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

FORM 10-Q

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

For the quarterly period ended June 30, 2004

OR

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

For the transition period from _____ to _____

Commission file number 000-23877

Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

California

77-0469558

(State or Other Jurisdiction of Incorporation or Organization)

(I.R.S. Employer Identification Number)

150 Almaden Boulevard

San Jose, California 95113

(Address of Principal Executive Offices including Zip Code)

(408) 947-6900

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES NO

APPLICABLE ONLY TO CORPORATE ISSUERS:

The Registrant had 11,666,341 shares of Common Stock outstanding on July 29, 2004

HERITAGE COMMERCE CORP

Heritage Commerce Corp and Subsidiaries Quarterly Report on Form 10-Q Table of Contents

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Part I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

HERITAGE COMMERCE CORP AND SUBSIDIARIES CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

<u>(Dollars in thousands)</u>	<u>June 30,</u> <u>2004</u>	<u>December 31,</u> <u>2003</u>
ASSETS		
Cash and due from banks.....	\$ 55,469	\$ 39,978
Interest bearing deposits in other financial institutions.....	935	2,039
Federal funds sold.....	13,800	72,200
Total cash and cash equivalents.....	70,204	114,217
Securities available-for-sale, at fair value.....	230,435	153,473
Loans held for sale, at lower of cost or market.....	31,916	30,638
Loans, net of deferred costs.....	706,857	666,088
Allowance for probable loan losses.....	(12,688)	(13,451)
Loans, net.....	694,169	652,637
Premises and equipment, net.....	3,641	4,034
Accrued interest receivable and other assets.....	22,564	20,425
Company owned life insurance.....	25,836	25,273
Other investments.....	4,622	2,504
TOTAL.....	\$ 1,083,387	\$ 1,003,201
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Deposits		
Demand, noninterest bearing.....	\$ 301,329	\$ 238,423
Demand, interest bearing.....	111,282	105,260
Savings and money market.....	364,124	345,886
Time deposits, under \$100.....	38,293	39,869
Time deposits, \$100 and over.....	96,096	94,002
Brokered deposits.....	8,045	11,970
Total deposits.....	919,169	835,410
Accrued interest payable and other liabilities.....	9,897	10,643
Other borrowings.....	39,800	43,600
Notes payable to subsidiary grantor trusts.....	23,702	23,702
Total liabilities.....	992,568	913,355
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, no par value; 10,000,000 shares authorized; none outstanding.....	--	--
Common stock, no par value; 30,000,000 shares authorized; shares issued and outstanding: 11,596,491 at June 30, 2004 and 11,381,037 at December 31, 2003.....	65,974	65,234
Unallocated ESOP shares.....	(318)	(443)
Accumulated other comprehensive income (loss), net of taxes.....	(2,620)	79
Retained earnings.....	27,783	24,976
Total shareholders' equity.....	90,819	89,846
TOTAL.....	\$ 1,083,387	\$ 1,003,201

See notes to condensed consolidated financial statements

HERITAGE COMMERCE CORP AND SUBSIDIARIES
CONDENSED CONSOLIDATED INCOME STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Interest income:				
Loans, including fees.....	\$ 10,912	\$ 10,799	\$ 21,427	\$ 21,983
Securities, taxable.....	1,615	814	2,898	1,882
Securities, non-taxable.....	70	83	185	180
Interest bearing deposits in other financial institutions.....	1	18	4	35
Federal funds sold.....	92	159	161	241
Total interest income	12,690	11,873	24,675	24,321
Interest expense:				
Deposits.....	1,579	2,052	3,160	4,332
Subsidiary grantor trusts.....	481	489	963	979
Other.....	238	11	364	14
Total interest expense	2,298	2,552	4,487	5,325
Net interest income before provision for probable				
loan losses.....	10,392	9,321	20,188	18,996
Provision for probable loan losses.....	600	600	1,200	1,900
Net interest income after provision for probable	9,792	8,721	18,988	17,096
Noninterest income:				
Gain on sale of loans.....	639	587	1,366	1,144
Servicing income.....	561	451	1,066	876
Service charges and other fees on deposit accounts.....	497	441	970	852
Appreciation of company owned life insurance	234	303	562	637
Gain on sale of securities available-for-sale.....	264	33	476	458
Mortgage brokerage fees	30	277	149	640
Other.....	79	424	189	873
Total noninterest income	2,304	2,516	4,778	5,480
Noninterest expenses:				
Salaries and employee benefits.....	5,456	4,521	10,176	9,224
Occupancy.....	880	835	1,930	1,654
Professional fees.....	961	419	1,316	690
Loan origination costs.....	411	360	768	677
Advertising and promotion.....	252	228	499	399
Furniture and equipment.....	255	367	492	758
Client services.....	231	225	416	475
Telephone.....	86	67	199	150
Stationery & supplies.....	82	57	152	163
Other.....	2,302	1,407	3,681	2,796
Total noninterest expenses	10,916	8,486	19,629	16,986
Income before provision for income taxes.....	1,180	2,751	4,137	5,590
Provision for income taxes.....	380	880	1,330	1,790
Net income	\$ 800	\$ 1,871	\$ 2,807	\$ 3,800
Earnings per share:				
Basic.....	\$ 0.07	\$ 0.17	\$ 0.24	\$ 0.34
Diluted.....	\$ 0.07	\$ 0.16	\$ 0.24	\$ 0.33

See notes to condensed consolidated financial statements

HERITAGE COMMERCE CORP AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN
SHAREHOLDERS' EQUITY (UNAUDITED)

<u>(Dollars in thousands)</u>	<u>Common Stock</u>		<u>Unallocated ESOP Shares</u>	<u>Accumulated Other Comprehensive Income (Loss) Net of Taxes</u>	<u>Retained Earnings</u>	<u>Total Shareholders' Equity</u>	<u>Other Comprehensive Income</u>
	<u>Shares</u>	<u>Amount</u>		<u>Net of Taxes</u>	<u>Earnings</u>	<u>Equity</u>	<u>Income</u>
BALANCES, DECEMBER 31, 2002.....	11,214,414	\$ 64,002	\$ (693)	\$ 1,714	\$ 17,194	\$ 82,217	
Net income.....	--	--	--	--	3,800	3,800	\$ 3,800
Net change in unrealized loss on securities available-for-sale, net of reclassification adjustment and taxes.....	--	--	--	(209)	--	(209)	<u>(209)</u>
							<u>\$ 3,591</u>
Total comprehensive income.....							
Amortization of stock compensation.....	--	--	125	--	--	125	
Additional paid-in-capital in ESOP.....	--	43	--	--	--	43	
Stock options exercised.....	82,454	753	--	--	--	753	
BALANCES, JUNE 30, 2003.....	<u>11,296,868</u>	<u>\$ 64,798</u>	<u>\$ (568)</u>	<u>\$ 1,505</u>	<u>\$ 20,994</u>	<u>\$ 86,729</u>	
 BALANCES, DECEMBER 31, 2003.....	11,381,037	\$ 65,234	\$ (443)	\$ 79	\$ 24,976	\$ 89,846	
Net income.....	--	--	--	--	2,807	2,807	\$ 2,807
Net change in unrealized loss on securities available-for-sale, net of reclassification adjustment and taxes.....	--	--	--	(2,699)	--	(2,699)	<u>(2,699)</u>
Total comprehensive income.....							<u>\$ 108</u>
Amortization of stock compensation.....	--	--	125	--	--	125	
Additional paid-in-capital in ESOP.....	--	103	--	--	--	103	
Common stock repurchased.....	(132,789)	(1,934)	--	--	--	(1,934)	
Stock options exercised.....	348,243	2,571	--	--	--	2,571	
BALANCES, JUNE 30, 2004.....	<u>11,596,491</u>	<u>\$ 65,974</u>	<u>\$ (318)</u>	<u>\$ (2,620)</u>	<u>\$ 27,783</u>	<u>\$ 90,819</u>	

See notes to condensed consolidated financial statements

HERITAGE COMMERCE CORP AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands)	Six Months Ended	
	June 30,	
	2004	2003
Cash flows from operating activities:		
Net income.....	\$ 2,807	\$ 3,800
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization.....	783	844
Provision for probable loan losses.....	1,200	1,900
Non-cash compensation expense related to ESOP plan.....	228	168
Gain on sale of securities available-for-sale.....	(476)	(458)
Net amortization of premiums / accretion of discounts.....	455	686
Gains on sales of loans held for sale.....	(1,366)	(1,144)
Proceeds from sales of loans held for sale.....	27,392	23,751
Originations of loans held for sale.....	(33,747)	(36,721)
Maturities of loans held for sale.....	6,443	14,327
Appreciation of company owned life insurance.....	(562)	(637)
Effect of changes in:		
Accrued interest receivable and other assets.....	(1,968)	(119)
Accrued interest payable and other liabilities.....	1,167	(1,242)
Net cash provided by operating activities.....	2,356	5,155
 Cash flows from investing activities:		
Net (increase) decrease in loans.....	(42,733)	35,910
Purchases of securities available-for-sale.....	(117,735)	(82,904)
Maturities/paydowns/calls of securities available-for-sale.....	13,371	28,847
Proceeds from sales of securities available-for-sale.....	22,641	23,562
(Purchases) Redemption of other investments.....	(2,118)	1,234
Purchases of premises and equipment.....	(391)	(293)
Net cash (used in) provided by investing activities.....	(126,965)	6,356
 Cash flows from financing activities:		
Net increase in deposits.....	83,759	5,969
Net proceeds from issuance of common stock.....	2,571	753
Common stock repurchased.....	(1,934)	--
Net change in other borrowings.....	(3,800)	28,600
Net cash provided by financing activities.....	80,596	35,322
Net (decrease) increase in cash and cash equivalents.....	(44,013)	46,833
Cash and cash equivalents, beginning of period.....	114,217	86,632
Cash and cash equivalents, end of period.....	\$ 70,204	\$ 133,465
 Supplemental disclosures of cash paid during the period for:		
Interest.....	\$ 4,555	\$ 5,919
Income taxes.....	\$ --	\$ 1,570
 Supplemental schedule on non-cash investing and financing activity:		
Transfer of loans to other real estate owned.....	\$ --	\$ 832

See notes to condensed consolidated financial statement

HERITAGE COMMERCE CORP AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements
June 30, 2004
(Unaudited)

1) Basis of Presentation

The unaudited condensed consolidated financial statements of Heritage Commerce Corp (the "Company") and its wholly owned subsidiary: Heritage Bank of Commerce ("HBC" or the "Bank") have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ("GAAP") for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Form 10-K for the year ended December 31, 2003. The Company has also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III which are Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities.

