6.1 million. A bargain purchase gain of $399,000 was recognized by the Company in the Condensed Consolidated Statement of Income for the three months ended March 31, 2013. A summary of the net assets purchased and the estimated fair value adjustments and resulting bargain purchase gain recognized from the NCB Acquisition was as follows:

	Northwest Commercial Bank January 9, 2013 (In thousands)	
Cost basis of net assets on acquisition date	$	6,113
Cash consideration paid		(2,967)
Fair value adjustments:		
Interest earning deposits		7
Investment securities		(2)
Purchased non-covered loans, net		(3,299)
Other real estate owned		(1,301)
Premises and equipment		(69)

Core deposit intangible		156
Prepaid expenses and other assets		(479)
Deferred income tax, net		2,873
Certificates of deposit		(11)
Accrued expenses and other liabilities		(622)
Bargain purchase gain recognized from the acquisition	$	399

Table of Contents

The bargain purchase gain represents the excess of the estimated fair value of the net assets acquired and liabilities assumed over the value of the consideration paid. The bargain purchase gain was influenced significantly by the net deferred tax asset acquired in the NCB Acquisition. NCB had significant net operating losses and as a result of its estimate of whether or not it was more likely than not that the net deferred tax asset would be realized, had recorded a full valuation allowance on the net deferred tax asset. The Company, however, has reviewed the net deferred tax asset and determined it is more likely than not that the net deferred tax asset would be realized by the Company.

The operating results of the Company for the three months ended March 31, 2013 include the operating results produced by the net assets acquired from the NCB Acquisition for the period from January 10, 2013 to March 31, 2013. The Company has considered the requirement of FASB ASC 805 related to the contribution of the NCB Acquisition to the Company s results of operations. The table below presents only the significant results for the acquired business from acquisition date to March 31, 2013.

	Northwest Commercial Bank January 10, 2013 to March 31, 2013 (In thousands)
Interest income: Interest and fees on loans (1)	$ 565
Interest income: Interest and fees on loans (2)	1,096
Interest expense: Deposits	(76)
Noninterest income:	438
Noninterest expense:	(1,028)
Net effect, pre-tax	$ 995

(1) Includes the contractual interest income on the purchased other loans.
(2) Includes the accretion of the purchased impaired loans and the amortization of the discount on the purchased other loans.

The Company also considered the pro forma requirements of FASB ASC 805 and deemed it not necessary to provide pro forma financial statements as required under the standard as the NCB Acquisition was not material to the Company. The Company believes that the historical NCB operating results are not of enough significance to be meaningful to the Company s results of operations.

There were no acquisitions completed by the Company during the year ended December 31, 2012.

(3) Loans Receivable

The Company originates loans in the ordinary course of business. These loans are identified as originated loans. Disclosures related to the Company s recorded investment in originated loans receivable generally exclude accrued interest receivable and net deferred loan origination fees and costs because they are insignificant. The Company has also acquired loans through FDIC-assisted and open bank transactions. Loans acquired in a business acquisition are designated as purchased loans. The Company refers to the purchased loans subject to the FDIC shared-loss agreements as covered loans, and those loans without a shared-loss agreement are referred to as non-covered loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that not all contractually required payments will be collected are accounted for under FASB ASC 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*. These loans are identified as purchased impaired loans. Loans purchased that are not accounted for under FASB ASC 310-30 are accounted for under FASB ASC 310-20, *Receivables Nonrefundable fees and Other Costs*. These loans are identified as purchased other loans.

(a) Loan Origination/Risk Management

The Company originates loans in one of the four segments of the total loan portfolio: commercial business, real estate construction and land development, one-to-four family residential, and consumer. Within these segments are classes of loans to which management monitors and assesses credit risk in the loan portfolios. The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, and nonperforming and potential problem loans. The Company also conducts external loan reviews and validates the credit risk assessment on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company s policies and procedures.

A discussion of the risk characteristics of each portfolio segment is as follows:

Commercial Business:

There are three significant classes of loans in the commercial portfolio segment, including commercial and industrial loans, owner-occupied commercial real estate, and non-owner occupied commercial real estate. The owner and non-owner occupied commercial real estate are both considered commercial real estate loans. As the commercial and industrial loans carry different risk characteristics than the commercial real estate loans, they are discussed separately below.

Commercial and industrial. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may include a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate. The Company originates commercial real estate loans within its primary market areas. These loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate involves more risk than other classes in that the lending typically involves higher loan principal amounts, and payments on loans secured by real estate properties are dependent on successful operation and management of the properties. Repayment of these loans may be more adversely affected by conditions in the real estate market or the economy.

One-to-Four Family Residential:

The majority of the Company s one-to four-family residential loans are secured by single-family residences located in its primary market areas. The Company s underwriting standards require that single-family portfolio loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms of maturity typically range from 15 to 30 years. The Company generally sells most single-family loans in the secondary market. Management determines to what extent the Company will retain or sell these loans and other fixed rate mortgages in order to control the Banks interest rate sensitivity position, growth and liquidity.

Real Estate Construction and Land Development:

The Company originates construction loans for one-to-four family residential and for five or more family residential and commercial properties. The one-to-four family residential construction loans generally include construction of custom homes whereby the home buyer is the borrower. The Company also provides financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Substantially all construction loans are short-term in nature and priced with a variable rate of interest. Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project s completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, the Company s estimates with regards to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If the Company s estimate of the value of a project at completion proves to be overstated, it may have inadequate security for repayment of the loan and may incur a loss if the borrower does not repay the loan. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term

Table of Contents

lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

Consumer:

The Company originates consumer loans and lines of credit that are both secured and unsecured. The underwriting process is developed to ensure a qualifying primary and secondary source of repayment. Underwriting standards for home equity loans are heavily influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such loans a borrower can have at one time and documentation requirements. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed. The majority of the consumer loans are relatively small amounts spread across many individual borrowers which minimizes the credit risk. Additionally, trend reports are reviewed by management on a regular basis.

