HERITAGE FINANCIAL CORP /WA/
Form 10-Q
May 09, 2011
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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, 2011

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 incorporation or organization)	**(I.R.S. Employer 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 ¨ 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 May 4, 2011 there were 15,648,809 common shares outstanding, with no par value, of the registrant.

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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: 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; 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; 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 Board of Governors of the Federal Reserve System (the Federal Reserve Board) 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, including the interpretation of regulatory capital or other rules including changes from the Dodd-Frank Wall Street Reform and Consumer Protection Act and regulations that have been or will be promulgated thereunder; our ability to control operating costs and expenses; 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 balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; computer systems on which we depend could fail or experience a security breach; 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; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired including the 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 and any goodwill charges related thereto; risks relating to acquiring assets or entering markets in which we have not previously operated and may not be familiar; 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 2011 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.

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ITEM 1. HERITAGE FINANCIAL CORPORATION

HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Dollars in thousands, except for per share amounts)

(Unaudited)

	March 31, 2011	December 31, 2010
Assets		
Cash on hand and in banks	$ 26,156	$ 37,179
Interest earning deposits	114,764	129,822
Federal funds sold		1,990
Investment securities available for sale	134,023	125,175
Investment securities held to maturity (market value of $14,085 and $14,290)	13,494	13,768
Loans held for sale	478	764
Originated loans receivable	753,190	742,019
Less: Allowance for loan losses	(21,382)	(22,062)
Originated loans receivable, net	731,808	719,957
Purchased covered loans receivable, net of allowance for loan losses of ($1,512 and $0)	123,452	128,715
Purchased non-covered loans receivable, net of allowance for loan losses of ($266 and $0)	109,860	131,049
Total loans receivable, net	965,120	979,721
FDIC indemnification asset	16,869	16,071
Other real estate owned	3,518	3,030
Premises and equipment, at cost, net	22,413	21,750
Federal Home Loan Bank stock, at cost	5,594	5,594
Accrued interest receivable	5,011	4,626
Prepaid expenses and other assets	8,467	8,974
Deferred income taxes, net	4,246	4,255
Intangible assets, net	1,840	1,953
Goodwill	13,012	13,012
Total assets	$ 1,335,005	$ 1,367,684
Liabilities and Stockholders Equity		
Deposits	$ 1,099,720	$ 1,136,276
Securities sold under agreement to repurchase	24,811	19,027
Accrued expenses and other liabilities	7,141	10,102
Total liabilities	1,131,672	1,165,405
Stockholders equity:		
Common stock, no par, 50,000,000 shares authorized; 15,648,809 and 15,568,471 shares outstanding at March 31, 2011 and December 31, 2010, respectively	128,688	128,436
Unearned compensation ESOP and other	(160)	(182)
Retained earnings	74,412	73,648
Accumulated other comprehensive income , net	393	377
Total stockholders equity	203,333	202,279
Total liabilities and stockholders equity	$ 1,335,005	$ 1,367,684

See Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in thousands, except for per share amounts)

(Unaudited)

	Three Months Ended March 31, 2011	2010
INTEREST INCOME:		
Interest and fees on loans	$ 16,572	$ 11,970
Taxable interest on investment securities	663	745
Nontaxable interest on investment securities	179	73
Interest on federal funds sold and interest bearing deposits	79	60
Total interest income	17,493	12,848
INTEREST EXPENSE:		
Deposits	1,875	2,163
Other borrowings	22	20
Total interest expense	1,897	2,183
Net interest income	15,596	10,665
Provision for loan losses	2,595	3,750
Provision for loan losses on purchased loans	1,778	
Net interest income after provision for loan losses	11,223	6,915
NON-INTEREST INCOME:		
Gains on sales of loans, net	151	66
Service charges on deposits	1,238	1,025
Merchant Visa income	699	715
FDIC loss sharing income, net	800	
Other income	590	350
Total non-interest income	3,478	2,156
NON-INTEREST EXPENSE:		
Impairment loss on investment securities	46	195
Less: Portion recorded as other comprehensive income	(20)	(5)
Impairment loss on investment securities, net	26	190
Salaries and employee benefits	6,637	4,015
Occupancy and equipment	1,846	1,027
Data processing	823	420
Marketing	315	211
Merchant Visa	569	597
Professional services	633	286
State and local taxes	356	217
Federal deposit insurance premium	456	354
Other real estate owned	517	26
Other expense	1,474	732
Total non-interest expense	13,652	8,075