HBC is a commercial bank serving customers located in Santa Clara, Alameda, and Contra Costa counties of California. No customer accounts for more than 10 percent of revenue for HBC or the Company. Management evaluates the Company's performance as a whole and does not allocate resources based on the performance of different lending or transaction activities. Accordingly, the Company and its subsidiary operate as one business segment.

In the Company's opinion, all adjustments necessary for a fair presentation of these condensed consolidated financial statements have been included and are of a normal and recurring nature. Certain reclassifications have been made to prior year amounts to conform to current year presentation.

The results for the three months and six months ended June 30, 2004 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2004.

2) New Accounting Standard

At the March 17-18, 2004 Emerging Issues Task Force (EITF) meeting, the Task Force reached a consensus on Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." Issue 03-1 provides guidance for the determination of when an investment is other-than-temporarily impaired. The guidance for evaluating whether an investment is other-than-temporarily impaired should be applied in other-than-temporary impairment evaluations made in reporting periods beginning after June 15, 2004. Other-than-temporary impairment that may need to be recognized upon adoption of Issue 03-1 will be dependant on market conditions and management's intent and ability at the time of the impairment evaluation to hold investments with market values below amortized cost until a forecasted recovery in fair value up to (or beyond) amortized cost. Management is in the process of evaluating the impacts of EITF 03-1 guidance.

As of June 30, 2004, the Company held 99 securities, of which 78 had market values below amortized cost. No securities have been carried with an unrealized loss for over 12 months. The lower market values are due to either current interest rates or new issue rates being greater at June 30, 2004 than when the securities were purchased. No security has sustained other than temporary loss of value due to a downgrade in credit ratings. All principal amounts are expected to be paid when securities mature, or are called by the issuer. The lower market values are considered temporary and not a permanent impairment.

3) Stock-Based Compensation

The Company accounts for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. No compensation expense has been recognized in the financial statements for employee stock arrangements, as the Company's stock option plan provides for the issuance of options at a price of no less than the fair market value at the date of the grant.

SFAS No. 123, Accounting for Stock-Based Compensation, requires the disclosure of pro forma net income and earnings per share had the Company adopted the fair value method at the grant date of all stock options. Under SFAS No. 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which differ significantly from the Company's stock option awards. Those models also require subjective assumptions, which greatly affect the calculated values. The Company's calculations were made using the Black-Scholes option pricing model with the following weighted average assumptions: expected life, 84 months; risk-free interest rate, 4.35% and 2.84% for June 30, 2004 and 2003; stock volatility of 31.37% and 16.76% in June 30, 2004 and 2003; and no dividends during the expected term. The Company's calculations are based on a multiple option valuation approach, and forfeitures are recognized as they occur.

Had compensation expense for the Company's stock option plan been determined under the requirements of SFAS No. 123, the Company's pro forma net income and earnings per common share would have been as follows:

(Dollars in thousands, except per share data)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
Net income				
As reported.....	\$ 800	\$ 1,871	\$ 2,807	\$ 3,800
Less: Compensation expense for amortization of fair value of stock awards, net of taxes.....	(202)	(177)	(403)	(353)
Pro forma.....	<u>\$ 598</u>	<u>\$ 1,694</u>	<u>\$ 2,404</u>	<u>\$ 3,447</u>
Net income per common share - basic				
As reported.....	\$ 0.07	\$ 0.17	\$ 0.24	\$ 0.34
Pro forma.....	\$ 0.05	\$ 0.15	\$ 0.21	\$ 0.31
Net income per common share - diluted				
As reported.....	\$ 0.07	\$ 0.16	\$ 0.24	\$ 0.33
Pro forma.....	\$ 0.05	\$ 0.15	\$ 0.20	\$ 0.30

4) Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted average common shares outstanding. Diluted earnings per share reflects potential dilution from outstanding stock options, using the treasury stock method. There were 16,830 and 324,389, respectively, stock options for three months ended June 30, 2004 and 2003, 118,816 and 310,386, respectively, for six months ended June 30, 2004 and 2003 considered to be antidilutive and excluded from the computation of diluted earnings per share. For each of the periods presented, net income is the same for basic and diluted earnings per share. Reconciliation of weighted average shares used in computing basic and diluted earnings per share is as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
Weighted average common shares outstanding - used in computing basic earnings per share.....	11,543,552	11,172,143	11,463,679	11,158,015
Dilutive effect of stock options outstanding, using the treasury stock method.....	<u>411,020</u>	<u>385,108</u>	<u>445,384</u>	<u>329,615</u>
Shares used in computing diluted earnings per share.....	<u>11,954,572</u>	<u>11,557,251</u>	<u>11,909,063</u>	<u>11,487,630</u>

5) Comprehensive Income (Loss)

Comprehensive income (loss) includes net income and other comprehensive income (loss), which represents the change in the Company's net assets during the period from non-owner sources. The Company's sources of other comprehensive income (loss) are unrealized gains and losses on securities available-for-sale and I/O strips, which are treated like available-for-sale securities, and are presented net of tax. Reclassification adjustments resulting from gains or losses on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive income (loss) as unrealized holding gains or losses in the period in which they arose are excluded from comprehensive income (loss) of the current period. The Company's total comprehensive income (loss) was as follows:

<u>(Dollars in thousands)</u>	<u>Three Months Ended</u> <u>June 30,</u>		<u>Six Months Ended</u> <u>June 30,</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Net income.....	\$ 800	\$ 1,871	\$ 2,807	\$ 3,800
Other comprehensive income (loss), net of tax:				
Net unrealized holding gain (loss) on available-for-sale securities and I/O strips during the period.....	(3,362)	165	(2,376)	102
Less: reclassification adjustment for realized gain on available-for-sale securities included in net income during the period.....	(179)	(22)	(323)	(311)
Other comprehensive income (loss).....	<u>(3,541)</u>	<u>143</u>	<u>(2,699)</u>	<u>(209)</u>
Comprehensive income (loss).....	\$ <u>(2,741)</u>	\$ <u>2,014</u>	\$ <u>108</u>	\$ <u>3,591</u>

6) Employee Termination Benefits

In the second quarter of 2004, the Company had \$972,000 of charges related to the elimination of 11 full-time positions and the resignation of the former CEO which was recorded as severance in salaries and employee benefits. At June 30, 2004, \$861,000 accrued severance has been recorded under other liabilities. In addition, \$689,000 of retirement plan expense has been recorded in other noninterest expense in the second quarter of 2004 related to the resignation of the former CEO and 3 executive employees out of the 11 full-time positions.

7) Supplemental Retirement Plan

The Company has a supplemental retirement plan (Plan) covering key executives and directors. The Plan is a nonqualified defined benefit plan and is unsecured and unfunded and there are no Plan assets. For the current fiscal year ending December 31, 2004, the Company estimates the contributions to be paid to the Plan will be \$1,800,000 of which \$981,000 and \$1,218,000 were paid for the three and six months ended June 30, 2004. The following table presents the amount of periodic benefit cost recognized for three and six months ended June 30, 2004 and 2003:

<u>(Dollars in thousands)</u>	<u>Three Months Ended</u> <u>June 30,</u>		<u>Six Months Ended</u> <u>June 30,</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Components of net periodic benefits cost				
Service cost.....	\$ 160	\$ 114	\$ 342	\$ 228
Interest cost.....	109	49	211	99
Amortization of (gain)/loss.....	41	(6)	81	(12)
Net periodic benefit cost.....	\$ <u>310</u>	\$ <u>157</u>	\$ <u>634</u>	\$ <u>315</u>

8) Commitments and Contingencies

Financial Instruments with Off-Balance Sheet Risk

HBC is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the

financing needs of its clients. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk, in excess of the amounts recognized in the balance sheets.

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

Commitments to extend credit as of June 30, were as follows:

(Dollars in thousands)	2004	2003
Commitments to extend credit.....	\$ 279,044	\$ 277,936
Standby letters of credit.....	4,588	2,339
	<u>\$ 283,632</u>	<u>\$ 280,275</u>

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

Standby letters of credit are written with conditional commitments issued by HBC to guaranty the performance of a client to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to clients. The Company has a deferred liability of \$28,000 as of June 30, 2004, which represents the fees received on the outstanding financial standby letters of credit. The Company recognizes these fees as income as the commitments are used or as they expire.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Discussions of certain matters in this Report on Form 10-Q may constitute forward looking statements within the meaning of Section 27A of the Securities Exchange Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and as such, may involve risks and uncertainties. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies, and expectations, are generally identifiable by the use of words such as "believe", "expect", "intend", "anticipate", "estimate", "project", or similar expressions. These forward-looking statements relate to, among other things, expectations of the business environment in which the Company operates, projections of future performance, potential future performance, potential future credit experience, perceived opportunities in the market, and statements regarding the Company's mission and vision. The Company's actual results, performance, and achievements may differ materially from the results, performance, and achievements expressed or implied in such forward-looking statements due to a wide range of factors. The factors include, but are not limited to changes in interest rates, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the US Government, real estate valuations, competition in the financial services industry, and other risks. For additional information relating to the risks of the Company's business see "Risk Factors" in the Company's Annual Report on Form 10-K. All of the Company's operations and most of its customers are located in California. California economic outlook could have an effect on the future operations of the Company or its customers, including borrowers. The Company does not undertake, and specifically disclaims any obligation, to update any forward-

looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

Heritage operates as the bank holding company for its subsidiary bank: Heritage Bank of Commerce. HBC is a California state chartered bank, which offers a full range of commercial and personal banking services to residents and the business/professional community in Santa Clara, Contra Costa and Alameda Counties.

CRITICAL ACCOUNTING POLICIES

General

Heritage Commerce Corp's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The financial information contained within our financial statements is, to a significant extent, based on approximate measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. In certain instances, the Company uses the discount factor and prepayment assumptions to determine the present value of assets and liabilities. A change in the discount factor or prepayment spreads could increase or decrease the values of those assets and liabilities which would result in either a beneficial or adverse impact to the Company's financial results. The Company used historical loss experience as one factor in determining the inherent loss that may be present in the Company's loan portfolio. Actual losses could differ significantly from the historical factors that we use. Other estimates that the Company used are related to the expected useful lives of the Company's depreciable assets. In addition GAAP itself may change from one previously acceptable method to another method. Although the economics of the Company's transactions would be the same, the timing of events that would impact the Company's transactions could change.