Originated loans receivable at March 31, 2013 and December 31, 2012 consisted of the following portfolio segments and classes:

	March 31, 2013	December 31, 2012
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 269,174	$ 277,240
Owner-occupied commercial real estate	193,518	188,494
Non-owner occupied commercial real estate	285,963	265,835
Total commercial business	748,655	731,569
One-to-four family residential	39,111	38,848
Real estate construction and land development:		
One-to-four family residential	23,003	25,175
Five or more family residential and commercial properties	50,658	52,075
Total real estate construction and land development	73,661	77,250
Consumer	27,928	28,914
Gross originated loans receivable	889,355	876,581
Net deferred loan fees	(2,244)	(2,096)
Originated loans receivable, net	887,111	874,485
Allowance for loan losses	(17,912)	(19,125)
Originated loans receivable, net of allowance for loan losses	$ 869,199	$ 855,360

The recorded investment of purchased covered loans receivable at March 31, 2013 and December 31, 2012 consisted of the following portfolio segments and classes:

	March 31, 2013	December 31, 2012
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 21,058	$ 25,781
Owner-occupied commercial real estate	33,609	34,796
Non-owner occupied commercial real estate	17,168	13,028

Total commercial business	71,835	73,605
One-to-four family residential	5,012	5,027
Real estate construction and land development:		
One-to-four family residential	4,505	4,433
Five or more family residential and commercial properties		
Total real estate construction and land development	4,505	4,433
Consumer	4,733	5,265
Gross purchased covered loans receivable	86,085	88,330
Allowance for loan losses	(4,710)	(4,352)
Purchased covered loans receivable, net	$ 81,375	$ 83,978

15

Table of Contents

The March 31, 2013 and December 31, 2012 gross recorded investment balance of purchased impaired covered loans accounted for under FASB ASC 310-30 was $57.4 million and $59.0 million, respectively. The gross recorded investment balance of purchased other covered loans was $28.6 million and $29.3 million at March 31, 2013 and December 31, 2012, respectively. At both March 31, 2013 and December 31, 2012, the recorded investment balance of purchased covered loans which are no longer covered under the FDIC loss-sharing agreements was $3.5 million.

Funds advanced on the purchased covered loans subsequent to acquisition, identified as subsequent advances, are included in the purchased covered loan balances as these subsequent advances are covered under the loss-sharing agreements. These subsequent advances are not accounted for under FASB ASC 310-30. The total balance of subsequent advances on the purchased covered loans was $7.7 million and $6.9 million as of March 31, 2013 and December 31, 2012, respectively.

The recorded investment of purchased non-covered loans receivable at March 31, 2013 and December 31, 2012 consisted of the following portfolio segments and classes:

	March 31, 2013	December 31, 2012
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 39,971	$ 24,763
Owner-occupied commercial real estate	26,670	13,211
Non-owner occupied commercial real estate	23,287	11,019
Total commercial business	89,928	48,993
One-to-four family residential	3,769	3,040
Real estate construction and land development:		
One-to-four family residential	715	513
Five or more family residential and commercial properties	3,277	864
Total real estate construction and land development	3,992	1,377
Consumer	12,152	10,713
Gross purchased non-covered loans receivable	109,841	64,123
Allowance for loan losses	(4,925)	(5,117)
Purchased non-covered loans receivable, net	$ 104,916	$ 59,006

The loans purchased in the NCB Acquisition on January 9, 2013 are included in the purchased non-covered loans receivable balances shown above as of March 31, 2013. The estimated fair value of the purchased non-covered loans totaled $51.5 million at the acquisition date. The gross recorded investment balance of the NCB purchased impaired loans and the NCB purchased other loans was $4.8 million and $44.3 million at March 31, 2013, respectively.

The March 31, 2013 and December 31, 2012 gross recorded investment balance of purchased impaired non-covered loans accounted for under FASB ASC 310-30 was $44.6 million and $42.0 million, respectively. The recorded investment balance of purchased other non-covered loans was $65.3 million and $22.1 million at March 31, 2013 and December 31, 2012, respectively.

(b) Concentrations of Credit

Most of the Company s lending activity occurs within the State of Washington, and to a lesser extent the State of Oregon. The primary market areas include Thurston, Pierce, King, Mason, Cowlitz and Clark counties in Washington and Multnomah County in Oregon, as well as other markets. The majority of the Company s loan portfolio consists of commercial and industrial, non-owner occupied commercial real estate, and owner occupied commercial real estate. As of March 31, 2013 and December 31, 2012, there were no concentrations of loans related to any single industry in excess of 10% of total loans.

Table of Contents

(c) Credit Quality Indicators

As part of the on-going monitoring of the credit quality of the Company s loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grade of the loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) nonperforming loans, and (v) the general economic conditions of the United States of America, and specifically the states of Washington and Oregon. The Company utilizes a risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 0 to 9, and a W . A description of the general characteristics of the risk grades is as follows:

Grades 0 to 5: These grades are considered pass grade and includes loans with negligible to above average but acceptable risk. These borrowers generally have strong to acceptable capital levels and consistent earnings and debt service capacity. Loans with the higher grades within the pass category may include borrowers who are experiencing unusual operating difficulties, but have acceptable payment performance to date. Increased monitoring of financials and/or collateral may be appropriate. Loans with this grade show no immediate loss exposure.

Grade W : This grade is considered pass grade and includes loans on management s watch list and is intended to be utilized on a temporary basis for pass grade borrowers where a potentially significant risk-modifying action is anticipated in the near term.

Grade 6: This grade includes Other Assets Especially Mentioned (OAEM) loans in accordance with regulatory guidelines, and is intended to highlight loans with elevated risks. Loans with this grade show signs of deteriorating profits and capital, and the borrower might not be strong enough to sustain a major setback. The borrower is typically higher than normally leveraged, and outside support might be modest and likely illiquid. The loan is at risk of further decline unless active measures are taken to correct the situation.

Grade 7: This grade includes Substandard loans in accordance with regulatory guidelines, for which Company has determined have a high credit risk. These loans also have well-defined weaknesses which make payment default or principal exposure likely, but not yet certain. The borrower may have shown serious negative trends in financial ratios and performance. Such loans may be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business. Loans with this grade can be placed on accrual or nonaccrual status based on the Company s accrual policy.

Grade 8: This grade includes Doubtful loans in accordance with regulatory guidelines, and the Company has determined these loans to have excessive risk. Such loans are placed on nonaccrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Additionally, these loans generally have a specific valuation allowance.

Grade 9: This grade includes Loss loans in accordance with regulatory guidelines, and the Company has determined these loans have the highest risk of loss. Such loans are charged-off or charged-down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be determined. Loss is not intended to imply that the loan or some portion of it will never be paid, nor does it in any way imply that there has been a forgiveness of debt.

Loan grades for all commercial business loans and real estate construction and land development loans are established at the origination of the loan. One-to-four family residential loans and consumer loans (non-commercial loans) are not graded as a 0 to 9 at origination date as these loans are determined to be pass graded loans. These non-commercial loans may subsequently require a 0-9 risk grade if the credit department has evaluated the credit and determined it necessary to classify the loan. Loan grades are reviewed on a quarterly basis, or more frequently if necessary, by the credit department. Typically, an individual loan grade will not be changed from the prior period unless there is a specific indication of credit deterioration or improvement. Credit deterioration is evidenced by delinquency, direct communications with the borrower, or other borrower information that becomes known to management. Credit improvements are evidenced by known facts regarding the borrower or the collateral property.