Income before income taxes		1,049		996
Income tax expense		285		300
Net income	$	764	$	696
Dividends accrued and discount accreted on preferred shares				331
Net income applicable to common shareholders	$	764	$	365
Earnings per common share:				
Basic	$	0.05	$	0.03
Diluted	$	0.05	$	0.03
Dividends declared per common share:	$		$	

See Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY FOR THE THREE MONTHS ENDED

MARCH 31, 2011 AND COMPREHENSIVE INCOME FOR THE THREE MONTHS ENDED

MARCH 31, 2011 AND 2010

(Dollars and shares in thousands)

(Unaudited)

	Number of common shares	Common stock	Unearned Compensation-ESOP and other	Retained earnings	Accumulated other comprehensive income, net	Total stockholders equity
Balance at December 31, 2010	15,568	$ 128,436	$ (182)	$ 73,648	$ 377	$ 202,279
Restricted stock awards issued	79					
Stock option compensation expense		52				52
Exercise of stock options (including tax benefits from nonqualified stock options)		1				1
Share based payment and earned ESOP	2	199	22			221
Net income				764		764
Change in fair value of securities available for sale, net of reclassification adjustments					(7)	(7)
Other-than-temporary impairment on securities held to maturity, net of tax					(13)	(13)
Accretion of other-than-temporary impairment on securities held to maturity, net of tax					36	36
Balance at March 31, 2011	15,649	$ 128,688	$ (160)	$ 74,412	$ 393	$ 203,333

Comprehensive Income	Three Months Ended March 31, 2011	2010
Net income	$ 764	$ 696
Change in fair value of securities available for sale, net of tax of $(4) and $161	(7)	299
Other-than-temporary impairment on securities held-to-maturity, net of tax of $(7) and $(2)	(13)	(3)
Accretion of other-than-temporary impairment in securities held-to-maturity, net of tax of $20 and $54	36	101
Comprehensive income	$ 780	$ 1,093

See Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the three months ended March 31, 2011 and 2010

(Dollars in thousands)

(Unaudited)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Cash flows from operating activities:		
Net income	$ 764	$ 696
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	322	404
Deferred loan fees, net of amortization	18	(46)
Provision for loan losses	4,373	3,750
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities	(3,636)	(102)
Recognition of compensation related to ESOP shares and share based payment	221	101
Stock option compensation expense	52	41
Tax provision realized from stock options exercised, share based payment and dividends on unallocated ESOP shares	(1)	4
Amortization of intangible assets	113	20
Deferred income tax		15
Impairment loss on investment securities	26	190
Origination of loans held for sale	(3,230)	(3,373)
Gain on sale of loans	(151)	(66)
Proceeds from sale of loans	3,667	3,630
Valuation adjustment on other real estate owned	361	
Loss (gain) on sale of other real estate owned	13	(93)
Net cash provided by operating activities	2,912	5,171
Cash flows from investing activities:		
Loans originated, net of principal payments	8,873	8,230
Maturities of investment securities available for sale	5,562	3,719
Maturities of investment securities held to maturity	570	616
Purchase of investment securities available for sale	(14,361)	(7,976)
Purchase of investment securities held to maturity	(271)	(492)
Purchase of premises and equipment	(1,060)	(453)
Proceeds from sales of other real estate owned	475	797
Net cash (used in) provided by investing activities	(212)	4,441
Cash flows from financing activities:		
Net decrease in deposits	(36,556)	(4,232)
Preferred stock cash dividends paid		(300)
Net increase (decrease) in securities sold under agreement to repurchase	5,784	(186)
Proceeds from exercise of stock options		201
Tax provision realized from stock options exercised, share based payment and dividends on unallocated ESOP shares	1	(4)

