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

FORM 10-Q

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

For the quarterly period ended September 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 [X] NO [ ]

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

The Registrant had 11,693,577 shares of Common Stock outstanding on October 29, 2004

HERITAGE COMMERCE CORP

Heritage Commerce Corp and Subsidiaries
Quarterly Report on Form 10-Q
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Part I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

(Dollars in thousands)	September 30, 2004	December 31, 2003
ASSETS		
Cash and due from banks	$ 46,055	$ 39,978
Interest bearing deposits in other financial institutions	1,292	2,039
Federal funds sold	5,800	72,200
Total cash and cash equivalents	53,147	114,217
Securities available-for-sale, at fair value	228,483	153,473
Loans held for sale, at lower of cost or market	28,782	30,638
Loans, net of deferred costs	727,615	666,088
Allowance for probable loan losses	(13,381)	(13,451)
Loans, net	714,234	652,637
Premises and equipment, net	3,489	4,034
Accrued interest receivable and other assets	23,470	20,425
Company owned life insurance	26,072	25,273
Other investments	4,655	2,504
TOTAL	$ 1,082,332	$ 1,003,201
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Deposits		
Demand, noninterest bearing	$ 290,845	$ 238,423
Demand, interest bearing	115,911	105,260
Savings and money market	349,004	345,886
Time deposits, under $100	38,170	39,869
Time deposits, $100 and over	104,762	94,002
Brokered deposits	3,964	11,970
Total deposits	902,656	835,410
Accrued interest payable and other liabilities	11,539	10,643
Other borrowings	47,800	43,600
Notes payable to subsidiary grantor trusts	23,702	23,702
Total liabilities	985,697	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: 11,657,865 at September 30, 2004 and 11,381,037 at December 31, 2003	66,490	65,234
Unallocated ESOP shares	(255)	(443)
Accumulated other comprehensive income (loss), net of taxes	(271)	79
Retained earnings	30,671	24,976
Total shareholders' equity	96,635	89,846
TOTAL	$ 1,082,332	$ 1,003,201

See notes to condensed consolidated financial statements

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands, except per share data)	**2004**	**2003**	**2004**	**2003**
Interest income:				
Loans, including fees	$ 11,709	$ 10,138	$ 33,135	$ 32,121
Securities, taxable	1,788	1,154	4,686	3,036
Securities, non-taxable	56	112	241	292
Interest bearing deposits in other financial institutions	3	5	7	40
Federal funds sold	77	147	238	388
Total interest income	13,633	11,556	38,307	35,877
Interest expense:				
Deposits	1,729	1,775	4,889	6,106
Subsidiary grantor trusts	492	470	1,455	1,450
Other	263	124	627	138
Total interest expense	2,484	2,369	6,971	7,694
Net interest income before provision for probable loan losses	11,149	9,187	31,336	28,183
Provision for probable loan losses	600	600	1,800	2,500
Net interest income after provision for probable loan losses	10,549	8,587	29,536	25,683
Noninterest income:				
Gain on sale of loans	920	561	2,285	1,705
Servicing income	616	463	1,682	1,339
Service charges and other fees on deposit accounts	415	480	1,385	1,332
Appreciation of company owned life insurance	236	254	798	891
Gain on sale of securities available-for-sale	0	74	476	532
Mortgage brokerage fees	19	210	168	851
Other	157	421	347	1,293
Total noninterest income	2,363	2,463	7,141	7,943
Noninterest expenses:				
Salaries and employee benefits	4,301	4,423	14,477	13,664
Occupancy	883	857	2,813	2,511
Professional fees	670	338	1,986	1,028
Retirement plan expense	358	17	1,576	528
Loan origination costs	426	369	1,194	1,046
Advertising and promotion	364	209	862	608
Furniture and equipment	206	385	698	1,143
Client services	228	239	644	714
Data processing expense	170	26	492	71
Stationery & supplies	140	83	292	246
Telephone	72	85	271	235
Other	1,071	1,279	3,212	3,502
Total noninterest expenses	8,889	8,310	28,517	25,296
Income before provision for income taxes	4,023	2,740	8,160	8,330
Provision for income taxes	1,135	800	2,465	2,590
Net income	$ 2,888	$ 1,940	$ 5,695	$ 5,740
Earnings per share:				
Basic	$ 0.25	$ 0.17	$ 0.49	$ 0.51
Diluted	$ 0.24	$ 0.17	$ 0.48	$ 0.50