The loan grades relate to the likelihood of losses in that the higher the grade, the greater the loss potential. Loans with a pass grade may have some inherent losses in the portfolios, but to a lesser extent than the other loan grades. These pass graded loans may also have a zero percent loss based on historical experience and current market trends. The OAEM loan grade is transitory in that the Company is waiting on additional information to determine the likelihood and extent of the potential loss. The likelihood of loss, however, is greater than Watch grade loans because there has been measurable credit deterioration. Loans with a Substandard grade are generally loans for which the Company has individually analyzed for potential impairment. For Doubtful and Loss graded loans, the Company is almost certain of the losses, and the unpaid principal balances are generally charged-off to the realizable value.

Table of Contents

The following tables present the balance of the originated loans receivable by credit quality indicator as of March 31, 2013 and December 31, 2012.

	March 31, 2013				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$ 245,894	$ 2,712	$ 19,361	$ 1,207	$ 269,174
Owner-occupied commercial real estate	187,033	2,487	3,998		193,518
Non-owner occupied commercial real estate	276,550	4,083	5,330		285,963
Total commercial business	709,477	9,282	28,689	1,207	748,655
One-to-four family residential	37,537	692	882		39,111
Real estate construction and land development:					
One-to-four family residential	14,819	1,783	6,401		23,003
Five or more family residential and commercial properties	47,393		3,265		50,658
Total real estate construction and land development	62,212	1,783	9,666		73,661
Consumer	27,796	81	51		27,928
Gross originated loans	$ 837,022	$ 11,838	$ 39,288	$ 1,207	$ 889,355

	December 31, 2012				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$ 254,593	$ 3,908	$ 18,157	$ 582	$ 277,240
Owner-occupied commercial real estate	181,630	2,658	4,206		188,494
Non-owner occupied commercial real estate	256,077	4,132	5,257	369	265,835
Total commercial business	692,300	10,698	27,620	951	731,569
One-to-four family residential	37,239	920	689		38,848
Real estate construction and land development:					
One-to-four family residential	16,446	1,795	6,934		25,175
Five or more family residential and commercial properties	48,718		3,357		52,075
Total real estate construction and land development	65,164	1,795	10,291		77,250
Consumer	28,748		156	10	28,914
Gross originated loans	$ 823,451	$ 13,413	$ 38,756	$ 961	$ 876,581

The tables above include $30.2 million and $27.5 million of originated impaired loans as of March 31, 2013 and December 31, 2012, respectively, as detailed in the impaired loans section below. These impaired loans have been individually reviewed for probable losses and have specific valuation allowance, as necessary. The tables above also include potential problem loans. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which management is monitoring because the financial information of the borrower causes concern as to their ability to meet their loan repayment terms. Potential problem originated loans as of March 31, 2013 and December 31, 2012 were $25.1 million and $28.3 million, respectively. The balance of potential problem originated loans guaranteed by a governmental agency was $2.5 million and $3.2 million as of March 31, 2013 and December 31, 2012, respectively. This guarantee reduces the Company s credit exposure.

The following tables present the recorded invested balance of the purchased other loans receivable by credit quality indicator as of March 31, 2013 and December 31, 2012.

	March 31, 2013				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$ 27,170	$ 496	$ 14	$	$ 27,680
Owner-occupied commercial real estate	35,395	2,380	332		38,107
Non-owner occupied commercial real estate	13,767	728	970		15,465

Table of Contents

	March 31, 2013				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Total commercial business	76,332	3,604	1,316		81,252
One-to-four family residential	765	550			1,315
Real estate construction and land development:					
One-to-four family residential					
Five or more family residential and commercial properties	1,745				1,745
Total real estate construction and land development	1,745				1,745
Consumer	9,130	186	248	32	9,596
Gross purchased other loans	$ 87,972	$ 4,340	$ 1,564	$ 32	$ 93,908

	December 31, 2012				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$ 11,393	$ 496	$ 92	$	$ 11,981
Owner-occupied commercial real estate	23,685	2,390	335		26,410
Non-owner occupied commercial real estate	3,108	732	973		4,813
Total commercial business	38,186	3,618	1,400		43,204
One-to-four family residential	770	553	61		1,384
Real estate construction and land development:					
One-to-four family residential					
Five or more family residential and commercial properties					
Total real estate construction and land development					
Consumer	6,385	2	346	32	6,765
Gross purchased other loans	$ 45,341	$ 4,173	$ 1,807	$ 32	$ 51,353

The tables above include $2.0 million and $2.2 million of purchased other impaired loans as of March 31, 2013 and December 31, 2012, respectively, as detailed in the impaired loans section below. These purchased other impaired loans have been individually reviewed for potential losses and have a specific valuation allowance, as necessary.

(d) Nonaccrual loans

Originated nonaccrual loans, segregated by segments and classes of loans, were as follows as of March 31, 2013 and December 31, 2012:

	March 31, 2013(1)	December 31, 2012(1)
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 5,863	$ 4,560
Owner-occupied commercial real estate	975	563
Non-owner occupied commercial real estate	89	369
Total commercial business	6,927	5,492
One-to-four family residential	586	389

Real estate construction and land development:		
One-to-four family residential	2,820	3,063
Five or more family residential and commercial properties	3,265	3,357
Total real estate construction and land development	6,085	6,420
Consumer	47	157
Gross originated nonaccrual loans	$ 13,645	$ 12,458

(1) $1.8 million and $1.2 million of nonaccrual originated loans were guaranteed by governmental agencies at March 31, 2013 and December 31, 2012, respectively.

Table of Contents

The recorded investment balance of purchased other nonaccrual loans, segregated by segments and classes of loans, were as follows as of March 31, 2013 and December 31, 2012:

	March 31, 2013(1)	December 31, 2012(1)
	(In thousands)	
Commercial business:		
Owner-occupied commercial real estate	$ 136	$ 139
Non-owner occupied commercial real estate	437	437
Total commercial business	573	576
One-to-four family residential		61
Consumer	39	163
Gross purchased other nonaccrual loans	$ 612	$ 800

(1) $39,000 of purchased other nonaccrual loans were covered by the FDIC shared-loss agreements at both March 31, 2013 and December 31, 2012.