Net cash used in financing activities	(30,771)	(4,521)
Net (decrease) increase in cash and cash equivalents	(28,071)	5,091
Cash and cash equivalents at beginning of period	168,991	107,231
Cash and cash equivalents at end of period	$ 140,920	$ 112,322
Supplemental disclosures of cash flow information:		
Cash paid for interest	$ 1,957	$ 2,193
Cash paid for income taxes	1,143	150
Loans transferred to other real estate owned	$ 1,337	$ 1,590

See Notes to Condensed Consolidated Financial Statements.

HERITAGE FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Three Months Ended March 31, 2011 and 2010

(Unaudited)

NOTE 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). is the Banks are Washington-chartered commercial banks and their deposits are insured by the Federal Deposit Insurance Corporation (FDIC) under the Deposit Insurance Fund (DIF). Heritage Bank conducts business from its main office in Olympia, Washington and its twenty-five 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 residential and commercial construction, income property, 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 commercial bank headquartered in Longview, Washington (the Cowlitz Acquisition). The Cowlitz Acquisition included nine branches of Cowlitz Bank, including its division Bay Bank, which became branches of Heritage Bank. 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 became a branch of Heritage Bank. The Cowlitz Acquisition and the Pierce Commercial Acquisition are collectively referred to as the Cowlitz and Pierce Acquisitions .

(b) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with Generally Accepted Accounting Principles, or 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. Generally Accepted Accounting Principles for complete financial statements. These condensed consolidated financial statements should be read with our December 31, 2010 audited consolidated financial statements and its accompanying notes included in our Annual Report on Form 10-K (2010 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 months ended March 31, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. 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.

Certain prior year amounts have been reclassified to conform to the current year s presentation.

(c) Significant Accounting Policies

The significant accounting policies used in preparation of our consolidated financial statements are disclosed in our 2010 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, 2010.

(d) Recently Issued Accounting Pronouncements

FASB ASU 2011-02, *Receivables (Topic 310): A Creditor s Determination of Whether a Restructuring is a Troubled Debt Restructuring* provides additional guidance to clarify when a loan modification or restructuring is considered a troubled debt restructuring (TDR) in order to address current diversity in practice and lead to more consistent application of U.S. GAAP for debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both of the following exist: (1) the restructuring constitutes a concession, and (2) the debtor is experiencing financial difficulties. The amendments to Topic 310 clarify the guidance regarding the evaluation of both considerations above. Additionally, the amendments clarify that a creditor is precluded from using the effective interest rate test in the debtor s guidance on restructuring of payables (paragraph 470-60-55-10) when evaluating whether a restructuring constitutes a TDR. This amendment is effective is July 1,

2011. Early adoption is permitted. Retrospective application to the beginning of the annual period of adoption for modifications occurring on or after the beginning of the annual adoption period is required. As a result of applying these amendments, the Company may identify receivables that are newly considered to be impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011.

FASB ASU No. 2011-01, *Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*, was issued in January 2011. ASU 2011-01 temporarily delays the effective date of the disclosures about troubled debt restructurings in Update 2010-20 for public entities. The delay is intended to allow the FASB time to complete its deliberations on what constitutes a troubled debt restructuring. The effective date of the new disclosures about troubled debt restructurings and the guidance for determining what constitutes a troubled debt restructuring will then be coordinated. Currently, that guidance is anticipated to be effective for interim and annual periods ending after June 15, 2011.