See notes to condensed consolidated financial statements

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

(Dollars in thousands)	Common Stock Shares	Common Stock Amount	Unallocated ESOP Shares	Accumulated Other Comprehensive Income (Loss) Net of Taxes	Retained Earnings	Total Shareholders' Equity	Total Comprehensive Income
BALANCES, DECEMBER 31, 2002	11,214,414	$64,002	$ (693)	$ 1,714	$ 17,194	$ 82,217	
Net income	--	--	--	--	5,740	5,740	$ 5,740
Net change in unrealized loss on securities available-for-sale, net of reclassification adjustment and taxes	--	--	--	(1,725)	--	(1,725)	(1,725)
							$ 4,015
Total comprehensive income							
Additional paid-in-capital in ESOP	--	104	--	--	--	104	
Amortization of stock compensation	--	--	250	--	--	250	
Stock options exercised	111,749	898	--	--	--	898	
BALANCES, SEPTEMBER 30, 2003	11,326,163	$65,004	$ (443)	$ (11)	$ 22,934	$ 87,484	
BALANCES, DECEMBER 31, 2003	11,381,037	$65,234	$ (443)	$ 79	$ 24,976	$ 89,846	
Net income	--	--	--	--	5,695	5,695	$ 5,695
Net change in unrealized loss on securities available-for-sale, net of reclassification adjustment and taxes	--	--	--	(350)	--	(350)	(350)
Total comprehensive income							$ 5,345
Amortization of stock compensation	--	--	188	--	--	188	
Additional paid-in-capital in ESOP	--	170	--	--	--	170	
Common stock repurchased	(176,528)	(2,581)	--	--	--	(2,581)	
Stock options exercised	453,356	3,667	--	--	--	3,667	
BALANCES, SEPTEMBER 30, 2004	11,657,865	$66,490	$ (255)	$ (271)	$ 30,671	$ 96,635	

See notes to condensed consolidated financial statements

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

(Dollars in thousands)	Nine Months Ended September 30, 2004	2003
Cash flows from operating activities:		
Net income	$ 5,695	$ 5,740
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,081	1,277
Provision for probable loan losses	1,800	2,500
Non-cash compensation expense related to ESOP plan	358	354
Gain on sale of securities available-for-sale	(476)	(532)
Net amortization of premiums / accretion of discounts	785	1,034
Gains on sales of loans held for sale	(2,285)	(1,705)
Proceeds from sales of loans held for sale	45,205	35,069
Originations of loans held for sale	(57,936)	(60,895)
Maturities of loans held for sale	16,871	24,940
Appreciation of company owned life insurance	(798)	(891)
Effect of changes in:		
Accrued interest receivable and other assets	(2,693)	(373)
Accrued interest payable and other liabilities	1,364	(757)
Net cash provided by operating activities	8,971	5,761
Cash flows from investing activities:		
Net (increase) decrease in loans	(63,397)	29,040
Purchases of securities available-for-sale	(117,735)	(120,478)
Maturities/paydowns/calls of securities available-for-sale	18,605	43,715
Proceeds from sales of securities available-for-sale	22,641	27,664
Purchases of company owned life insurance	0	(225)
(Purchases) Redemption of other investments	(2,151)	1,213
Purchases of premises and equipment	(536)	(625)
Net cash used in investing activities	(142,573)	(19,696)
Cash flows from financing activities:		
Net increase (decrease) in deposits	67,246	(5,989)
Net proceeds from issuance of common stock	3,667	898
Common stock repurchased	(2,581)	0
Net change in other borrowings	4,200	28,600
Net cash provided by financing activities	72,532	23,509
Net (decrease) increase in cash and cash equivalents	(61,070)	9,574
Cash and cash equivalents, beginning of period	114,217	86,632
Cash and cash equivalents, end of period	$ 53,147	$ 96,206
Supplemental disclosures of cash paid during the period for:		
Interest	$ 7,362	$ 8,726
Income taxes	$ 750	$ 2,735
Supplemental schedule on non-cash investing and financing activity:		
Transfer of loans to other real estate owned	$ 0	$ 652

See notes to condensed consolidated financial statement

HERITAGE COMMERCE CORP AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements
September 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 nine months ended September 30, 2004 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2004.

2) Securities Available-for-Sale

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. On September 30, 2004, the FASB deferred the effective date of paragraphs 10 through 20 of EITF Issue No. 03-1. Application of those paragraphs is deferred pending issuance of a final FASB Staff Position. Management is in the process of evaluating the impacts of EITF 03-1 guidance. 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.