Allowance for Probable Loan Losses

The allowance for probable loan losses is an estimate of the losses that may be sustained in the Company's loan portfolio. The allowance is based on two basic principles of accounting. (1) Statement of Financial Accounting Standards ("SFAS") No. 5 "Accounting for Contingencies", which requires that losses be accrued when they are probable of occurring and estimable and (2) SFAS No. 114, "Accounting by Creditors for Impairment of a Loan", which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance.

The Company's allowance for probable loan losses has three basic components: the formula allowance, the specific allowance and the unallocated allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The formula allowance uses an historical loss view as an indicator of probable future losses and as a result could differ from the losses incurred in the future. The specific allowance uses various techniques to arrive at an estimate of loss. Historical loss information, and fair market value of collateral are used to estimate those losses. The use of these values is inherently subjective and our actual losses could be greater or less than the estimates. The unallocated allowance captures losses that are attributable to various economic events, industry or geographic sectors whose impact on the portfolio have occurred but have yet to be recognized in either the formula or specific allowances. For further information regarding our allowance for credit losses, see Allowance for Probable Loan Losses on page 22.

Loan Sales and Servicing

The amounts of gains recorded on sales of loans and the initial recording of servicing assets and interest only strips is based on the estimated fair values of the respective components. In recording the initial value of the servicing assets and the fair value of the Interest-Only (I/O) strips receivable, the Company uses estimates which are made based on management's expectations of future prepayment and discount rates. For the quarter ended June 30, 2004, management's estimate of constant prepayment rate ("CPR") was 14% and the weighted average discount rate assumption was 10%. These prepayment and discount rates were based on current market conditions and historical

performance of the various pools of loans. If actual prepayments with respect to sold loans occur more quickly than projected the carrying value of the servicing assets may have to be adjusted through a charge to earnings. Variations in prevailing interest rates on borrowed funds, changes in general economic conditions, among other factors, could cause changes in the prepayment experience. A corresponding decrease in the value of the I/O strip receivable would also be expected.

Stock Based Awards

The Company accounts for its stock based awards using the intrinsic value method in accordance with Accounting Principles Board (“APB”) Opinion No. 25 and related interpretations. Since the Company’s stock option plans provide for the issuance of options at a price of no less than the fair market value at the date of the grant, no compensation expense has been recognized in the financial statements at the date of grant.

RESULTS OF OPERATIONS

Overview

Net income for the three and six months ended June 30, 2004 was \$800,000 and \$2,807,000, down \$1,071,000 and \$993,000, or 57% and 26%, respectively, as compared to the three and six months ended June 30, 2003. Earnings per diluted share for the three and six months ended June 30, 2004 were \$0.07 and \$0.24, respectively, down 56% and 27% from \$0.16 and \$0.33 per diluted share for the three and six months ended June 30, 2003, respectively. Annualized return on average assets and return on average equity for the three months ended June 30, 2004 were 0.30% and 3.47%, respectively, down from 0.81% and 8.75%, respectively, for the same period in the prior year. Annualized return on average assets and return on average equity for the six months ended June 30, 2004 were 0.55% and 6.14%, respectively, down from 0.83% and 9.03%, respectively, for the same period in the prior year. The significant decrease in net income and earnings per share for the comparable 2003 and 2004 periods is primarily attributable to non-recurring expenses related to the elimination of 11 full time positions to reduce operating costs and the resignation of the former CEO. The non-recurring expenses were partially offset by increases in net interest income.

For the three and six months ended June 30, 2004, as compared with the same period in the prior year, net interest income before provision for probable loan losses increased to \$10,392,000 and \$20,188,000 from \$9,321,000 and \$18,996,000, an increase of \$1,071,000, or 11% and \$1,192,000, or 6%, respectively. The Company's net interest margin was 4.27% and 4.32% for the three and six months ended June 30, 2004, compared with 4.38% and 4.51% for the three and six months ended June 30, 2003, respectively.

Total assets as of June 30, 2004 were \$1,083,387,000, an increase of \$86,936,000, or 9%, from \$996,451,000 as of June 30, 2003, and an increase of \$80,186,000, or 8%, from total assets of \$1,003,201,000 as of December 31, 2003. Total deposits as of June 30, 2004 were \$919,169,000, an increase of \$71,264,000, or 8%, from \$847,905,000 as of June 30, 2003, and an increase of \$83,759,000, or 10%, from total deposits of \$835,410,000 as of December 31, 2003.

The total loan portfolio as of June 30, 2004 was \$706,857,000, an increase of \$69,294,000, or 11%, from \$637,563,000 as of June 30, 2003 and an increase of \$40,769,000, or 6%, from \$666,088,000 as of December 31, 2003. The Company's allowance for probable loan losses was \$12,688,000, or 1.79%, of total loans at June 30, 2004. This compares to an allowance for probable loan losses of \$14,692,000, or 2.30%, and \$13,451,000, or 2.02% of total loans at June 30, 2003 and December 31, 2003, respectively. The decrease in the overall level of the allowance of loan losses since December 31, 2003 is primarily the result of a \$2,000,000 charge-off related to one unsecured commercial loan in the first quarter of 2004 which was provided for in 2003 offset by the provisions made during the period. The Company's nonperforming assets were \$2,632,000, compared to \$2,631,000 as of June 30, 2003 and \$4,580,000 as of December 31, 2003.

The Company's shareholders' equity at June 30, 2004 was \$90,819,000, up from \$86,729,000 at June 30, 2003 and \$89,846,000 as of December 31, 2003. The increase in shareholders' equity is a result of the income generated over the period and the exercise of common stock options offset by repurchase of common stock and a decline in other comprehensive income from fair value changes. Book value per share increased to \$7.83 at June 30, 2004, from \$7.68 at June 30, 2003. Book value per share was \$7.89 at December 31, 2003. The Company's leverage capital ratio was 10.67% at June 30, 2004 compared to 11.46% at June 30, 2003 and 11.17% at December 31, 2003.

Net Interest Income and Net Interest Margin

The following table presents the Company's average balance sheet, net interest income and the resultant yields and rates paid for the period presented:

(Dollars in thousands)	For the Three Months Ended June 30, 2004			For the Three Months Ended June 30, 2003		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
Assets:						
Loans, gross.....	\$ 718,700	\$ 10,912	6.11%	\$ 672,717	\$ 10,799	6.44%
Investment securities.....	220,990	1,685	3.07%	119,062	897	3.02%
Interest bearing deposits in other financial institutions....	607	1	0.66%	8,151	18	0.89%
Federal funds sold.....	<u>38,742</u>	<u>92</u>	0.96%	<u>54,025</u>	<u>159</u>	1.18%
Total interest earning assets.....	979,039	\$ <u>12,690</u>	5.21%	853,955	\$ <u>11,873</u>	5.58%
Cash and due from banks.....	50,239			39,016		
Premises and equipment, net.....	3,812			4,944		
Other assets.....	<u>32,916</u>			<u>33,156</u>		
Total assets.....	\$ <u>1,066,006</u>			\$ <u>931,071</u>		
Liabilities and shareholders' equity:						
Deposits:						
Demand, interest bearing.....	\$ 110,531	\$ 115	0.42%	\$ 96,564	\$ 136	0.56%
Savings and money market.....	350,445	866	0.99%	303,219	933	1.23%
Time deposits, under \$100.....	39,211	137	1.41%	44,530	220	1.98%
Time deposits, \$100 and over.....	98,457	348	1.42%	103,542	491	1.90%
Brokered deposits.....	10,102	113	4.50%	26,592	272	4.10%
Other borrowings.....	<u>71,520</u>	<u>719</u>	4.05%	<u>26,235</u>	<u>500</u>	7.64%
Total interest bearing liabilities.....	680,266	\$ <u>2,298</u>	1.36%	600,682	\$ <u>2,552</u>	1.70%
Demand, noninterest bearing.....	283,460			235,557		
Other liabilities.....	<u>9,639</u>			<u>9,043</u>		
Total liabilities.....	973,365			845,282		
Shareholders' equity.....	<u>92,641</u>			<u>85,789</u>		
Total liabilities and shareholders' equity.....	\$ <u>1,066,006</u>			\$ <u>931,071</u>		
Net interest income / margin.....		\$ <u>10,392</u>	4.27%		\$ <u>9,321</u>	4.38%

Note: Yields and amounts earned on loans include loan fees of \$1,049,000 and \$954,000 for the three month periods ended June 30, 2004 and 2003, respectively. Interest income is reflected on an actual basis, not a fully taxable equivalent basis, and does not include a fair value adjustment. Nonaccrual loans of \$2,102,000 and \$767,000 for the period ended June 30, 2004 and 2003, respectively, are included in the average balance calculation above.

	For the Six Months Ended June 30, 2004			For the Six Months Ended June 30, 2003		
	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense	Average Yield/ Rate
(Dollars in thousands)						
Assets:						
Loans, gross.....	\$ 705,161	\$ 21,427	6.11%	\$ 683,284	\$ 21,983	6.49%
Investment securities.....	198,587	3,083	3.12%	117,991	2,062	3.52%
Interest bearing deposits in other financial institutions....	1,322	4	0.61%	7,736	35	0.91%
Federal funds sold.....	33,943	161	0.95%	41,020	241	1.18%
Total interest earning assets.....	939,013	\$ 24,675	5.28%	850,031	\$ 24,321	5.77%
Cash and due from banks.....	47,638			38,110		
Premises and equipment, net.....	3,898			5,079		
Other assets.....	32,347			33,449		
Total assets.....	\$ <u>1,022,896</u>			\$ <u>926,669</u>		
Liabilities and shareholders' equity:						
Deposits:						
Demand, interest bearing.....	\$ 108,337	\$ 234	0.43%	\$ 94,610	\$ 283	0.60%
Savings and money market.....	343,404	1,707	1.00%	302,988	1,908	1.27%
Time deposits, under \$100.....	39,411	279	1.42%	44,847	463	2.08%
Time deposits, \$100 and over.....	97,354	697	1.44%	105,698	1,040	1.98%
Brokered deposits.....	10,877	243	4.49%	32,269	638	3.99%
Other borrowings.....	62,207	1,327	4.29%	25,475	993	7.86%
Total interest bearing liabilities.....	661,590	\$ 4,487	1.36%	605,887	\$ 5,325	1.77%
Demand, noninterest bearing	259,076			226,595		
Other liabilities.....	10,220			9,319		
Total liabilities.....	930,886			841,801		
Shareholders' equity.....	92,010			84,868		
Total liabilities and shareholders' equity.....	\$ <u>1,022,896</u>			\$ <u>926,669</u>		
Net interest income / margin.....		\$ <u>20,188</u>	4.32%		\$ <u>18,996</u>	4.51%

Note: Yields and amounts earned on loans include loan fees of \$2,040,000 and \$2,055,000 for the six month periods ended June 30, 2004 and 2003, respectively. Interest income is reflected on an actual basis, not a fully taxable equivalent basis, and does not include a fair value adjustment. Nonaccrual loans of \$2,102,000 and \$767,000 for the period ended June 30, 2004 and 2003, respectively, are included in the average balance calculation above.