FASB ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures About Fair Value Measurements* requires expanded disclosures related to fair value measurements including (i) the amounts of significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers, (ii) the reasons for transfers of assets or liabilities in or out of Level 3 of the fair value hierarchy, with significant transfers disclosed separately, (iii) the policy for determining when transfers between levels of the fair value hierarchy are recognized and (iv) for recurring fair value measurements of assets and liabilities in Level 3 of the fair value hierarchy, a gross presentation of information about purchases, sales, issuances and settlements. ASU 2010-06 further clarifies that (i) fair value measurement disclosures should be provided for each class of assets and liabilities (rather than major category), which would generally be a subset of assets or liabilities within a line item in the statement of financial position and (ii) companies should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for each class of assets and liabilities included in Levels 2 and 3 of the fair value hierarchy. The disclosures related to the gross presentation of purchases, sales, issuances and settlements of assets and liabilities included in Level 3 of the fair value hierarchy are required for the Company beginning January 1, 2011. The remaining disclosure requirements and clarifications made by ASU 2010-06 became effective for the Company on January 1, 2010. See Note 11 Fair Value of Measurements .

NOTE 2. Loans Receivable

(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 segments 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 each of the classes carries different risk characteristics, management will discuss them separately.

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 incorporate 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 multifamily and 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 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 Bank s 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 residential properties 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. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term 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, 2011 and December 31, 2010 consisted of the following portfolio segments and classes:

	March 31, 2011	**December 31, 2010**
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 255,055	$ 232,857
Owner-occupied commercial real estate	158,206	159,444
Non-owner occupied commercial real estate	213,938	221,739
Total commercial business	627,199	614,040
One-to-four family residential	44,686	47,505
Real estate construction and land development:		
One-to-four family residential	26,927	29,377
Five or more family residential and commercial properties	32,980	28,588
Total real estate construction and land development	59,907	57,965
Consumer	22,739	23,832
Gross originated loans receivable	754,531	743,342

Deferred loan fees	(1,341)	(1,323)
Total originated loans receivable	$ 753,190	$ 742,019

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Loans acquired in a business acquisition are designated as purchased loans. Purchased loans subject to loss-sharing agreements with the FDIC are identified as covered loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are accounted for under Financial Accounting Standards Board (FASB) Accounting Standards Codification (FASB ASC) 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*, formerly AICPA SOP 03-3 *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. These loans are identified as 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,* formerly SFAS91 *Nonrefundable fees and Other Costs.* These loans are identified as other loans. Funds advanced on the 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. The subsequent advances for loans accounted for under FASB ASC 310-30 are reported with the balances of the purchased impaired covered loans despite the fact that the subsequent advances are not accounted for under FASB ASC 310-30. The total balance of subsequent advances on the purchased impaired covered loans was $7.2 million and $6.0 million as of March 31, 2011 and December 31, 2010, respectively.

The recorded investment of purchased covered loans receivable at March 31, 2011 and December 31, 2010 consisted of the following portfolio segments and classes:

	March 31, 2011	December 31, 2010
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 45,396	$ 47,048
Owner-occupied commercial real estate	43,827	45,220
Non-owner occupied commercial real estate	17,027	17,575
Total commercial business	106,250	109,843
One-to-four family residential	9,604	10,022
Real estate construction and land development:		
One-to-four family residential	5,734	5,875
Five or more family residential and commercial properties		
Total real estate construction and land development	5,734	5,875
Consumer	3,376	2,975
Total purchased loans receivable	124,964	128,715
Allowance for loan losses	(1,512)	
Purchased loans receivable, net	$ 123,452	$ 128,715

The March 31, 2011 and December 31, 2010 gross recorded investment balance of impaired purchased covered loans accounted for under FASB ASC 310-30 was $86.8 million and $90.1 million, respectively. The gross recorded investment balance of other purchased covered loans was $38.2 million and $38.6 million at March 31, 2011 and December 31, 2010, respectively.