The following table shows the gross unrealized losses and fair value of the Company’s investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2004:

(Dollars in thousands)	Less Than 12 Months Market Value	Less Than 12 Months Unrealized Losses	12 Months or More Market Value	12 Months or More Unrealized Losses	Total Market Value	Total Unrealized Losses
U.S. Treasury	$ 5,964	$ 33	$ –	$ –	$ 5,964	$ 33
U.S. Government Agencies	63,003	418	2,912	88	65,915	506
Municipals	4,583	17	–	–	4,583	17
FHLMC and FNMA mortgage-backed securities	35,946	524	43,149	1,265	79,095	1,789
CMOs	19,717	185	–	–	19,717	185
Total securities available-for-sale	$ 129,213	$ 1,177	$ 46,061	$ 1,353	$ 175,274	$ 2,530

As of September 30, 2004, the Company held 99 securities, of which 50 had market values below amortized cost. Six securities have been carried with an unrealized loss for over 12 months. Higher interest rates at September 30, 2004 resulted in lower market values for the period. Other than temporary loss was primarily due to interest rates. There was no security which sustained downgrades in credit ratings. All principal amounts are expected to be paid when securities mature. Because the Company has the ability and intent to hold these securities until a recovery of fair value, which may be maturity, the Company does not consider these securities to be other-than-temporarily impaired at September 30, 2004.

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.

Statement of Financial Accounting Standards (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, 3.75% and 3.74% for September 30, 2004 and 2003; stock volatility of 25% and 11% in September 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 September 30, 2004	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
Net income				
As reported	$ 2,888	$ 1,940	$ 5,695	$ 5,740
Less: Compensation expense for amortization of fair value of stock awards, net of taxes	(209)	(187)	(605)	(541)
Pro forma	$ 2,679	$ 1,753	$ 5,090	$ 5,199
Net income per common share - basic				
As reported	$ 0.25	$ 0.17	$ 0.49	$ 0.51
Pro forma	$ 0.23	$ 0.16	$ 0.44	$ 0.46
Net income per common share - diluted				
As reported	$ 0.24	$ 0.17	$ 0.48	$ 0.50
Pro forma	$ 0.22	$ 0.15	$ 0.43	$ 0.45

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 11,557 and 182,328 stock options for three months ended September 30, 2004 and 2003 and 17,699 and 353,028 for nine months ended September 30, 2004 and 2003, respectively, that were considered to be antidilutive and excluded from the computation of diluted earnings per share. For each of the periods presented, net income is the same for basic and diluted earnings per share. Reconciliation of weighted average shares used in computing basic and diluted earnings per share is as follows:

	Three Months Ended September 30, 2004	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
Weighted average common shares outstanding - used in computing basic earnings per share	11,621,963	11,254,328	11,522,054	11,201,345
Dilutive effect of stock options outstanding, using the treasury stock method	376,557	441,879	418,444	367,595
Shares used in computing diluted earnings per share	11,998,520	11,696,207	11,940,498	11,568,940

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:

(Dollars in thousands)	Three Months Ended September 30, 2004	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
Net income	$ 2,888	$ 1,940	$ 5,695	$ 5,740
Other comprehensive income (loss), net of tax:				
Net unrealized holding gain (loss) on available-for-sale securities and I/O strips during the period	2,349	(1,464)	(17)	(1,358)
Less: reclassification adjustment for realized gain on available-for-sale securities included in net income during the period	0	(52)	(333)	(367)
Other comprehensive income (loss)	2,349	(1,516)	(350)	(1,725)
Comprehensive income	$ 5,237	$ 424	$ 5,345	$ 4,015

6) 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 $358,000 and $1,576,000 were accrued for the three and nine months ended September 30, 2004. The following table presents the amount of periodic benefit cost recognized for three and nine months ended September 30, 2004 and 2003:

(Dollars in thousands)	Three Months Ended September 30, 2004	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
Components of net periodic benefits cost				
Service cost	$ 310	$ 115	$ 652	$ 343
Interest cost	105	50	316	149
Amortization of (gain)/loss	38	(6)	119	(18)
Net periodic benefit cost	$ 453	$ 159	1,087	$ 474

7) Commitments and Contingencies

Financial Instruments with Off-Balance Sheet Risk

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

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 September 30, were as follows:

(Dollars in thousands)	2004	2003
Commitments to extend credit	$ 311,017	$ 270,347
Standby letters of credit	5,125	2,290
	$ 316,142	$ 272,637

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 $23,000 as of September 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.

Claims

The Company is involved in certain legal actions arising from normal business activities. Management, based upon the advice of legal counsel, believes the ultimate resolution of all pending legal actions will not have a material effect on the financial statements of the Company.

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 24.