The Company's net interest income before provision for probable loan losses for the three and six months ended June 30, 2004 was \$10,392,000 and \$20,188,000, an increase of \$1,071,000 or 11% and \$1,192,000 or 6% over the same periods in the prior year. For the three and six months ended June 30, 2004 compared to the same periods in the prior year, average interest earning assets increased by \$125,084,000, or 15% and \$88,982,000, or 10%. For the three months ended June 30, 2004, the average yield on interest earning assets was 5.21%, down 37 basis points from 5.58% for the same period in 2003. Over the same period the rates paid on interest bearing liabilities declined 34 basis points to 1.36% from 1.70%. For the six months ended June 30, 2004, the average yield on interest earning assets was 5.28%, down 49 basis points from 5.77% for the same period in 2003. Over the same period the rates paid on interest bearing liabilities declined 41 basis points to 1.36% from 1.77%. As a result, the net interest margin decreased 11 basis points to 4.27% for the three months ended June 30, 2004 from 4.38% for the same period in the prior year and decreased 19 basis points to 4.32% for the six months ended June 30, 2004 from 4.51% for the same period in the prior year. The slight decrease in net interest margin in the second quarter and for the six month period was primarily attributable to a decrease in market rates of interest and a change in mix of earning assets with loans, the highest yielding assets, decreasing as a percentage of total earning assets. The increase in average interest bearing liabilities was primarily attributable to growth in demand interest bearing, savings and money market deposits, offset by a decrease of time and brokered deposits and an increase in other borrowings, primarily fixed rate repurchase agreements with maturity of one to five years. The changes in volume contributed

\$1,049,000 to net interest income while the effect of the changes in rates produced an increase of \$22,000 resulting in the overall increase of \$1,071,000 for the three months ended June 30, 2004 from 2003. The changes in volume contributed \$1,426,000 to net interest income while the effect of the changes in rates reduced the contribution by \$234,000 resulting in the overall increase of \$1,192,000 for the six months ended June 30, 2004 from 2003.

The following table sets forth an analysis of the changes in interest income resulting from changes in the average volume of interest earning assets and liabilities and changes in the average rates earned and paid. The total change is shown in the column designated "Net Change" and is allocated in the columns to the left, to the portions respectively attributable to volume changes and rate changes that occurred during the period indicated. Changes due to both volume and rate have been allocated to the change in volume.

(Dollars in thousands)	Three Months Ended June 30, 2004 vs. 2003		
	Increase (Decrease) Due to Change In:		
	Average Volume	Average Rate	Net Change
Interest earning assets			
Loans, gross.....	\$ 692	\$ (579)	\$ 113
Investments securities.....	776	12	788
Interest bearing deposits in other financial institutions.....	(12)	(5)	(17)
Federal funds sold.....	(37)	(30)	(67)
Total interest earning assets.....	<u>\$ 1,419</u>	<u>\$ (602)</u>	<u>\$ 817</u>
Interest bearing liabilities			
Demand, interest bearing.....	16	(38)	(22)
Savings and money market.....	120	(187)	(67)
Time deposits, under \$100.....	(19)	(64)	(83)
Time deposits, \$100 and over.....	(18)	(125)	(143)
Brokered Deposits.....	(185)	26	(159)
Other borrowings.....	456	(236)	220
Total interest bearing liabilities.....	<u>\$ 370</u>	<u>\$ (624)</u>	<u>\$ (254)</u>
Net interest income.....	<u>\$ 1,049</u>	<u>\$ 22</u>	<u>\$ 1,071</u>

(Dollars in thousands)	Six Months Ended June 30, 2004 vs. 2003		
	Increase (Decrease) Due to Change In:		
	Average Volume	Average Rate	Net Change
Interest earning assets			
Loans, gross.....	\$ 667	\$ (1,223)	\$ (556)
Investments securities.....	1,252	(231)	1,021
Interest bearing deposits in other financial institutions.....	(19)	(12)	(31)
Federal funds sold.....	(33)	(47)	(80)
Total interest earning assets.....	<u>\$ 1,867</u>	<u>\$ (1,513)</u>	<u>\$ 354</u>
Interest bearing liabilities			
Demand, interest bearing.....	\$ 32	\$ (81)	\$ (49)
Savings and money market.....	200	(401)	(201)
Time deposits, under \$100.....	(38)	(146)	(184)
Time deposits, \$100 and over.....	(60)	(283)	(343)
Brokered Deposits.....	(477)	82	(395)
Other borrowings.....	784	(450)	334
Total interest bearing liabilities.....	<u>\$ 441</u>	<u>\$ (1,279)</u>	<u>\$ (838)</u>
Net interest income.....	<u>\$ 1,426</u>	<u>\$ (234)</u>	<u>\$ 1,192</u>

Provision for Probable Loan Losses

The provision for probable loan losses represents the current period expense associated with maintaining an appropriate allowance for credit losses. The loan loss provision and level of allowance for each period is dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of the quality of the loan portfolio, the valuation of problem loans and the general economic conditions in the Company's market area. Periodic fluctuations in the provision for loan losses result from management's assessment of the adequacy of the allowance for probable loan losses; however, actual loan losses may vary from current estimates. For the three and six months ended June 30, 2004, the provision for probable loan losses was \$600,000 and \$1,200,000, compared to \$600,00 and \$1,900,000 for the same periods in the prior year. See additional discussion at Allowance for Probable Loan Losses on page 22.

Noninterest Income

The following table sets forth the various components of the Company's noninterest income for the periods indicated:

(Dollars in thousands)	Three Months Ended June 30,		Increase (decrease) 2004 versus 2003	
	2004	2003	Amount	Percent
Gain on sale of loans.....	\$ 639	\$ 587	\$ 52	9 %
Servicing income.....	561	451	110	24 %
Service charges and other fees on deposit accounts.....	497	441	56	13 %
Appreciation of company owned life insurance.....	234	303	(69)	(23)%
Gain on sale of securities available-for-sale.....	264	33	231	700 %
Mortgage brokerage fees.....	30	277	(247)	(89)%
Other.....	79	424	(345)	(81)%
Total.....	\$ 2,304	\$ 2,516	\$ (212)	(8)%

(Dollars in thousands)	Six Months Ended June 30,		Increase (decrease) 2004 versus 2003	
	2004	2003	Amount	Percent
Gain on sale of loans.....	\$ 1,366	\$ 1,144	\$ 222	19 %
Servicing income.....	1,066	876	190	22 %
Service charges and other fees on deposit accounts.....	970	852	118	14 %
Appreciation of company owned life insurance.....	562	637	(75)	(12)%
Gain on sale of securities available-for-sale.....	476	458	18	4 %
Mortgage brokerage fees.....	149	640	(491)	(77)%
Other.....	189	873	(684)	(78)%
Total.....	\$ 4,778	\$ 5,480	\$ (702)	(13)%

Noninterest income for the three and six months ended June 30, 2004 was \$2,304,000 and \$4,778,000, down 8% and 13% from \$2,516,000 and \$5,480,000 for the same periods in the prior year. The decrease was primarily due to the amendment of an equipment lease agreement resulting in a change in the classification from equipment under operating leases to a direct financing lease arrangement, which is now included in the loan portfolio. As a result, the payment amounts are now recorded as principal and interest payments rather than as other noninterest income and expense. The mortgage brokerage fees decreased \$247,000 and \$491,000 for the three and six months ended June 30, 2004 from the prior year as a result of a lower demand for mortgages. The Company discontinued its residential mortgage operation in June 2004 due to market conditions. An increase in gain on sales of loans of \$52,000 and \$222,000 and servicing income of \$110,000 and \$190,000 for the three and six months ended June 30, 2004 from the prior year, which was primarily the result of expansion of the SBA lending operation into additional geographic areas of California and the overall increase in the level of loans serviced. The increase in service charges and other fees on deposit accounts of \$56,000 and \$118,000 was due to an increase in the activity and level of demand deposit accounts. An increase in gain on sale of securities available-for-sale of \$231,000 for three months ended June 30, 2004 from 2003 was due to market conditions.

Noninterest Expense

The following table sets forth the various components of the Company's noninterest expenses for the periods indicated:

(Dollars in thousands)	Three Months Ended June 30,		Increase (decrease) 2004 versus 2003	
	2004	2003	Amount	Percent
Salaries and employee benefits.....	\$ 5,456	\$ 4,521	\$ 935	21 %
Occupancy.....	880	835	45	5 %
Professional fees.....	961	419	542	129 %
Loan origination costs.....	411	360	51	14 %
Advertising and promotion.....	252	228	24	11 %
Furniture and equipment.....	255	367	(112)	(31)%
Client services.....	231	225	6	3 %
Telephone.....	86	67	19	28 %
Stationery & supplies.....	82	57	25	44 %
Other.....	2,302	1,407	895	64 %
Total.....	\$ 10,916	\$ 8,486	\$ 2,430	29 %

(Dollars in thousands)	Six Months Ended June 30,		Increase (decrease) 2004 versus 2003	
	2004	2003	Amount	Percent
Salaries and employee benefits.....	\$ 10,176	\$ 9,224	\$ 952	10 %
Occupancy.....	1,930	1,654	276	17 %
Professional fees.....	1,316	690	626	91 %
Loan origination costs.....	768	677	91	13 %
Advertising and promotion.....	499	399	100	25 %
Furniture and equipment.....	492	758	(266)	(35)%
Client services.....	416	475	(59)	(12)%
Telephone.....	199	150	49	33 %
Stationery & supplies.....	152	163	(11)	(7)%
Other.....	3,681	2,796	885	32 %
Total.....	\$ 19,629	\$ 16,986	\$ 2,643	16 %

The following table indicates the percentage of noninterest expense in each category:

(Dollars in thousands)	For The Three Months Ended June 30,			
	2004	Percent of Total	2003	Percent of Total
Salaries and employee benefits.....	\$ 5,456	50 %	\$ 4,521	53 %
Occupancy.....	880	8 %	835	10 %
Professional fees.....	961	9 %	419	5 %
Loan origination costs.....	411	4 %	360	4 %
Advertising and promotion.....	252	2 %	228	3 %
Furniture and equipment.....	255	2 %	367	4 %
Client services.....	231	2 %	225	3 %
Telephone.....	86	1 %	67	1 %
Stationery & supplies.....	82	1 %	57	1 %
Other.....	2,302	21 %	1,407	16 %
Total.....	\$ 10,916	100 %	\$ 8,486	100 %

(Dollars in thousands)	For The Six Months Ended June 30,			
	2004	Percent of Total	2003	Percent of Total
Salaries and employee benefits.....	\$ 10,176	52 %	\$ 9,224	54 %
Occupancy.....	1,930	10 %	1,654	10 %
Professional fees.....	1,316	7 %	690	4 %
Loan origination costs.....	768	4 %	677	4 %
Advertising and promotion.....	499	2 %	399	2 %
Furniture and equipment.....	492	2 %	758	5 %
Client services.....	416	2 %	475	3 %
Telephone.....	199	1 %	150	1 %
Stationery & supplies.....	152	1 %	163	1 %
Other.....	3,681	19 %	2,796	16 %
Total.....	\$ 19,629	100 %	\$ 16,986	100 %

Noninterest expenses for the three and six months ended June 30, 2004 were \$10,916,000 and \$19,629,000, up \$2,430,000 and \$2,643,000, or 29% and 16%, from \$8,486,000 and \$16,986,000 for the same period in the prior year.

For the three months ended June 30, 2004, salaries and employee benefits increased \$935,000, or 21%, to \$5,456,000, as compared to the same period in the prior year. The increase was primarily related to severance of \$461,000 for the elimination of 11 full time positions and \$511,000 associated with the resignation of the former CEO partially offset by a decrease of \$186,000 in loan officer commissions. Salaries and employee benefits increased \$952,000, or 10%, to \$10,176,000 for the six months of 2004, as compared to the same period in the prior year. Salaries and employee benefits, as a percentage of total noninterest expenses decreased to 50% and 52% from 53% and 54%, respectively, over the comparative three and six months period. The Company believes that the elimination of 11 full time positions will result in a savings in salary and employee benefits of approximately \$300,000 pre-tax per quarter beginning in the third quarter of 2004.

For the comparative three month periods, occupancy increased by \$45,000, or 5%, to \$880,000, and for the six month periods the increase was \$276,000, or 17%, to \$1,930,000 primarily as a result of increased rental costs related to the opening of a new branch office in Los Gatos in December 2003, depreciation on leasehold improvements and write-offs associated with the outsourcing of the data processing function. Occupancy costs, as a

percentage of total noninterest expenses decreased to 8% from 10% over the comparative three months periods and remained fairly constant over the comparative six month periods.

For the comparative three month periods, professional fees increased \$542,000, or 129%, to \$961,000, and for the six month periods the increase was \$626,000, or 91%, to \$1,316,000 primarily due to increased legal expenses related to the proxy solicitation for the 2004 annual meetings and other corporate severance matters. Professional fees, as a percentage of total noninterest expenses increased to 9% and 7% from 5% and 4% over the comparative three and six month periods.

For the comparative three month periods, loan origination costs increased by \$51,000, or 14%, to \$411,000, and for the six month periods the increase was \$91,000, or 13%, to \$768,000 primarily due to continued growth in the loan portfolio. Loan origination costs, as a percentage of total noninterest expenses remained fairly constant over the comparative three and six month periods.

For the comparative three month periods, advertising and promotion increased \$24,000, or 11%, to \$252,000, and for the six month periods the increase was \$100,000, or 25%, to \$499,000 primarily due to several new promotions and sponsorships in 2004. Advertising and promotion, as a percentage of total noninterest expenses decreased to 2% from 3% over the comparative three month periods but remained fairly constant over the comparative six month periods.

For the comparative three month periods, furniture and equipment decreased by \$112,000, or 31%, to \$255,000, and for the six month periods the decrease was \$266,000, or 35%, to \$492,000 primarily due to the decrease in the level of purchase of small equipment, fewer equipment repairs, and lower depreciation on furniture and equipment in 2004. Furniture and equipment, as a percentage of total noninterest expenses decreased to 2% from 4% and 5%, respectively, over the comparative three and six month periods.

For the comparative three month periods, client services increased by \$6,000, or 3%, to \$231,000 but for the six month periods decreased by \$59,000, or 12%, to \$416,000 primarily due to a reduction in the level and pricing for certain of these services, such as imprinted check charges, courier and armored car, in 2004 compared to the same period in 2003. Client services, as a percentage of total noninterest expenses decreased to 2% from 3% over the comparative three and six month periods.

For the comparative three month periods, telephone expense increased by \$19,000, or 28%, to \$86,000, and for the six month periods the increase was \$49,000, or 33%, to \$199,000. Telephone, as a percentage of total noninterest expenses remained fairly constant over the comparative three and six month periods.

For the comparative three month periods, stationery and supplies increased by \$25,000, or 44%, to \$82,000, and for the six month periods the decrease was \$11,000, or 7%, to \$152,000. Stationery and supplies, as a percentage of total noninterest expenses remained fairly constant over the comparative three and six month periods.

For the comparative three month period, other noninterest expenses increased \$895,000, or 64%, to \$2,302,000, and for the six month periods the increase was \$885,000, or 32%, to \$3,681,000, primarily due to an increase of \$707,000 in retirement plan expense associated with the resignation of the former CEO and the elimination of 3 executive employees out of the 11 full time positions in the second quarter of 2004.

In June 2004, the Company announced a plan to streamline its operations and integrate the Bank's four divisions into a single unified business-focused bank, under the Heritage Bank of Commerce name. With the outsourcing of core data processing operations in the first quarter of 2004 and the reduction in staff completed in the second quarter of 2004, the Company anticipates annual savings of approximately \$1.4 million pre-tax beginning in the third quarter of 2004.

Income Taxes

The provision for income taxes for the three and six months ended June 30, 2004 was \$380,000 and \$1,330,000, as compared to \$880,000 and \$1,790,000 for the same periods in the prior year. The following table shows the effective income tax rate for each period indicated.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
Effective income tax rate.....	32.20 %	31.99 %	32.15 %	32.02 %

The difference in the effective tax rate compared to the statutory tax rate of 42% is primarily the result of the Company's investment in Bank Owned Life Insurance policies whose earnings are not subject to taxes, low income housing tax credits and investments in municipal securities.

FINANCIAL CONDITION

Total assets increased \$80,186,000, or 8%, to \$1,083,387,000 at June 30, 2004 from \$1,003,201,000 at December 31, 2003, and increased \$86,936,000, or 9%, from \$996,451,000 at June 30, 2003. Total securities available-for-sale increased \$76,962,000, or 50%, to \$230,435,000 at June 30, 2004 from \$153,473,000 at December 31, 2003, and increased \$74,075,000, or 47%, from \$156,360,000 at June 30, 2003. Total loan portfolio increased \$40,769,000, or 6%, to \$706,857,000 at June 30, 2004 from \$666,088,000 at December 31, 2003, and increased \$69,294,000, or 11%, from \$637,563,000 at June 30, 2003. Total deposits increased \$83,759,000, or 10%, to \$919,169,000 at June 30, 2004 from \$835,410,000 at December 31, 2003, and increased \$71,264,000, or 8%, from \$847,905,000 at June 30, 2003. Other borrowings decreased \$3,800,000, or 9%, to \$39,800,000 at June 30, 2004 from \$43,600,000 at December 31, 2003, and increased \$11,200,000, or 39%, from \$28,600,000 at June 30, 2003.

Securities Portfolio

The following table sets forth the estimated fair value of investment securities at the dates indicated:

(Dollars in thousands)	June 30,		December 31,
	2004	2003	2003
Securities available-for-sale (at fair value)			
U.S. Treasury.....	\$ 5,934	\$ 4,617	\$ 7,015
U.S. Government Agencies.....	90,439	38,265	36,115
Mortgage-Backed Securities.....	105,531	81,628	79,615
Municipals.....	9,084	11,350	15,704
CMOs.....	19,447	20,500	15,024
Total securities available-for-sale.....	<u>\$ 230,435</u>	<u>\$ 156,360</u>	<u>\$ 153,473</u>

The following table summarizes the composition of the Company's investment securities and the weighted average yields at June 30, 2004:

(Dollars in thousands)	June 30, 2004									
	Maturity									
	Within One Year		After One and		After Five and		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Securities available-for-sale:										
U.S. Treasury.....	\$ --	-- %	\$ 5,934	1.67 %	\$ --	-- %	\$ --	-- %	\$ 5,934	1.67 %
U.S. Government Agencies.....	--	-- %	90,439	2.31 %	--	-- %	--	-- %	90,439	2.31 %
Mortgage-Backed Securities.....	--	-- %	266	5.08 %	12,186	3.81 %	93,079	3.86 %	105,531	3.86 %
Municipals - Nontaxable.....	461	4.71 %	8,301	2.27 %	322	3.00 %	--	-- %	9,084	2.42 %
CMOs.....	--	-- %	--	-- %	--	-- %	19,447	2.71 %	19,447	2.71 %
Total available-for-sale.....	<u>\$ 461</u>	4.71 %	<u>\$ 104,940</u>	2.28 %	<u>\$ 12,508</u>	3.79 %	<u>\$ 112,526</u>	3.66 %	<u>\$ 230,435</u>	3.04 %

Note: Yield on non-taxable municipal securities are not presented on a fully tax equivalent basis.

Loans

Total loans increased \$40,769,000, or 6%, to \$706,857,000 as of June 30, 2004 from \$666,088,000 as of December 31, 2003, and increased \$69,294,000, or 11%, from \$637,563,000 as of June 30, 2003.

For the three and six months ended June 30, 2004, \$21,296,000 and \$33,747,000 in loans guaranteed by the U.S. Small Business Administration (SBA) were generated and held for sale, and \$13,273,000 and \$26,026,000 of SBA loans held for sale were sold into the secondary market. Gains on sale of SBA loans were \$639,000 and \$1,366,000, respectively, for the three and six months ended June 30, 2004, compared to \$587,000 and \$1,144,000, respectively for the three and six months ended June 30, 2003.