The recorded investment of purchased non-covered loans receivable at March 31, 2011 and December 31, 2010 consisted of the following portfolio segments and classes:

	March 31, 2011	December 31, 2010
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 56,739	$ 69,049
Owner-occupied commercial real estate	17,948	18,840
Non-owner occupied commercial real estate	15,343	18,970

Total commercial business	90,030	106,859
One-to-four family residential	10,641	12,209
Real estate construction and land development:		
One-to-four family residential	3,833	3,816
Five or more family residential and commercial properties	1,241	1,244
Total real estate construction and land development	5,074	5,060
Consumer	4,381	6,921
Total purchased loans receivable	110,126	131,049
Allowance for loan losses	(266)	
Purchased loans receivable, net	$ 109,860	$ 131,049

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During the quarter ended March 31, 2011, the purchased non-covered loans were added to the Heritage Bank s loan servicing system. At that time, it was determined that certain loans should be reclassified to better represent the class of loan based on the Bank s methodology. Therefore, the December 31, 2010 loan balances have been re-classified since being reported in the Annual Report on Form 10-K.

The March 31, 2011 and December 31, 2010 gross recorded investment balance of impaired purchased non-covered loans accounted for under FASB ASC 310-30 was $69.7 million and $80.2 million, respectively. The recorded investment balance of other purchased non-covered loans was $40.4 million and $50.8 million at March 31, 2011 and December 31, 2010, 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, 2011 and December 31, 2010, there were no concentrations of loans related to any single industry in excess of 10% of total loans.

(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 nine risk grades is as follows:

Grades 0 to 5 These grades are considered pass grade 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. Overall, loans with this grade show no immediate loss exposure.

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

Grade 6 This grade is for Other Assets Especially Mentioned (OAEM) 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 the loan has a high risk. The loan also has 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 are apt to 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 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. These loans are determined to 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.

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Loan grades for all commercial loans are established at the origination of the loan. 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 public. 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 are believed to have some inherent losses in the portfolios, but at a lesser extent than the other loan grades. These pass graded loans might 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. However, the likelihood of loss is greater than Watch grade 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.

The following tables present the balance of the originated loans receivable by credit quality indicator as of March 31, 2011 and December 31, 2010.

	March 31, 2011				
	Pass	OAEM	Substandard	Doubtful	Total
	(in thousands)				
Commercial business:					
Commercial and industrial	$ 222,154	$ 3,471	$ 28,640	$ 790	$ 255,055
Owner-occupied commercial real estate	152,815	1,921	3,470		158,206
Non-owner occupied commercial real estate	202,995	6,164	4,779		213,938
Total commercial business	577,964	11,556	36,889	790	627,199
One-to-four family residential	44,230		456		44,686
Real estate construction and land development:					
One-to-four family residential	11,040	2,009	13,878		26,927
Five or more family residential and commercial properties	19,270		13,710		32,980
Total real estate construction and land development	30,310	2,009	27,588		59,907
Consumer	22,593		146		22,739
Gross originated loans	$ 675,097	$ 13,565	$ 65,079	$ 790	$ 754,531

	December 31, 2010				
	Pass	OAEM	Substandard	Doubtful	Total
	(in thousands)				
Commercial business:					
Commercial and industrial	$ 199,566	$ 2,615	$ 29,871	$ 805	$ 232,857
Owner-occupied commercial real estate	154,910	913	3,621		159,444
Non-owner occupied commercial real estate	206,178	12,991	2,570		221,739
Total commercial business	560,654	16,519	36,062	805	614,040
One-to-four family residential	46,653		850	2	47,505
Real estate construction and land development:					
One-to-four family residential	10,287	2,317	16,773		29,377
Five or more family residential and commercial properties	19,078	793	8,717		28,588
Total real estate construction and land development	29,365	3,110	25,490		57,965

Consumer	23,704		128		23,832
Gross originated loans	$ 660,376	$ 19,629	$ 62,530	$ 807	$ 743,342

The tables above include impaired loan balances. 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, 2011 and December 31, 2010 were $50.1 million and $56.1 million, respectively. The balance of potential problem originated loans guaranteed by a governmental agency was $4.2 million and $5.9 million as of March 31, 2011 and December 31, 2010, respectively. This guarantee reduces the Company s credit exposure.

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The following tables present the recorded balance of the other purchased loans receivable by credit quality indicator as of March 31, 2011 and December 31, 2010.