Loan Sales and Servicing

The amount 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 September 30, 2004, management's estimate of constant prepayment rate ("CPR") was 14% and the weighted average discount rate assumption was 9%. 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 nine months ended September 30, 2004 was $2,888,000 and $5,695,000, respectively, up $948,000, or 49%, but down $45,000, or less than 1%, as compared to the three and nine months ended September 30, 2003. Earnings per diluted share for the three and nine months ended September 30, 2004 were $0.24 and $0.48, respectively, up 41%, and down 4%, from $0.17 and $0.50 per diluted share for the three and nine months ended September 30, 2003. Annualized return on average assets and return on average equity for the three months ended September 30, 2004 were 1.05% and 12.19%, up from 0.78% and 8.80%, for the same periods in the prior year. Annualized return on average assets and return on average equity for the nine months ended September 30, 2004 were 0.73% and 8.20%, down from 0.81% and 8.95%, for the same periods in the prior year.

For the three and nine months ended September 30, 2004, as compared with the same periods in the prior year, net interest income before provision for probable loan losses increased to $11,149,000 and $31,336,000 from $9,187,000 and $28,183,000, an increase of $1,962,000, or 21% and $3,153,000, or 11%, respectively. The Company's net interest margin was 4.42% and 4.36% for the three and nine months ended September 30, 2004, compared with 4.01% and 4.33% for the same periods in the prior year.

Total assets as of September 30, 2004 were $1,082,332,000, an increase of $97,612,000, or 10%, from $984,720,000 as of September 30, 2003, and an increase of $79,131,000, or 8%, from total assets of $1,003,201,000 as of December 31, 2003. Total deposits as of September 30, 2004 were $902,656,000, an increase of $66,709,000, or 8%, from $835,947,000 as of September 30, 2003, and an increase of $67,246,000, or 8%, from total deposits of $835,410,000 as of December 31, 2003.

The total loan portfolio as of September 30, 2004 was $727,615,000, an increase of $85,435,000, or 13%, from $642,180,000 as of September 30, 2003 and an increase of $61,527,000, or 9%, from $666,088,000 as of December 31, 2003. The Company's allowance for probable loan losses was $13,381,000, or 1.84%, of total loans at September 30, 2004. This compares with an allowance for probable loan losses of $13,039,000, or 2.03%, and $13,451,000, or 2.02% of total loans at September 30, 2003 and December 31, 2003. 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 offset by the provisions made during the period. The Company's nonperforming assets were $2,637,000 at September 30, 2004, compared to $7,544,000 as of September 30, 2003 and $4,580,000 as of December 31, 2003.

The Company's shareholders' equity at September 30, 2004 was $96,635,000, up from $87,484,000 at September 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 $8.29 at September 30, 2004, from $7.72 at September 30, 2003. Book value per share was $7.89 at December 31, 2003. The Company's leverage capital ratio was 10.72% at September 30, 2004 compared to 10.99% at September 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 September 30, 2004 Average Balance	Interest Income/ Expense	Average Yield/ Rate	For the Three Months Ended September 30, 2003 Average Balance	Interest Income/ Expense	Average Yield/ Rate
Assets:						
Loans, gross	$ 746,157	$ 11,709	6.24%	$ 668,769	$ 10,138	6.01%
Investment securities	234,438	1,844	3.13%	175,338	1,266	2.86%
Interest bearing deposits in other financial institutions	1,026	3	1.16%	2,977	5	0.67%
Federal funds sold	22,282	77	1.37%	61,059	147	0.96%
Total interest earning assets	1,003,903	$ 13,633	5.40%	908,143	$ 11,556	5.05%
Cash and due from banks	51,147			41,990		
Premises and equipment, net	3,661			4,803		
Other assets	35,619			34,494		
Total assets	$ 1,094,330			$ 989,430		
Liabilities and shareholders' equity:						
Deposits:						
Demand, interest bearing	$ 116,053	$ 134	0.46%	$ 95,681	$ 106	0.44%
Savings and money market	370,398	1,011	1.09%	325,198	884	1.08%
Time deposits, under $100	38,006	140	1.47%	41,957	179	1.69%
Time deposits, $100 and over	99,178	381	1.53%	98,010	402	1.63%
Brokered deposits	5,745	63	4.36%	19,833	204	4.08%
Other borrowings	71,222	755	4.22%	51,600	594	4.57%
Total interest bearing liabilities	700,602	$ 2,484	1.41%	632,279	$ 2,369	1.49%
Demand, noninterest bearing	288,096			259,000		
Other liabilities	11,357			10,723		
Total liabilities	1,000,055			902,002		
Shareholders' equity	94,275			87,428		
Total liabilities and shareholders' equity	$ 1,094,330			$ 989,430		
Net interest income / margin		$ 11,149	4.42%		$ 9,187	4.01%

Note: Yields and amounts earned on loans include loan fees of $951,000 and $876,000 for the three month periods ended September 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 $1,926,000 and $6,497,000 for the period ended September 30, 2004 and 2003, respectively, are included in the average balance calculation above.