Table of Contents

(e) Past due loans

The Company performs an aging analysis of past due loans using the categories of 30-89 days past due and 90 or more days past due. This policy is consistent with regulatory reporting requirements. The balances of originated past due loans, segregated by segments and classes of loans, as of March 31, 2013 and December 31, 2012 were as follows:

	March 31, 2013					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$ 1,214	$ 2,871	$ 4,085	$ 265,089	$ 269,174	$
Owner-occupied commercial real estate	832	681	1,513	192,005	193,518	
Non-owner occupied commercial real estate		89	89	285,874	285,963	
Total commercial business	2,046	3,641	5,687	742,968	748,655	
One-to-four family residential		225	225	38,886	39,111	
Real estate construction and land development:						
One-to-four family residential	607	2,820	3,427	19,576	23,003	
Five or more family residential and commercial properties	265	3,000	3,265	47,393	50,658	
Total real estate construction and land development	872	5,820	6,692	66,969	73,661	
Consumer	86	47	133	27,795	27,928	
Gross originated loans	$ 3,004	$ 9,733	$ 12,737	$ 876,618	$ 889,355	$

	December 31, 2012					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$ 2,768	$ 2,014	$ 4,782	$ 272,458	$ 277,240	$ 25
Owner-occupied commercial real estate	920	112	1,032	187,462	188,494	
Non-owner occupied commercial real estate	92	369	461	265,374	265,835	
Total commercial business	3,780	2,495	6,275	725,294	731,569	25
One-to-four family residential	239	375	614	38,234	38,848	
Real estate construction and land development:						
One-to-four family residential	847	3,242	4,089	21,086	25,175	179
Five or more family residential and commercial properties		3,018	3,018	49,057	52,075	
Total real estate construction and land development	847	6,260	7,107	70,143	77,250	179
Consumer	68	146	214	28,700	28,914	10
Gross originated loans	$ 4,934	$ 9,276	$ 14,210	$ 862,371	$ 876,581	$ 214

Table of Contents

The balances of purchased other past due loans, segregated by segments and classes of loans, as of March 31, 2013 and December 31, 2012 are as follows:

	March 31, 2013					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$ 279	$	$ 279	$ 27,401	$ 27,680	$
Owner-occupied commercial real estate				38,107	38,107	
Non-owner occupied commercial real estate		437	437	15,028	15,465	
Total commercial business	279	437	716	80,536	81,252	
One-to-four family residential				1,315	1,315	
Real estate construction and land development:						
One-to-four family residential						
Five or more family residential and commercial properties				1,745	1,745	
Total real estate construction and land development				1,745	1,745	
Consumer	20	32	52	9,544	9,596	
Gross purchased other loans	$ 299	$ 469	$ 768	$ 93,140	$ 93,908	$

	December 31, 2012					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$	$	$	$ 11,981	$ 11,981	$
Owner-occupied commercial real estate	662		662	25,748	26,410	
Non-owner occupied commercial real estate		437	437	4,376	4,813	
Total commercial business	662	437	1,099	42,105	43,204	
One-to-four family residential		61	61	1,323	1,384	
Real estate construction and land development:						
One-to-four family residential						
Five or more family residential and commercial properties						
Total real estate construction and land development						
Consumer	75	216	291	6,474	6,765	
Gross purchased other loans	$ 737	$ 714	$ 1,451	$ 49,902	$ 51,353	$

Table of Contents

(f) Impaired loans

Originated impaired loans (including restructured loans) at March 31, 2013 and December 31, 2012 are set forth in the following tables.

	March 31, 2013				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
			(In thousands)		
Commercial business:					
Commercial and industrial	$ 9,360	$ 3,915	$ 13,275	$ 15,244	$ 1,747
Owner-occupied commercial real estate	1,394	1,057	2,451	2,621	431
Non-owner occupied commercial real estate	2,734	4,200	6,934	6,934	1,360
Total commercial business	13,488	9,172	22,660	24,799	3,538
One-to-four family residential	676	586	1,262	1,272	75
Real estate construction and land development:					
One-to-four family residential	650	2,350	3,000	4,173	661
Five or more family residential and commercial properties	265	3,000	3,265	3,379	643
Total real estate construction and land development	915	5,350	6,265	7,552	1,304
Consumer	47		47	47	
Gross originated loans	$ 15,126	$ 15,108	$ 30,234	$ 33,670	$ 4,917

	December 31, 2012				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
			(In thousands)		
Commercial business:					
Commercial and industrial	$ 7,797	$ 2,643	$ 10,440	$ 10,741	$ 858
Owner-occupied commercial real estate	633	1,418	2,051	2,134	509
Non-owner occupied commercial real estate	3,031	4,226	7,257	7,257	1,386
Total commercial business	11,461	8,287	19,748	20,132	2,753
One-to-four family residential	422	389	811	811	46
Real estate construction and land development:					
One-to-four family residential	700	2,724	3,424	4,597	792
Five or more family residential and commercial properties		3,357	3,357	3,397	658
Total real estate construction and land development	700	6,081	6,781	7,994	1,450
Consumer	47	110	157	157	110
Gross originated loans	$ 12,630	$ 14,867	$ 27,497	$ 29,094	$ 4,359

23

Table of Contents

The Company had governmental guarantees of $3.0 million and $1.9 million related to the impaired originated loan balances at March 31, 2013 and December 31, 2012, respectively.

The average recorded investment of originated impaired loans (including restructured loans) for the three months ended March 31, 2013 and March 31, 2012 are set forth in the following table.

	Three Months Ended March 31, 2013	2012
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 11,858	$ 11,093
Owner-occupied commercial real estate	2,251	2,440
Non-owner occupied commercial real estate	7,095	7,900
Total commercial business	21,204	21,433
One-to-four family residential	1,036	993
Real estate construction and land development:		
One-to-four family residential	3,213	5,159
Five or more family residential and commercial properties	3,310	7,230
Total real estate construction and land development	6,523	12,389
Consumer	102	178
Gross originated impaired loans	$ 28,865	$ 34,993

Purchased other loans become impaired when classified as nonaccrual or when modified, resulting in troubled debt restructure. Purchased other impaired loans (including restructured loans) at March 31, 2013 and December 31, 2012 are set forth in the following tables.

	March 31, 2013				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
			(In thousands)		
Commercial business:					
Commercial and industrial	$ 334	$ 104	$ 438	$ 437	$ 13
Owner-occupied commercial real estate		136	136	132	7
Non-owner occupied commercial real estate	437	533	970	924	15
Total commercial business	771	773	1,544	1,493	35
One-to-four family residential		463	463	434	41
Consumer		39	39	48	41
Gross purchased other impaired loans	$ 771	$ 1,275	$ 2,046	$ 1,975	$ 117

	December 31, 2012				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment (In thousands)	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
Commercial business:					
Commercial and industrial	$ 330	$ 106	$ 436	$ 434	$ 14
Owner-occupied commercial real estate		139	139	135	7
Non-owner occupied commercial real estate	437	536	973	926	18
Total commercial business	767	781	1,548	1,495	39
One-to-four family residential		527	527	489	105
Consumer		163	163	173	157
Gross purchased other impaired loans	$ 767	$ 1,471	$ 2,238	$ 2,157	$ 301

25

Table of Contents

The average recorded investment of purchased other impaired loans (including restructured loans) for three months ended March 31, 2013 and March 31, 2012 are set forth in the following table.

	Three Months Ended March 31, 2013	2012
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 437	$ 70
Owner-occupied commercial real estate	138	
Non-owner occupied commercial real estate	972	218
Total commercial business	1,547	288
One-to-four family residential	495	
Consumer	101	445
Gross purchased other impaired loans	$ 2,143	$ 733

For the three months ended March 31, 2013 and March 31, 2012 no interest income was recognized subsequent to a loan s classification as impaired.