At June 30, 2004 and December 31, 2003, the Company serviced SBA loans that it had sold into the secondary market of approximately \$132,361,000 and \$117,770,000, respectively. At June 30, 2004 and December 31, 2003, the carrying amounts of the servicing asset were \$2,054,000 and \$1,876,000, respectively. There was no valuation allowance as of June 30, 2004 or December 31, 2003. The carrying amounts of interest-only (I/O) strip receivable at June 30, 2004 and December 31, 2003 were \$3,364,000, net of unrealized gain of \$1,183,000, and \$2,803,000, net of unrealized gain of \$925,000, respectively. These assets represent the servicing spread generated from the sold guaranteed portions of SBA loans. Servicing income from these loans was \$561,000 and \$1,066,000 for the quarter and six months ended June 30, 2004, compared to \$451,000 and \$876,000 for the same periods in 2003. Amortization of the related assets was \$366,000 and \$745,000 for the quarter and six months ended June 30, 2004, compared to \$349,000 and \$646,000 for the same periods in 2003. HBC is a SBA Preferred Lender, which allows the Company to grant certain SBA loans without the prior approval of the SBA.

The following table summarizes the composition of the Company's loan portfolio at the dates indicated:

(Dollars in thousands)	June 30,		December 31,	
	2004	Total	2003	Total
Commercial.....	\$ 298,828	42 %	\$ 281,561	42 %
Real estate - mortgage.....	290,956	41 %	276,908	42 %
Real estate - land and construction.....	111,161	16 %	101,082	15 %
Direct financing lease.....	3,578	1 %	3,931	1 %
Consumer.....	1,625	0 %	1,743	0 %
Total loans.....	706,148	100 %	665,225	100 %
Deferred loan costs.....	709		863	
Allowance for loan losses.....	(12,688)		(13,451)	
Loans, net.....	\$ 694,169		\$ 652,637	

The loan portfolio is primarily composed of commercial loans to companies principally engaged in manufacturing, wholesale, and service businesses and real estate lending, with the balance in direct equipment finance leases and consumer loans. As of June 30, 2004, real estate mortgage loans consists of loans secured by commercial property of \$235,211,000, loans secured by first mortgages on 1 – 4 family residential properties of \$3,446,000, and home equity lines of credit secured by junior deeds of trust on 1 – 4 family residential properties of \$52,299,000. Properties securing the real estate mortgage loans are primarily located in the Company's trade area. While no specific industry concentration is considered significant, the Company's lending operations are dependent on the technology and real estate industries and their supporting companies. The Company's borrowers could be adversely impacted by a downturn in these sectors of the economy, which could reduce the demand for loans and adversely impact the borrowers' abilities to repay their loans.

The following table sets forth the maturity distribution of the Company's loans at June 30, 2004:

<u>(Dollars in thousands)</u>	Due in One Year or Less	Over One Year But Less Than Five Years	Over Five Years	Total
Commercial.....	\$ 288,178	\$ 10,136	\$ 514	\$ 298,828
Real estate - mortgage.....	200,220	48,834	41,902	290,956
Real estate - land and construction.....	111,161	--	--	111,161
Direct financing lease.....	982	2,596	--	3,578
Consumer.....	1,389	236	--	1,625
Total loans.....	<u>\$ 601,930</u>	<u>\$ 61,802</u>	<u>\$ 42,416</u>	<u>\$ 706,148</u>
Loans with variable interest rates.....	\$ 582,613	\$ 23,943	\$ --	\$ 606,556
Loans with fixed interest rates.....	19,317	37,859	42,416	99,592
Total loans.....	<u>\$ 601,930</u>	<u>\$ 61,802</u>	<u>\$ 42,416</u>	<u>\$ 706,148</u>

The table above also shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the western edition of *The Wall Street Journal*. At June 30, 2004, approximately 86% of the Company's loan portfolio consisted of floating interest rate loans.

Nonperforming assets

Nonperforming assets consist of nonaccrual loans, loans past due 90 days and still accruing, troubled debt restructurings and other real estate owned. Management generally places loans on nonaccrual status when they become 90 days past due, unless they are well secured and in the process of collection. When a loan is placed on nonaccrual status, any interest previously accrued but not collected is generally reversed from income. Loans are charged off when management determines that collection has become unlikely. Restructured loans are those where HBC has granted a concession on the interest paid or original repayment terms due to financial difficulties of the borrower. Other real estate owned ("OREO") consists of real property acquired through foreclosure on the related underlying defaulted loans. The following table shows nonperforming assets at the dates indicated:

<u>(Dollars in thousands)</u>	<u>June 30,</u>		<u>December 31,</u>
	<u>2004</u>	<u>2003</u>	<u>2003</u>
Nonaccrual loans.....	\$ 2,102	\$ 767	\$ 3,972
Loans 90 days past due and still accruing.....	530	1,032	608
Restructured loans.....	--	--	--
Total nonperforming loans.....	2,632	1,799	4,580
Other real estate owned.....	--	832	--
Total nonperforming assets.....	<u>\$ 2,632</u>	<u>\$ 2,631</u>	<u>\$ 4,580</u>

Nonperforming assets as a percentage of period end loans plus other real estate owned...	0.37 %	0.41 %	0.69 %
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As of June 30, 2004, the Company had \$2,102,000 loans on nonaccrual status, compared to \$767,000 in the same period of the prior year, which were considered impaired loans. The impaired loans had a related valuation allowance of \$240,000 at June 30, 2004 and \$289,000 at June 30, 2003. The Company had \$530,000 loans past due 90 days or more and still accruing interest, no restructured loans and no other real estate owned assets as of June 30, 2004, compared to \$1,032,000 loans past due 90 days or more and still accruing interest, no restructured loans and \$832,000 other real estate owned assets as of June 30, 2003. The Company had \$3,972,000 loans on nonaccrual status as of December 31, 2003, which were considered impaired loans. The impaired loans had a related valuation allowance of \$464,000 at December 31, 2003. The Company had \$608,000 loans past due 90 days or more and still accruing interest, no restructured loans and no other real estate owned assets as of December 31, 2003. For the three and six months ended June 30, 2004, the Company had \$251,000 and \$509,000 foregone interest income on nonaccrual loans. For the three and six months ended June 30, 2004, the Company recognized \$10,000 and \$27,000

in interest income for cash payments received on nonaccrual loans. The Company did not recognize any interest income for cash payments received on nonaccrual loans for the three and six months ended June 30, 2003.

The Company assigns a risk grade consistent with the system recommended by regulatory agencies to all of its loans. Grades range from "Pass" to "Loss" depending on credit quality, with "Pass" representing loans that involve an acceptable degree of risk. Management conducts a critical evaluation of the loan portfolio monthly. This evaluation includes periodic loan by loan review for certain loans to evaluate the level of impairment as well as detailed reviews of other loans (either individually or in pools) based on an assessment of the following factors: past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, collateral value, loan volumes and concentrations, size and complexity of the loans, recent loss experience in particular segments of the portfolio, bank regulatory examination results, and current economic conditions in the Company's marketplace, in particular the state of the technology industry and the real estate market.

This process attempts to assess the risk of loss inherent in the portfolio by segregating loans into four components for purposes of determining an appropriate level of the allowance: "watch," "special mention," "substandard" and "doubtful." Additionally, the Company maintains a program for regularly scheduled reviews of certain new and renewed loans by an outside loan review consultant. Any loans identified during an external review process that expose the Company to increased risk are appropriately downgraded and an increase in the allowance for loan losses is established for such loans. Further, the Company is examined periodically by the FDIC, FRB, and the California Department of Financial Institutions at which time a further review of loan quality is conducted.

Loans that demonstrate a weakness, for which there is a possibility of loss if the weakness is not corrected, are categorized as "classified." Classified loans include all loans graded substandard, doubtful and loss and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate).

Allowance for Loan Losses

It is the policy of management to maintain the allowance for probable loan losses at a level adequate for risks inherent in the loan portfolio. Based on information currently available to analyze loan loss delinquency and a history of actual charge-offs, management believes that the loan loss allowance is adequate. However, the loan portfolio could be adversely affected if California economic conditions and the real estate market in the Company's market area were to continue to weaken. Additionally, any weakness of a prolonged nature in the technology industry would have a negative impact on the local market. The effect of such events, although uncertain at this time, could result in an increase in the level of nonperforming loans and increased loan losses, which could adversely affect the Company's future growth and profitability. No assurance of the ultimate level of credit losses can be given with any certainty. Loans are charged against the allowance when management believes that the collectibility of the principal is unlikely.

The following table summarizes the Company's loan loss experience as well as provisions, charge-offs and recoveries to the allowance for loan losses and certain pertinent ratios for the periods indicated:

(Dollars in thousands)	Six Months Ended		For the Year Ended
	June 30,		December 31,
	2004	2003	2003
Balance, beginning of period / year.....	\$ 13,451	\$ 13,227	\$ 13,227
Net charge-offs.....	(1,963)	(435)	(2,676)
Provision for probable loan losses.....	1,200	1,900	2,900
Balance, end of period / year.....	<u>\$ 12,688</u>	<u>\$ 14,692</u>	<u>\$ 13,451</u>

Ratios:

Net charge-offs to			
average loans outstanding.....	0.58 %	0.13 %	0.41 %
Allowance for loan losses to average			
loans.....	1.88 %	2.25 %	2.07 %
Allowance for loan losses to total			
loans.....	1.79 %	2.30 %	2.02 %
Allowance for loan losses to			
non-performing assets.....	482 %	558 %	294 %

Charge-offs reflects the realization of losses in the portfolio that were recognized previously though provisions for probable loan losses. The net charge-offs for the six months ended June 30, 2004 were \$1,963,000, compared to \$435,000 for the six months ended June 30, 2003. Historical net charge-offs are not necessarily indicative of the amount of net charge-offs that the Company will realize in the future.