	March 31, 2011				
	Pass	OAEM	Substandard	Doubtful	Total
	(in thousands)				
Commercial business:					
Commercial and industrial	$ 28,869	$ 23	$ 359	$	$ 29,251
Owner-occupied commercial real estate	33,854		595		34,449
Non-owner occupied commercial real estate	7,368	508	555		8,431
Total commercial business	70,091	531	1,509		72,131
One-to-four family residential	2,341				2,341
Real estate construction and land development:					
One-to-four family residential	54				54
Five or more family residential and commercial properties					
Total real estate construction and land development	54				54
Consumer	4,043				4,043
Gross other purchased covered loans	$ 76,529	$ 531	$ 1,509	$	$ 78,569

	December 31, 2010				
	Pass	OAEM	Substandard	Doubtful	Total
	(in thousands)				
Commercial business:					
Commercial and industrial	$ 20,065	$ 117	$ 40	$	$ 20,222
Owner-occupied commercial real estate	34,844		398		35,242
Non-owner occupied commercial real estate	11,987	575			12,562
Total commercial business	66,896	692	438		68,026
One-to-four family residential	3,665				3,665
Real estate construction and land development:					
One-to-four family residential	54				54
Five or more family residential and commercial properties	152				152
Total real estate construction and land development	206				206
Consumer	17,345	144			17,489
Gross other purchased covered loans	$ 88,112	$ 836	$ 438	$	$ 89,386

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Originated nonaccrual loans, segregated by class of loans, were as follows as of March 31, 2011 and December 31, 2010:

	March 31, 2011(1)	December 31, 2010(1)
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 10,681	$ 9,934
Owner-occupied commercial real estate	723	129
Non-owner occupied commercial real estate	778	778
Total commercial business	12,182	10,841
Real estate construction and land development:		
One-to-four family residential	6,900	10,226
Five or more family residential and commercial properties	4,877	5,416
Total real estate construction and land development	11,777	15,642
Consumer		
Gross originated loans	$ 23,959	$ 26,483

(1) $3.7 million and $3.2 million of nonaccrual originated loans were guaranteed by governmental agencies at March 31, 2011 and December 31, 2010, respectively.

There were no nonaccrual loans recorded in the other purchased covered and non-covered loans as of March 31, 2011 and December 31, 2010, respectively.

The Company performs 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 class of loans, as of March 31, 2011 and December 31, 2010 are as follows.

	March 31, 2011					
	30-89 Days	Greater Than 90 Days	Total Past Due	Current	Total	> 90 Days and Still Accruing
			(in thousands)			
Commercial business:						
Commercial and industrial	$ 2,996	$ 5,684	$ 8,680	$ 246,375	$ 255,055	$ 15
Owner-occupied commercial real estate	1,824	851	2,675	155,531	158,206	128
Non-owner occupied commercial real estate		778	778	213,160	213,938	
Total commercial business	4,820	7,313	12,133	615,066	627,199	143
One-to-four family residential	844	47	891	43,795	44,686	47
Real estate construction and land development:						
One-to-four family residential		6,901	6,901	20,026	26,927	
Five or more family residential and commercial properties	793	4,876	5,669	27,311	32,980	
Total real estate construction and land development	793	11,777	12,570	47,337	59,907	
Consumer	235		235	22,504	22,739	

Gross originated loans	$ 6,692	$ 19,137	$ 25,829	$ 728,702	$ 754,531	$ 190

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	December 31, 2010					
	30-89 Days	Greater Than 90 Days	Total Past Due (in thousands)	Current	Total	> 90 days and still accruing
Commercial business:						
Commercial and industrial	$ 2,585	$ 3,561	$ 6,146	$ 226,711	$ 232,857	$ 199
Owner-occupied commercial real estate	187	1,372	1,559	157,885	159,444	594
Non-owner occupied commercial real estate	3,396	1,201	4,597	217,142	221,739	
Total commercial business	6,168	6,134	12,302	601,738	614,040	793
One-to-four family residential	624	49	673	46,832	47,505	47
Real estate construction and land development:						
One-to-four family residential		2,844	2,844	26,533	29,377	
Five or more family residential and commercial properties	941	5,416	6,357	22,231	28,588	381
Total real estate construction and land development	941	8,260	9,201	48,764	57,965	381
Consumer	42		42	23,790	23,832	
Gross originated loans	$ 7,775	$ 14,443	$ 22,218	$ 721,124	$ 743,342	$ 1,221