(g) Troubled Debt Restructured Loans

A troubled debt restructured loan (TDR) is a restructuring in which the Banks, for economic or legal reasons related to a borrower s financial difficulties, grants a concession to the borrower that it would not otherwise consider. TDRs are considered impaired and are separately measured for impairment under FASB ASC 310-10-35, whether on accrual or nonaccrual status.

The recorded investment balance and related allowance for loan losses of accruing and non-accruing TDRs as of March 31, 2013 and December 31, 2012 are as follows:

	March 31, 2013 Accruing TDRs	Non-Accruing TDRs	December 31, 2012 Accruing TDRs	Non-Accruing TDRs
	(In thousands)			
Originated TDRs	$ 16,588	$ 8,948	$ 15,039	$ 9,311
Allowance for loan losses on originated TDRs	2,871	1,871	2,131	1,994
Purchased other TDRs	1,434	7	1,437	7
Allowance for loan losses on purchased other TDRs	69	1	76	2

The unfunded commitment to borrowers related to originated TDRs was $2.2 million and $1.5 million as of March 31, 2013 and December 31, 2012, respectively. There were no unfunded commitments to borrowers related to the purchased other TDRs as of March 31, 2013 and December 31, 2012.

Originated loans that were modified as TDRs during the three months ended March 31, 2013 and March 31, 2012 are set forth in the following table:

	Three Months Ended March 31, 2013 Number of Contracts (1)	Outstanding Principal Balance (1)(2)	2012 Number of Contracts (1)	Outstanding Principal Balance (1)(2)

			(Dollars in thousands)			
Commercial business:						
Commercial and industrial	11	$	4,224	9	$	1,800
Owner-occupied commercial real estate				2		561
Total commercial business	11		4,224	11		2,361
One-to-four family residential	1		257			
Real estate construction and land development:						
One-to-four family residential	1		180	3		578
Five or more family residential and commercial properties				1		384

26

Table of Contents

	Three Months Ended March 31, 2013		2012	
	Number of Contracts (1)	Outstanding Principal Balance (1)(2)	Number of Contracts (1)	Outstanding Principal Balance (1)(2)
	(Dollars in thousands)			
Total real estate construction and land development	1	180	4	962
Total originated TDRs	13	$ 4,661	15	$ 3,323

(1) Number of contracts and outstanding principal balance represent loans which have balances as of period end dates as certain loans may have been paid-down or charged-off during the three months ended March 31, 2013 and March 31, 2012.

(2) Includes subsequent payments after modifications and reflects the balance as of the end of the period. The Banks initial recorded investments in the loans did not change as a result of the modifications as the Banks did not forgive any principal or interest balance as part of the modifications.

Of the 13 loans modified during the three months ended March 31, 2013, five loans with a total outstanding principal balance of $1.9 million were previously reported as TDRs as of December 31, 2012. Of the 15 loans modified during the three months ended March 31, 2012, five loans with a total outstanding principal balance of $1.1 million were previously reported as TDRs as of December 31, 2011. The Banks typically grant shorter extension periods to continually monitor the troubled credits despite the fact that the extended date might not be the date the Banks expect the cash flow. The Company does not consider these modifications a subsequent default of a TDR as new loan terms, specifically maturity dates, were granted. The potential losses related to these loans would have been considered in the period the loan was first reported as a TDR and adjusted, as necessary, in the current periods based on more recent information.

There were no purchased other loans that were modified as TDRs during the three months ended March 31, 2013. There was one commercial and industrial purchased other loan totaling $19,000 that was modified for the first time as a TDR during the three months ended March 31, 2012.

The majority of the Banks TDRs are a result of granting extensions to troubled credits which have already been adversely classified. We grant such extensions to reassess the borrower s financial status and to develop a plan for repayment. Certain modifications with extensions also include interest rate reductions, which is the second most prevalent concession. Certain TDRs were additionally re-amortized over a longer period of time. These modifications would all be considered a concession for a borrower that could not obtain similar financing terms from another source other than from the Banks.

The financial effects of each modification will vary based on the specific restructure. For the majority of the Banks TDRs, the loans were interest-only with a balloon payment at maturity. If the interest rate is not adjusted and the terms are consistent with market, the Banks might not experience any loss associated with the restructure. If, however, the restructure involves forbearance agreements or interest rate modifications, the Banks might not collect all the principal and interest based on the original contractual terms. The Banks estimate the necessary allowance for loan losses on TDRs using the same guidance as other impaired loans.

There were no originated or purchased other TDRs that had been modified during the previous twelve months ended that subsequently defaulted during the three months ended March 31, 2013 and March 31, 2012.

(h) Purchased Impaired Loans

As indicated above, the Company purchased impaired loans from the Cowlitz, Pierce and NCB Acquisitions which are accounted for under FASB ASC 310-30.

Table of Contents

The following tables reflect the outstanding balance at March 31, 2013 and December 31, 2012 of the purchased impaired loans by acquisition:

	Cowlitz Bank	
	March 31, 2013	December 31, 2012
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 16,685	$ 21,624
Owner-occupied commercial real estate	16,461	17,157
Non-owner occupied commercial real estate	16,495	12,908
Total commercial business	49,641	51,689
One-to-four family residential	4,232	4,262
Real estate construction and land development:		
One-to-four family residential	6,082	6,122
Five or more family residential and commercial properties		
Total real estate construction and land development	6,082	6,122
Consumer	2,946	3,533
Gross purchased impaired covered loans	$ 62,901	$ 65,606

The total balance of subsequent advances on the purchased impaired covered loans was $4.6 million and $3.8 million as of March 31, 2013 and December 31, 2012, respectively. Heritage Bank has the option to modify certain purchased covered loans which may terminate the FDIC loss-share coverage on those modified loans. At both March 31, 2013 and December 31, 2012, the recorded investment balance of purchased impaired covered loans which are no longer covered under the FDIC loss-sharing agreements was $1.7 million. Heritage Bank continues to report these loans in the covered portfolio as they are in a pool and they continue to be accounted for under FASB ASC 310-30. The FDIC indemnification asset has been properly adjusted to reflect the change in the loan status.