The following table summarizes the allocation of the allowance for loan losses (ALL) by loan type and the allocated allowance as a percent of loans outstanding in each loan category at the dates indicated:

(Dollars in thousands)	June 30, 2004		June 30, 2003		December 31, 2003	
	Amount	Percent of ALL by category to total loans by category	Amount	Percent of ALL by category to total loans by category	Amount	Percent of ALL by category to total loans by category
Commercial.....	\$ 9,690	3.24 %	\$ 8,551	3.25 %	\$ 9,628	3.42 %
Real estate - mortgage.....	1,625	0.56 %	2,522	1.00 %	2,003	0.72 %
Real estate - land and construction.....	1,253	1.13 %	1,722	1.45 %	1,714	1.70 %
Direct financing lease.....	63	1.76 %	--	-- %	39	0.99 %
Consumer.....	44	2.71 %	60	2.36 %	37	2.12 %
Unallocated.....	13	-- %	1,837	-- %	30	-- %
Total	<u>\$ 12,688</u>	1.79 %	<u>\$ 14,692</u>	2.30 %	<u>\$ 13,451</u>	2.02 %

The decrease in the overall level of the allowance and in the allowance as a percentage of total loans since December 31, 2003 is primarily the result of the activity related to one unsecured commercial loan. As reported in the Form 10-K for the fiscal year ended December 31, 2003, during the first quarter of 2004 the Company identified a \$4.0 million unsecured commercial line of credit with risks that created doubt about full repayment under the original terms of the agreement. The loan was placed on nonaccrual and a specific reserve was established. Subsequent to placement on nonaccrual, the Company was advised that the borrower had filed for bankruptcy protection and \$2.0 million was charged-off in the first quarter of 2004. The Company continued to negotiate with the borrower within the framework of the bankruptcy and the remaining \$2.0 million of the loan was paid in full during the second quarter of 2004. Other than the loans already classified at June 30, 2004, the Company has not identified any potential problem loans.

Loans are charged against the allowance when management believes that the collectibility of the principal is doubtful. The Company's methodology for assessing the appropriateness of the allowance consists of several key elements, which include specific allowances, the formula allowance and the unallocated allowance.

Specific allowances are established in cases where management has identified significant conditions or circumstances related to a credit that management believes indicate the probability that a loss may be incurred in excess of the amount determined by the application of the formula allowance. As of June 30, 2004, nonperforming loans had a related specific valuation allowance of \$240,000 compared to \$474,000 at December 31, 2003.

The formula allowance is calculated by applying loss factors to outstanding loans and certain unused commitments. Loss factors are based on management's experience and may be adjusted for significant factors that, in management's judgment, may affect the collectibility of the portfolio as of the evaluation date. Due to the Company's limited historical loss experience, management utilizes their prior industry experience to determine the loss factor for each category of loan. The formula allowance on June 30, 2004 was \$12,435,000, compared to \$12,947,000 on December 31, 2003.

The unallocated allowance is based upon management's evaluation of various conditions that are not directly measured in the determination of the formula and specific allowances. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they are not identified with specific problem credits or portfolio segments. As of June 30, 2004, the Company's unallocated allowance was \$13,000, compared to \$30,000 on December 31, 2003. In evaluating the appropriateness of the unallocated allowance, management considered the changes in the trend of the volume and severity of past due and classified loans; and trends in the volume of nonaccrual loans, troubled debt restructurings and other loan modifications, changes in national and local economic and business conditions, trends, and developments, including the condition of various market segments, changes in underwriting standards and collection, charge-off, and recovery practices, and changes in the volume and mix of the loan portfolio and in credit concentrations particularly in commercial and real estate land and construction lending. There can be no assurance that the adverse impact of any of these conditions on the Bank will not be in excess of the range set forth above.

In addition, the current business, economic, and real estate markets along with the seasoning of the portfolio and the nature and duration of the current business cycle will affect the amount of unallocated reserve.

In an effort to improve its analysis of risk factors associated with its loan portfolio, the Company continues to monitor and to make appropriate changes to its internal loan policies. These efforts better enable the Company to assess risk factors prior to granting new loans and to assess the sufficiency of the allowance for loan losses.

Management believes that it has adequately provided an allowance for estimated probable losses in the credit portfolio. Significant deterioration in Northern California real property values or economic downturns could impact future operating results, liquidity or capital resources and require additional provisions to the allowance or cause losses in excess of the allowance.

Deposits

Deposits totaled \$919,169,000 at June 30, 2004, up 10%, compared to deposits of \$835,410,000 at December 31, 2003, and up 8%, compared to deposits of \$847,905,000 at June 30, 2003. Compared to December 31, 2003, noninterest bearing demand deposits increased \$62,906,000, or 26%, interest bearing demand deposits increased \$6,022,000, or 6%, savings and money market accounts increased \$18,238,000, or 5%, total time deposits increased \$518,000, or less than 1%, and brokered deposits decreased \$3,925,000, or 33%.

The following table summarizes the distribution of average deposits and the average rates paid for the periods indicated:

	Six Months Ended June 30, 2004		Year Ended December 31, 2003	
	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid
(Dollars in thousands)				
Demand, noninterest bearing.....	\$ 259,076	-- %	\$ 238,467	-- %
Demand, interest bearing.....	108,337	0.43 %	96,772	0.51 %
Saving and money market.....	343,404	1.00 %	318,774	1.16 %
Time deposits, under \$100.....	39,411	1.42 %	43,060	1.85 %
Time deposits, \$100 and over.....	97,354	1.44 %	101,406	1.79 %
Brokered deposits.....	10,877	4.49 %	24,559	4.05 %
Total average deposits.....	<u>\$ 858,459</u>	0.74 %	<u>\$ 823,038</u>	0.95 %

Deposit Concentration and Deposit Volatility

The following table indicates the maturity schedule of the Company's time deposits (including brokered deposits) of \$100,000 or more as of June 30, 2004.

(Dollars in thousands)	Balance	% of Total
Three months or less.....	\$ 53,640	52 %
Over three months through twelve months.....	41,021	39 %
Over twelve months.....	9,480	9 %
Total.....	<u>\$ 104,141</u>	<u>100 %</u>

The Company focuses primarily on servicing business accounts that are frequently over \$100,000 in average size. Certain types of accounts that the Company makes available are typically in excess of \$100,000 in average balance per account, and certain types of business clients whom the Company serves typically carry deposits in excess of \$100,000 on average. The account activity for some account types and client types necessitates appropriate liquidity management practices by the Company to ensure its ability to fund deposit withdrawals.

Return on Equity and Assets

The following table indicates the ratios on the annualized return on average assets and average equity and average equity to average assets for each indicated period.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Return on average assets.....	0.30%	0.81%	0.55%	0.83%
Return on average equity.....	3.47%	8.75%	6.14%	9.03%
Average equity to average assets ratio....	8.69%	9.21%	9.00%	9.16%

Annualized return on average assets and return on average equity for the quarter ended June 30, 2004 were 0.30% and 3.47%, respectively, compared with returns of 0.81% and 8.75%, respectively, for the same period in 2003. The equity to asset ratio for the quarter ended June 30, 2004 was 8.69%, compared to 9.21% for the same period in 2003.

Annualized return on average assets and return on average equity for the six months ended June 30, 2004 were 0.55% and 6.14%, respectively, compared with returns of 0.83% and 9.03%, respectively, for the same period in

2003. The equity to asset ratio for the six months ended June 30, 2004 was 9.00%, compared to 9.16% for the same period in 2003.

The decrease in return on average assets and return on average equity for the three and six months ended June 30, 2004 from 2003 was due to non-recurring expenses of \$2.05 million pre-tax for severance, annual meeting and other corporate matters in the second quarter of 2004.

Interest Rate Risk

The planning of asset and liability maturities is an integral part of the management of an institution's net yield. To the extent maturities of assets and liabilities do not match in a changing interest rate environment, net yields may change over time. Even with perfectly matched repricing of assets and liabilities, risks remain in the form of prepayment of loans or investments or in the form of delays in the adjustment of rates of interest applying to either earning assets with floating rates or to interest bearing liabilities. The Company has generally been able to control its exposure to changing interest rates by maintaining primarily floating interest rate loans and a majority of its time certificates with relatively short maturities.

The following table sets forth the interest rate sensitivity of the Company's interest-earning assets and interest-bearing liabilities at June 30, 2004, using the rate sensitivity gap ratio. For purposes of the following table, an asset or liability is considered rate-sensitive within a specified period when it can be repriced or when it is scheduled to mature within the specified time frame:

<u>(Dollars in thousands)</u>	Within Three Months	Due in Three to Twelve Months	Due After One to Five Years	Due After Five Years	Not Rate- Sensitive	Total
Interest earning assets:						
Federal funds sold.....	\$ 13,800	\$ --	\$ --	\$ --	\$ --	\$ 13,800
Interest bearing deposits in other financial Institutions.....	935	--	--	--	--	935
Securities.....	--	461	104,940	125,034	--	230,435
Total loans.....	<u>553,273</u>	<u>81,282</u>	<u>61,802</u>	<u>42,416</u>	--	<u>738,773</u>
Total interest earning assets.....	<u>568,008</u>	<u>81,743</u>	<u>166,742</u>	<u>167,450</u>	--	<u>983,943</u>
Cash and due from banks.....	--	--	--	--	55,469	55,469
Other assets.....	--	25,836	--	--	18,139	43,975
Total assets.....	<u>\$ 568,008</u>	<u>\$ 107,579</u>	<u>\$ 166,742</u>	<u>\$ 167,450</u>	<u>\$ 73,608</u>	<u>\$ 1,083,387</u>
Interest bearing liabilities:						
Demand, interest bearing.....	\$ 111,282	\$ --	\$ --	\$ --	\$ --	\$ 111,282
Savings and money market.....	364,124	--	--	--	--	364,124
Time deposits.....	68,600	59,671	14,163	--	--	142,434
Other borrowings.....	--	7,100	32,700	--	--	39,800
Notes payable to subsidiary grantor trusts.....	9,279	--	--	14,423	--	23,702
Total interest bearing liabilities.....	<u>553,285</u>	<u>66,771</u>	<u>46,863</u>	<u>14,423</u>	--	<u>681,342</u>
Noninterest demand deposits.....	86,977	--	--	--	214,352	301,329
Accrual interest payable and other liabilities.....	--	--	--	--	9,897	9,897
Shareholders' equity.....	--	--	--	--	90,819	90,819
Total liabilities and shareholders' equity.....	<u>\$ 640,262</u>	<u>\$ 66,771</u>	<u>\$ 46,863</u>	<u>\$ 14,423</u>	<u>\$ 315,068</u>	<u>\$ 1,083,387</u>
Interest rate sensitivity GAP.....	<u>\$ (72,254)</u>	<u>\$ 40,808</u>	<u>\$ 119,879</u>	<u>\$ 153,027</u>	<u>\$ (241,460)</u>	<u>\$ --</u>
Cumulative interest rate sensitivity GAP.....	\$ (72,254)	\$ (31,446)	\$ 88,433	\$ 241,460	\$ --	\$ --
Cumulative interest rate sensitivity GAP ratio.....	(6.67)%	(2.90)%	8.16%	22.29%	--%	--%

Interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Varying interest rate environments can create unexpected changes in prepayment levels of assets and liabilities, which may have a significant effect on the net interest margin and are not reflected in the interest sensitivity analysis table. Because of these factors, an interest sensitivity gap report may not provide a complete assessment of the exposure to changes in interest rates. To supplement traditional GAP analysis, the Company performs simulation modeling to estimate the

potential effects of changing interest rate environments. The process allows the Company to explore the complex relationships within the GAP over time and various interest rate environments.