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The balances of other purchased past due loans, segregated by class of loans, as of March 31, 2011 and December 31, 2010 are as follows:

	March 31, 2011					
	30-89 Days	Greater Than 90 Days	Total Past Due (in thousands)	Current	Total	> 90 Days and Still Accruing
Commercial business:						
Commercial and industrial	$ 95	$	$ 95	$ 29,156	$ 29,251	$
Owner-occupied commercial real estate	155		155	34,294	34,449	
Non-owner occupied commercial real estate	445		445	7,986	8,431	
Total commercial business	695		695	71,436	72,131	
One-to-four family residential	131		131	2,210	2,341	
Real estate construction and land development:						
One-to-four family residential				54	54	
Five or more family residential and commercial properties						
Total real estate construction and land development				54	54	
Consumer	65		65	3,978	4,043	
Gross other purchased covered loans	$ 891	$	$ 891	$ 77,678	$ 78,569	$

	December 31, 2010					
	30-89 Days	Greater Than 90 Days	Total Past Due (in thousands)	Current	Total	> 90 days and still accruing
Commercial business:						
Commercial and industrial	$ 774	$	$ 774	$ 19,448	$ 20,222	$
Owner-occupied commercial real estate	9,898		9,898	25,344	35,242	
Non-owner occupied commercial real estate				12,562	12,562	
Total commercial business	10,672		10,672	57,354	68,026	
One-to-four family residential				3,665	3,665	
Real estate construction and land development:						
One-to-four family residential				54	54	
Five or more family residential and commercial properties				152	152	
Total real estate construction and land development				206	206	
Consumer	184		184	17,305	17,489	
Gross other purchased covered loans	$ 10,856	$	$ 10,856	$ 78,530	$ 89,386	$

Impaired originated loans at March 31, 2011 and December 31, 2010 are set forth in the following tables.

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	March 31, 2010					
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance	Average Recorded Investment
	(in thousands)					
Commercial business:						
Commercial and industrial	$ 5,876	$ 4,805	$ 10,681	$ 10,719	$ 1,719	$ 10,306
Owner-occupied commercial real estate	129	593	722	734	123	426
Non-owner occupied commercial real estate	1,167		1,167	1,172		1,169
Total commercial business	7,172	5,398	12,570	12,625	1,842	11,901
One-to-four family residential						
Real estate construction and land development:						
One-to-four family residential	5,988	913	6,901	8,239	323	8,564
Five or more family residential and commercial properties	3,734	5,973	9,707	12,426	308	7,561
Total real estate construction and land development	9,722	6,886	16,608	20,665	631	16,125
Consumer						
Gross originated loans	$ 16,894	$ 12,284	$ 29,178	$ 33,290	$ 2,473	$ 28,026

	December 31, 2010					
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance	Average Recorded Investment
	(in thousands)					
Commercial business:						
Commercial and industrial	$ 2,462	$ 5,691	$ 8,153	$ 9,261	$ 2,569	$ 8,909
Owner-occupied commercial real estate	129	650	779	822	163	771
Non-owner occupied commercial real estate	2,301		2,301	3,972		2,175
Total commercial business	4,892	6,341	11,233	14,055	2,732	11,855
One-to-four family residential		2	2	2	2	2
Real estate construction and land development:						
One-to-four family residential	1,804	8,423	10,227	10,183	1,664	11,228
Five or more family residential and commercial properties		5,416	5,416	6,453	201	5,697
Total real estate construction and land development	1,804	13,839	15,643	16,636	1,865	16,925
Consumer						
Gross originated loans	$ 6,696	$ 20,182	$ 26,878	$ 30,693	$ 4,599	$ 28,782

For the quarter ended March 31, 2011, no interest income was recognized subsequent to a loan s classification as impaired. For the year ended December 31, 2010, $13,000 of interest income was recognized on impaired loans.