	Pierce Commercial Bank	
	March 31, 2013	December 31, 2012
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 20,298	$ 21,953
Owner-occupied commercial real estate	5,389	5,748
Non-owner occupied commercial real estate	7,478	7,802
Total commercial business	33,165	35,503
One-to-four family residential	4,139	3,303
Real estate construction and land development:		
One-to-four family residential	3,207	3,375
Five or more family residential and commercial properties	819	820
Total real estate construction and land development	4,026	4,195
Consumer	2,988	4,393
Gross purchased impaired non-covered loans	$ 44,318	$ 47,394

Northwest Commercial Bank

		March 31, 2013 (1) (In thousands)
Commercial business:		
Commercial and industrial	$	1,828
Owner-occupied commercial real estate		1,738
Non-owner occupied commercial real estate		2,346
Total commercial business		5,912
One-to-four family residential		
Real estate construction and land development:		
One-to-four family residential		
Five or more family residential and commercial properties		994
Total real estate construction and land development		994
Consumer		88
Gross purchased impaired non-covered loans	$	6,994

(1) The NCB Acquisition was effective January 9, 2013

28

On the acquisition date, the amount by which the undiscounted expected cash flows of the purchased impaired loans exceed the estimate fair value of the loan is the accretable yield . The accretable yield is then measured at each financial reporting date and represents the difference between the remaining undiscounted expected cash flows and the current carrying value of the purchased impaired loan.

The following table summarizes the accretable yield on the purchased impaired loans resulting from the Cowlitz, Pierce and NCB Acquisitions for the three months ended March 31, 2013 and 2012. As the NCB Acquisition was as of January 9, 2013, there are no three months ended March 31, 2012 balances.

	Three Months Ended March 31, 2013		
	Cowlitz Bank	Pierce Commercial Bank	Northwest Commercial Bank
		(In thousands)	
Balance at the beginning of period (1)	$ 14,286	$ 7,352	$ 713
Accretion	(1,354)	(1,282)	(116)
Disposals and other	945	2,822	
Change in accretable yield	231	28	
Balance at the end of period	$ 14,108	$ 8,920	$ 597

(1) For the NCB Acquisition, the balance at the beginning of the period represents the balance acquired at January 9, 2013. The contractual cash flows were $8.1 million and the expected cash flows were $5.6 million, resulting in a non-accretable difference of $2.5 million. As the fair value of these purchased impaired loans was $4.9 million, this provides an accretable yield of $713,000.

	Three Months Ended March 31, 2012	
	Cowlitz Bank	Pierce Commercial Bank
	(In thousands)	
Balance at the beginning of period	$ 19,912	$ 14,638
Accretion	(1,916)	(1,571)
Disposals and other	(239)	(519)
Change in accretable yield	67	
Balance at the end of period	$ 17,824	$ 12,548

(4) Allowance for Loan Losses

The allowance for loan losses is maintained at a level deemed appropriate by management to adequately provide for known and inherent risks in the loan portfolio. A summary of the changes in the originated loans allowance for loan losses for the three months ended March 31, 2013 and March 31, 2012 are as follows:

	Three Months Ended March 31,	
	2013	2012
	(In thousands)	
Balance at the beginning of period	$ 19,125	$ 22,317

Loans charged off	(1,827)	(1,334)
Recoveries of loans previously charged off	119	1,580
Provision charged to operations	495	
Balance at the end of period	$ 17,912	$ 22,563

29

Table of Contents

A summary of the changes in the purchased covered and purchased non-covered loans allowance for loan losses for the three months ended March 31, 2013 and March 31, 2012 are as follows:

	Three Months Ended March 31,			
	2013		2012	
	Purchased Covered	Purchased Non-covered	Purchased Covered	Purchased Non-covered
	(In thousands)			
Balance at the beginning of period	$ 4,352	$ 5,117	$ 3,963	$ 4,635
Loans charged off		(197)	(33)	(224)
Recoveries of loans charged off				
Provisions charged to operations	358	5	181	(290)
Balance at the end of period	$ 4,710	$ 4,925	$ 4,111	$ 4,121

The purchased loans acquired in the Cowlitz, Pierce and NCB Acquisitions are subject to the Company s internal and external credit review. If and when credit deterioration occurs subsequent to the acquisition dates, a provision for loan losses will be charged to earnings for the full amount without regard to the FDIC loss-sharing agreement for the covered loan balances. The portion of the estimated loss reimbursable from the FDIC is recorded in noninterest income and increases the FDIC indemnification asset.

Table of Contents

The following table details activity in the allowance for loan losses disaggregated on the basis of the Company s impairment method as of and for the three months ended March 31, 2013:

	Commercial and industrial	Owner-occupied commercial real estate	Non-owner occupied commercial real estate	One-to-four family residential	Real estate construction and land development: one-to-four family residential	Real estate construction and land development: five or more family residential and commercial properties	Consumer	Unallocated	Total
					(In thousands)				
Allowance for loan losses for the three months ended March 31, 2013:									
December 31, 2012	$ 9,912	$ 4,021	$ 5,369	$ 1,221	$ 3,131	$ 2,309	$ 1,761	$ 870	$ 28,594
Charge-offs	(1,637)			(52)		(83)	(252)		(2,024)
Recoveries	110						9		119
Provisions for / (Reallocation of) allowance	2,459	(180)	(94)	37	(476)	(891)	(23)	26	858
March 31, 2013	$ 10,844	$ 3,841	$ 5,275	$ 1,206	$ 2,655	$ 1,335	$ 1,495	$ 896	$ 27,547
Allowance for loan losses as of March 31, 2013 allocated to:									
Originated loans individually evaluated for impairment	$ 1,747	$ 431	$ 1,360	$ 75	$ 661	$ 643	$	$	$ 4,917
Originated loans collectively evaluated for impairment	5,616	1,885	2,067	565	816	570	580	896	12,995
Purchased other covered loans individually evaluated for impairment	3			41			41		85
Purchased other covered loans collectively evaluated for impairment	39	29		16			6		90
Purchased other non-covered loans individually evaluated for impairment	10	7	15						32
Purchased other non-covered loans collectively evaluated for impairment	30	28	9	27			52		146
Purchased impaired covered loans collectively evaluated for impairment	855	1,072	1,418	243	823		124		4,535
Purchased impaired non-covered loans collectively evaluated for impairment	2,544	389	406	239	355	122	692		4,747
March 31, 2013	$ 10,844	$ 3,841	$ 5,275	$ 1,206	$ 2,655	$ 1,335	$ 1,495	$ 896	$ 27,547

Table of Contents

The following table details the recorded investment balance of the loan receivables disaggregated on the basis of the Company s impairment method as of March 31, 2013:

	Commercial and industrial	Owner-occupied commercial real estate	Non-owner occupied commercial real estate	One-to-four family residential	Real estate construction and land development: one-to-four family residential	Real estate construction and land development: five or more family residential and commercial properties	Consumer	Total
	(In thousands)							
Originated loans individually evaluated for impairment	$ 13,275	$ 2,451	$ 6,934	$ 1,262	$ 3,000	$ 3,265	$ 47	$ 30,234
Originated loans collectively evaluated for impairment	255,899	191,067	279,029	37,849	20,003	47,393	27,881	859,121
Purchased other covered loans individually evaluated for impairment	56			463			39	558
Purchased other covered loans collectively evaluated for impairment	7,059	17,799	383	852			1,990	28,083
Purchased other non-covered loans individually evaluated for impairment	382	136	970					1,488
Purchased other non-covered loans collectively evaluated for impairment	20,183	20,172	14,112			1,745	7,567	63,779
Purchased impaired covered loans collectively evaluated for impairment	13,943	15,810	16,785	3,697	4,505		2,704	57,444
Purchased impaired non-covered loans collectively evaluated for impairment	19,406	6,362	8,205	3,769	715	1,532	4,585	44,574
Total gross loans receivable as of March 31, 2013	$ 330,203	$ 253,797	$ 326,418	$ 47,892	$ 28,223	$ 53,935	$ 44,813	$ 1,085,281