Liquidity risk represents the potential for loss as a result of limitations on the Company's ability to adjust for future cash flows, to meet the needs of depositors and borrowers, and to fund operations on a timely and cost-effective basis. The liquidity policy approved by the board of directors requires annual review of the Company's liquidity by the asset/liability committee, which is composed of senior executives, and the finance and investment committee of the board of directors.

The Company's internal asset/liability committee and the finance and investment committee of the board of directors each meet monthly to monitor the Company's investments, liquidity needs and to oversee its asset/liability management. The Company evaluates the rates offered on its deposit products on a weekly basis.

Liquidity and Liability Management

To meet liquidity needs, the Company maintains a portion of its funds in cash deposits in other banks, in Federal funds sold, and in investment securities. At June 30, 2004, the Company's primary liquidity ratio was 17.59%. The liquidity ratio is arrived at by calculating the total of assets with immediate liquidity including \$105,401,000 of investment securities available-for-sale with maturities (or probable calls) of up to five years, Federal funds sold of \$13,800,000, and \$55,469,000 in cash and due from banks less \$15,735,000 of securities that were pledged to secure public and certain other deposits as required by law and contract, as a percentage of total unsecured deposits of \$903,434,000. The Company has lines of credit of approximately \$114,000,000 available from the Federal Home Loan Bank and correspondent banks to meet short-term liquidity needs. There were no balances outstanding on these lines of credit at June 30, 2004 and 2003.

Capital Resources

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of the Company:

(Dollars in thousands)	June 30,		December 31,		Minimum Regulatory Requirements
	2004	2003	2003		
Capital components:					
Tier 1 Capital.....	\$ 114,385	\$ 106,542	\$ 110,891		
Tier 2 Capital.....	10,994	10,106	10,403		
Total risk-based capital.....	<u>\$ 125,379</u>	<u>\$ 116,648</u>	<u>\$ 121,294</u>		
Risk-weighted assets.....	\$ 879,146	\$ 803,900	\$ 830,537		
Average assets.....	\$ 1,071,685	\$ 929,905	\$ 992,608		
Capital ratios:					
Total risk-based capital.....	14.3 %	14.5 %	14.6 %	8.0 %	
Tier 1 risk-based capital.....	13.0 %	13.3 %	13.4 %	4.0 %	
Leverage ratio (1).....	10.7 %	11.5 %	11.2 %	4.0 %	

(1) Tier 1 capital divided by average assets (excluding goodwill).

At June 30, 2004 and 2003, and December 31, 2003, the Company's capital met all minimum regulatory requirements. As of June 30, 2004, management believes that HBC was considered "Well Capitalized" under the Prompt Corrective Action Provisions.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

No material changes have occurred during the quarter to the Company's market risk profile or information. For further information refer to the Company's Form 10-K.

ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) that are designed to ensure that information required to be disclosed in our reports filed under the Exchange Act, is recorded, processed, summarized and reported within the time period specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief (principal) Executive Officer and Chief (principal) Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

(a) We carried out an evaluation under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as of the end of the period covered by this report, pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934. Based on their review of our disclosure controls and procedures, the principal executive officer and principal financial officer have concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to us that is required to be included in our periodic SEC filings.

(b) There were no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, such controls.

Part II — OTHER INFORMATION

ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

In June 2004, the Company's Board of Director authorized the purchase of up to \$10 million of its common stock, which represents approximately 700,000 share, or 6%, of its outstanding shares at current market price. The share repurchase authorization is valid through June 1, 2005.

The Company intends to finance the purchase using its available cash. Shares may be repurchased by the Company in open market purchases or in privately negotiated transactions as permitted under applicable rules and regulations. The repurchase program may be modified, suspended or terminated by the Board of Directors at any time without notice. The extent to which the Company repurchases its shares and the timing of such repurchases will depend upon market conditions and other corporate considerations.

As of June 30, 2004, repurchases of equity securities are presented in the table below.

Date	Total Number of Shares Purchased	Price Paid Per Shares	Total Number of Shares Purchased as Part of Publicly Announced Plans	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans
June 7, 2004.....	5,664	\$ 14.29	5,664	\$ 9,919,061
June 9, 2004.....	1,100	\$ 14.30	1,100	\$ 9,903,331
June 10, 2004.....	40,000	\$ 14.62	40,000	\$ 9,318,531
June 14, 2004.....	4,325	\$ 14.40	4,325	\$ 9,256,251
June 15, 2004.....	900	\$ 14.40	900	\$ 9,243,291
June 16, 2004.....	5,300	\$ 14.48	5,300	\$ 9,166,547
June 17, 2004.....	23,000	\$ 14.90	23,000	\$ 8,823,847
June 18, 2004.....	5,300	\$ 14.51	5,300	\$ 8,746,944
June 21, 2004.....	6,800	\$ 14.48	6,800	\$ 8,648,480
June 22, 2004.....	20,000	\$ 14.40	20,000	\$ 8,360,480
June 23, 2004.....	6,800	\$ 14.31	6,800	\$ 8,263,172
June 24, 2004.....	6,800	\$ 14.50	6,800	\$ 8,164,572
June 25, 2004.....	6,800	\$ 14.51	6,800	\$ 8,065,904
Total.....	132,789		132,789	

ITEM 4. SUBMISSIONS OF MATTERS TO A VOTE OF SECURITY HOLDERS

On May 4, 2004, the Company announced that Brad L. Smith had tendered his resignation as Chief Executive Officer and Director to facilitate the settlement with shareholders who had nominated alternative directors for the upcoming annual meeting. Chairman of the Board William Del Biaggio, Jr. was appointed interim CEO effective immediately, while the search for a permanent CEO is completed. The Board appointed Ranson Webster to fill the seat vacated by Smith. Webster is the Company's largest individual shareholder and is one of the founders of HBC. As part of the proposed settlement agreement, the Concerned Shareholders Committee has agreed in principle not to further pursue proxy solicitation measures for two years.

The Company held its 2004 Annual Meeting of Shareholders on May 26, 2004. There were 11,222,564 issued and outstanding shares of Company Common Stock on April 1, 2004, the Record Date for the 2004 Annual Meeting. Each of the shares voting at the meeting was entitled to one vote.

At the 2004 Annual Meeting, the following actions were taken:

Election of Directors

The Company's board is divided into three classes. At the 2004 Annual Meeting, four directors of the Company were elected. The following chart indicates the number of shares cast for each elected director:

Name of Director	Votes For	Votes Withheld
Frank G. Bisceglia	9,155,676	522,033
Anneke Dury	9,115,720	561,989
Louis "Lon" O. Normandin	9,243,872	433,837
Humphrey P. Polanen	9,229,154	448,555

In addition to the above four individuals, the following previously elected directors' terms continued after the meeting:

<u>Name of Director</u>	<u>Title</u>
James Blair	Director
Richard L. Conniff	Director/Chief Operating Officer
William Del Biaggio, Jr.	Director/Chairman of the Board/Interim Chief Executive Officer
Roy Lave	Director
Jack Peckham	Director
Kirk M. Rossmann	Director
Charles J. Toeniskoetter	Director
Ranson Webster	Director

Approve of Heritage Commerce Corp 2004 Stock Option Plan grants of stock options to officers, employees and directors of the Company.

FOR	5,609,584
AGAINST	756,243
ABSTAIN	182,540
BROKER NON-VOTES	3,129,342

Ratification of Deloitte & Touche, LLP as the Company's auditors

The number of shares cast for and against the ratification of the Board of Directors' selection of Deloitte & Touche, LLP to serve as the Company's auditors for the fiscal year ending December 31, 2004 was as follows:

FOR	8,646,909
AGAINST	675,248
ABSTENTIONS	355,552

To consider and transact such other business as may properly be brought before the meeting.

FOR	8,645,483
AGAINST	676,674
ABSTAIN	355,552

ITEM 6. - Exhibits and Reports on Form 8-K

(a) Exhibits included with this filing:

The exhibit list required by this item is incorporated by reference to the Exhibit Index filed as part of this report.

(b) Reports on Form 8-K

The Registrant furnished a Current Report on Form 8-K dated July 20, 2004 under item 7 and item 12 to report its second quarter ended June 30, 2004 financial results, and condensed consolidated financial information.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	<u>Heritage Commerce Corp</u> (Registrant)
<u>August 9, 2004</u> Date	<u>/s/ William Del Biaggio, Jr.</u> William Del Biaggio, Jr. Interim Chief Executive Officer
<u>August 9, 2004</u> Date	<u>/s/ Lawrence D. McGovern</u> Lawrence D. McGovern Chief Financial Officer

Exhibit Index

Exhibit	Description
31.1	Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

CERTIFICATION PURSUANT TO SECTION 302 OF
THE SARBANEX-OXLEY ACT OF 2002

I, William Del Biaggio, Jr., Interim Chief Executive Officer of Heritage Commerce Corp, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the Quarter Ended June 30, 2004 of Heritage Commerce Corp;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

- (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2004

/s/ William Del Biaggio, Jr.

William Del Biaggio, Jr.

Interim Chief Executive Officer

CERTIFICATION PURSUANT TO SECTION 302 OF
THE SARBANEX-OXLEY ACT OF 2002

I, Lawrence D. McGovern, Chief Financial Officer of Heritage Commerce Corp, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the Quarter Ended June 30, 2004 of Heritage Commerce Corp;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter

that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2004

/s/ Lawrence D. McGovern

Lawrence D. McGovern

Chief Financial Officer

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Heritage Commerce Corp (the "Company") on Form 10-Q for the period ending June 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, William Del Biaggio, Jr., Interim Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

August 9, 2004

/s/ William Del Biaggio, Jr.

William Del Biaggio, Jr.

Interim Chief Executive Officer

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Heritage Commerce Corp (the "Company") on Form 10-Q for the period ending June 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Lawrence D. McGovern, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

August 9, 2004

/s/ Lawrence D. McGovern

Lawrence D. McGovern

Chief Financial Officer