The Company had governmental guarantees of $3.7 million and $3.2 million related to the impaired originated loan balances at March 31, 2011 and December 31, 2010, respectively.

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(f) Troubled Debt Restructured Loans

At March 31, 2011, the Company had $11.0 million in originated restructured loans, of which $5.4 million were accruing and $5.6 million were non-accruing and considered impaired. The majority of originated restructured loans were real estate construction commercial loans, in the amount of $5.0 million, followed by $4.7 million of real estate construction one-to-four family residential loans, $868,000 of commercial and industrial loans and $389,000 of non-owner occupied commercial properties. At December 31, 2010, the Company had $9.1 million in originated restructured loans, of which $394,000 were accruing and $8.7 million were non-accruing and considered impaired. The majority of originated restructured loans were real estate construction one-to-four family residential loans in the amount of $7.8 million, followed by commercial and industrial loans of $900,000 and non-owner occupied commercial properties of $400,000.

(g) Impaired Purchased Loans

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

The following tables reflect the outstanding balance at March 31, 2011 and December 31, 2010 of the purchased impaired loans:

	Cowlitz Bank	
	March 31, 2011	December 31, 2010
	(In thousands)	
Covered purchased loans:		
Commercial business:		
Commercial and industrial	$ 43,112	$ 38,636
Owner-occupied commercial real estate	23,006	24,575
Non-owner occupied commercial real estate	19,548	20,771
Total commercial business	85,666	83,982
One-to-four family residential	9,201	9,612
Real estate construction and land development:		
One-to-four family residential	10,569	10,858
Five or more family residential and commercial properties		
Total real estate construction and land development	10,569	10,858
Consumer	485	495
Gross impaired purchased covered loans	105,921	104,947
Non-covered purchased loans:		
Consumer	632	676
Total impaired purchased loans	106,553	105,623

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	Pierce Commercial Bank	
	March 31, 2011	December 31, 2010
	(In thousands)	
Non-covered purchased loans:		
Commercial business:		
Commercial and industrial	$ 47,771	$ 55,556
Owner-occupied commercial real estate	7,652	7,722
Non-owner occupied commercial real estate	8,738	8,926
Total commercial business	64,161	72,214
One-to-four family residential	11,315	12,140
Real estate construction and land development:		
One-to-four family residential	11,843	11,925
Five or more family residential and commercial properties	4,323	4,332
Total real estate construction and land development	16,166	16,257
Consumer	3,455	3,862
Gross impaired purchased non-covered loans	95,097	104,473

On 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 Cowlitz Bank and Pierce Commercial Bank impaired purchased loans as of December 31, 2010 and the changes therein through March 31, 2011.

	Cowlitz Bank	Pierce Commercial Bank
	(In thousands)	
Accretable yield at December 31, 2010	$ 20,082	$ 10,943
Accretion	(2,068)	(1,125)
Disposals and other	1,518	433
Increase in accretable yield	5,953	
Accretable yield at March 31, 2011	$ 25,485	$ 10,251

NOTE 3. 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, 2011 and March 31, 2010 are as follows:

	Three months ended	
	March 31, 2011	March 31, 2010
	(In thousands)	
Balance at the beginning of period	$ 22,062	$ 26,164
Loans charged off	(3,994)	(5,437)
Recoveries of loans charged off	719	320
Provision charged to operations	2,595	3,750

Balance at the end of period	$ 21,382	$ 24,797

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A summary of the changes in the purchased loans   allowance for loan losses for the three months ended March 31, 2011 are as follows:

	Purchased Covered	Purchased Non-Covered