32

Table of Contents

The following table details the balance in the allowance for loan losses disaggregated on the basis of the Company s impairment method for the three months ended March 31, 2012 and as of December 31, 2012:

	Commercial and industrial	Owner-occupied commercial real estate	Non-owner occupied commercial real estate	One-to-four family residential	Real estate construction and land development: one-to-four family residential	Real estate construction and land development: five or more family residential and commercial properties	Consumer	Unallocated	Total
					(In thousands)				
Allowance for loan losses for the three months ended March 31, 2012:									
December 31, 2011	$ 11,805	$ 2,979	$ 4,394	$ 794	$ 4,823	$ 3,800	$ 1,410	$ 910	$ 30,915
Charge-offs	(489)			(42)	(371)	(445)	(244)		(1,591)
Recoveries	1,428		11		125		16		1,580
Provisions for (Reallocation of) allowance	(1,049)	689	19	105	(538)	322	278	65	(109)
March 31, 2012	$ 11,695	$ 3,668	$ 4,424	$ 857	$ 4,039	$ 3,677	$ 1,460	$ 975	$ 30,795
Allowance for loan losses as of December 31, 2012 allocated to:									
Originated loans individually evaluated for impairment	$ 858	$ 509	$ 1,386	$ 46	$ 792	$ 658	$ 110	$	$ 4,359
Originated loans collectively evaluated for impairment	5,372	2,054	2,375	591	1,339	1,527	638	870	14,766
Purchased other covered loans individually evaluated for impairment	4			44			33		81
Purchased other covered loans collectively evaluated for impairment	38	29		23			4		94
Purchased other non-covered loans individually evaluated for impairment	10	7	18	61			124		220
Purchased other non-covered loans collectively evaluated for impairment	30	40	16	5			14		105
Purchased impaired covered loans collectively evaluated for impairment	1,034	989	1,164	210	639		141		4,177
Purchased impaired non-covered loans collectively evaluated for impairment	2,566	393	410	241	361	124	697		4,792
December 31, 2012	$ 9,912	$ 4,021	$ 5,369	$ 1,221	$ 3,131	$ 2,309	$ 1,761	$ 870	$ 28,594

Table of Contents

The following table details the recorded investment balance of the loan receivables disaggregated on the basis of the Company s impairment method for the year ended December 31, 2012:

	Commercial and industrial	Owner-occupied commercial real estate	Non-owner occupied commercial real estate	One-to-four family residential	Real estate construction and land development: one-to-four family residential	Real estate construction and land development: five or more family residential and commercial properties	Consumer	Total
				(In thousands)				
Originated loans individually evaluated for impairment	$ 10,440	$ 2,051	$ 7,257	$ 811	$ 3,424	$ 3,357	$ 157	$ 27,497
Originated loans collectively evaluated for impairment	266,800	186,443	258,578	38,037	21,751	48,718	28,757	849,084
Purchased other covered loans individually evaluated for impairment	51			466			38	555
Purchased other covered loans collectively evaluated for impairment	7,232	18,347	384	857			1,911	28,731
Purchased other non-covered loans individually evaluated for impairment	385	139	973	61			125	1,683
Purchased other non-covered loans collectively evaluated for impairment	4,313	7,924	3,456				4,691	20,384
Purchased impaired covered loans collectively evaluated for impairment	18,498	16,449	12,644	3,704	4,433		3,316	59,044
Purchased impaired non-covered loans collectively evaluated for impairment	20,065	5,148	6,590	2,979	513	864	5,897	42,056
Total gross loans receivable as of December 31, 2012	$ 327,784	$ 236,501	$ 289,882	$ 46,915	$ 30,121	$ 52,939	$ 44,892	$ 1,029,034

34

Table of Contents

(5) FDIC Indemnification Asset

Changes in the FDIC indemnification asset during the three months ended March 31, 2013 and March 31, 2012 are as follows:

	Three Months Ended March 31, 2013	2012
	(In thousands)	
Beginning Balance	$ 7,100	$ 10,350
Cash payments received or receivable from the FDIC	(1,480)	(1,253)
FDIC share of additional estimated losses	88	341
Net amortization	(355)	(517)
Balance at March 31, 2013	$ 5,353	$ 8,921

(6) Other Real Estate Owned

Changes in the other real estate owned during the three months ended March 31, 2013 and March 31, 2012 are as follows:

	Three Months Ended March 31, 2013	2012
	(In thousands)	
Beginning Balance	$ 5,666	$ 4,484
Additions		4,309
Additions from acquisition	2,279	
Proceeds from dispositions	(2,961)	(101)
Gain (loss) on sales	172	(12)
Valuation adjustment	107	(331)
Balance at March 31, 2013	$ 5,263	$ 8,349

(7) Accumulated Other Comprehensive Income

The changes in accumulated other comprehensive income (AOCI) by component, during the three months ended March 31, 2013 and March 31, 2012 are as follows:

	Three Months Ended March 31, 2013		
	Changes in fair value of available for sale securities(1)	Accretion of other-than-temporary impairment on held to maturity securities (1)	Total
	(In thousands)		
Beginning Balance	$ 2,042	$ (298)	$ 1,744
AOCI before reclassification			
Amounts reclassified from AOCI	(342)	14	(328)

Net current period other comprehensive (loss) income	(342)	14	(328)
Ending Balance	$ 1,700	$ (284)	$ 1,416

	Three Months Ended March 31, 2012		
	Changes in fair value of available for sale securities(1)	Accretion of other-than-temporary impairment on held to maturity securities (1)	Total
	(In thousands)		
Beginning Balance	$ 2,105	$ (369)	$ 1,736
AOCI before reclassification			
Amounts reclassified from AOCI	(327)	26	(301)
Net current period other comprehensive (loss) income	(327)	26	(301)
Ending Balance	$ 1,778	$ (343)	$ 1,435

(1) All amounts are net of tax. Amounts in parenthesis indicate debits.

(8) Stockholders Equity

(a) Earnings Per Common Share

The following table illustrates the reconciliation of weighted average shares used for earnings per common share computations for the three months ended March 31, 2013 and 2012:

	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012
	(Dollars in thousands)	
Net income:		
Net income	$ 2,885	$ 4,170
Less: Dividends and undistributed earnings allocated to participating securities	(34)	(46)
Net income allocated to common shareholders	$ 2,851	$ 4,124
Basic:		
Weighted average common shares outstanding	15,128,944	15,465,510
Less: Restricted stock awards	(186,751)	(170,821)
Total basic weighted average common shares outstanding	14,942,193	15,294,689
Diluted:		
Basic weighted average common shares outstanding	14,942,193	15,294,689
Incremental shares from stock options	15,996	12,277
Total diluted weighted average common shares outstanding	14,958,189	15,306,966

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three months ended March 31, 2013 and March 31, 2012 anti-dilutive shares outstanding related to options and warrants to acquire common stock totaled 207,468 and 305,660, respectively, as the assumed proceeds from exercise price, tax benefits and future compensation was in excess of the market value.

(b) Dividends

Common Stock: The timing and amount of cash dividends paid on our common stock depends on the Company s earnings, capital requirements, financial condition and other relevant factors. Dividends on common stock from the Company depend substantially upon receipt of dividends from the Banks, which are the Company s predominant sources of income. The following table summarizes the dividend activity for the three months ended March 31, 2013 and subsequent through the date of this filing.

Declared	Cash Dividend per Share	Record Date	Paid or Payable
January 30, 2013	$ 0.08	February 8, 2013	February 22, 2013
April 24, 2013	$ 0.08	May 10, 2013	May 24, 2013

The FDIC and the Washington DFI have the authority under their supervisory powers to prohibit the payment of dividends by Heritage Bank and Central Valley Bank to the Company. Additionally, current guidance from the Federal Reserve Board provides, among other things, that dividends per share on the Company s common stock generally should not exceed earnings per share, measured over the previous four fiscal quarters. Current regulations allow the Company and its subsidiary banks to pay dividends on their common stock if the Company s or Banks regulatory capital would not be reduced below the statutory capital requirements set by the Federal Reserve Board and the FDIC.

(c) Stock Repurchase Program

The Company has had various stock repurchase programs since March 1999. On August 30, 2012, the Board of Directors approved the Company s tenth stock repurchase plan, authorizing the repurchase of up to 5% of the Company s outstanding shares or approximately 757,000 shares. During the three months ended March 31, 2013, the Company did not repurchase shares under the plan. In total, the Company has repurchased 52,900 shares at an average price of $13.88 per share under this tenth plan. The Company repurchased 7,780 shares at an average price of $14.21 to pay withholding taxes on restricted stock that vested during the three months ended March 31, 2013.

(9) Stock-Based Compensation

Stock options generally vest ratably over three years and expire five years after they become exercisable or vest ratably over four years and expire ten years from date of grant. Restricted stock awards issued generally have a five-year cliff vesting or four year ratable vesting schedule. The Company issues new shares to satisfy share option exercises and restricted stock awards. As of March 31, 2013, 244,151 shares remain available for future issuances under stock-based compensation plans.

(a) Stock Option Awards

For the three months ended March 31, 2013 and 2012 the Company recognized compensation expense related to stock options of $22,000 and $42,000, respectively, and a related tax benefit of $0 and $1,000, respectively. As of March 31, 2013, the total unrecognized compensation expense related to non-vested stock options was $74,000 and the related weighted average period over which it is expected to be recognized is approximately 1.2 years. The intrinsic value and cash proceeds from options exercised during the three months ended March 31, 2013 totaled $6,000 and $20,000, respectively. There were no options exercised during the three months ended March 31, 2012.

The following tables summarize the stock option activity for the three months ended March 31, 2013 and 2012.

	March 31, 2013			
	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value (In thousands)
Outstanding at December 31, 2012	300,658	$ 17.48		
Granted				
Exercised	(1,800)	11.35		
Forfeited or expired	(35,735)	20.42		
Outstanding at March 31, 2013	263,123	$ 17.12	3.5 years	$ 236
Vested and expected to vest at March 31, 2013	262,902	$ 17.12	3.5 years	$ 236

Exercisable at March 31, 2013	225,647	$ 17.51	2.9 years	$ 236

Table of Contents

	March 31, 2012			
	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value (In thousands)
Outstanding at December 31, 2011	417,123	$ 18.33		
Granted				
Exercised				
Forfeited or expired	(66,745)	20.24		
Outstanding at March 31, 2012	350,378	$ 17.97	3.7 years	$ 204
Vested and expected to vest at March 31, 2012	348,040	$ 17.97	3.7 years	$ 204
Exercisable at March 31, 2012	284,407	$ 18.71	2.8 years	$ 204

(b) Restricted Stock Awards

For the three months ended March 31, 2013 and 2012, the Company recognized compensation expense related to restricted stock awards of $251,000 and $195,000, respectively, and a related tax benefit of $88,000 and $68,000, respectively. As of March 31, 2013, the total unrecognized compensation expense related to non-vested restricted stock awards was $1.9 million and the related weighted average period over which it is expected to be recognized is approximately 2.4 years. The vesting date fair value of restricted stock awards that vested during the three months ended March 31, 2013 and 2012 was $615,000 and $290,000, respectively.

The following tables summarize the restricted stock award activity for the three months ended March 31, 2013 and 2012.

	March 31, 2013	
	Shares	Weighted-Average Grant Date Fair Value
Nonvested at December 31, 2012	189,670	$ 14.86
Granted	37,197	14.31
Vested	(43,491)	16.87
Forfeited	(890)	15.64
Nonvested at March 31, 2013	182,486	$ 14.27

	March 31, 2012	
	Shares	Weighted-Average Grant Date Fair Value
Nonvested at December 31, 2011	164,880	$ 16.29
Granted	28,390	14.08
Vested	(19,574)	14.83
Forfeited	(1,541)	18.19
Nonvested at March 31, 2012	172,155	$ 16.08

Table of Contents

(10) Investment Securities

The Company s investment policy is designed primarily to provide and maintain liquidity, generate a favorable return on assets without incurring undue interest rate and credit risk, and complement our Banks lending activities. Securities are classified as either available for sale or held to maturity when acquired.

(a) Securities by Type and Maturity

The amortized cost, gross unrealized gains and losses, and fair values of investment securities at the dates indicated were as follows:

Securities Available for Sale

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(In thousands)		
March 31, 2013				
U.S. Treasury and U.S. Government-sponsored agencies	$ 5,628	$ 6	$	$ 5,634
Municipal securities	50,610	1,725	(321)	52,014
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	88,292	1,469	(261)	89,500
Total	$ 144,530	$ 3,200	$ (582)	$ 147,148
December 31, 2012				
U.S. Treasury and U.S. Government-sponsored agencies	$ 11,016	$ 19	$	$ 11,035
Municipal securities	45,537	1,943	(120)	47,360
Mortgage backed securities and collateralized mortgage obligations-residential:				