(Dollars in thousands)	For the Nine Months Ended September 30, 2004 Average Balance	Interest Income/ Expense	Average Yield/ Rate	For the Nine Months Ended September 30, 2003 Average Balance	Interest Income/ Expense	Average Yield/ Rate
Assets:						
Loans, gross	$ 718,827	$ 33,135	6.16%	$ 678,446	$ 32,121	6.33%
Investment securities	210,537	4,927	3.13%	137,107	3,328	3.25%
Interest bearing deposits in other financial institutions.	1,223	7	0.76%	6,134	40	0.87%
Federal funds sold	30,056	238	1.06%	47,699	388	1.09%
Total interest earning assets	960,643	$ 38,307	5.33%	869,386	$ 35,877	5.52%
Cash and due from banks	48,808			39,418		
Premises and equipment, net	3,819			4,987		
Other assets	33,438			33,664		
Total assets	$ 1,046,708			$ 947,455		
Liabilities and shareholders' equity:						
Deposits:						
Demand, interest bearing	$ 110,909	$ 368	0.44%	$ 94,967	$ 389	0.55%
Savings and money market	352,402	2,718	1.03%	310,391	2,792	1.20%
Time deposits, under $100	38,943	419	1.44%	43,884	641	1.95%
Time deposits, $100 and over	97,962	1,078	1.47%	103,135	1,442	1.87%
Brokered deposits	9,166	306	4.46%	28,124	842	4.00%
Other borrowings	65,212	2,082	4.26%	33,721	1,588	6.30%
Total interest bearing liabilities	674,594	$ 6,971	1.38%	614,222	$ 7,694	1.67%
Demand, noninterest bearing	268,749			237,396		
Other liabilities	10,600			10,116		
Total liabilities	953,943			861,734		
Shareholders' equity	92,765			85,721		
Total liabilities and shareholders' equity	$ 1,046,708			$ 947,455		
Net interest income / margin		$ 31,336	4.36%		$ 28,183	4.33%

Note: Yields and amounts earned on loans include loan fees of $2,991,000 and $2,932,000 for the nine month periods ended September 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 $1,926,000 and $6,497,000 for the period ended September 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 nine months ended September 30, 2004 was $11,149,000 and $31,336,000, respectively, an increase of $1,962,000, or 21% and $3,153,000 or 11% over the same periods in the prior year. For the three and nine months ended September 30, 2004, average interest earning assets increased by $95,760,000, or 11% and $91,257,000, or 10%, respectively. For the three months ended September 30, 2004, the average yield on interest earning assets was 5.40%, up 35 basis points from 5.05% for the same period in 2003. Over the same period the rates paid on interest bearing liabilities declined 8 basis points to 1.41% from 1.49%. For the nine months ended September 30, 2004, the average yield on interest earning assets was 5.33%, down 19 basis points from 5.52% for the same period in 2003. Over the same period the rates paid on interest bearing liabilities declined 29 basis points to 1.38% from 1.67%. As a result, the net interest margin increased 41 basis points to 4.42% for the three months ended September 30, 2004, from 4.01% for the same period in the prior year and increased 3 basis points to 4.36% for the nine months ended September 30, 2004 from 4.33% for the same period in the prior year. The increase in net interest margin in the third quarter and for the nine month period was primarily attributable to the increase in average earning assets and increase in key market interest rates since June 30, 2004. During the third quarter of 2004, there were three increases totaling 75 basis points in the target interest rate for Federal funds sold set by the Federal Open Market Committee (FOMC) and the prime rate of interest, which is the index for the pricing on most of the Company’s loan portfolio. 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 in brokered and other time deposits. The changes in volume contributed $1,357,000 to net interest income while the effect of the changes in rates produced an increase of

$605,000 resulting in the overall increase of $1,962,000 for the three months ended September 30, 2004, from September 30, 2003. The changes in volume contributed $2,756,000 to net interest income while the effect of the changes in rates produced an increase of $397,000 resulting in the overall increase of $3,153,000 for the nine months ended September 30, 2004 from the prior period.

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.

	Three Months Ended September 30, 2004 vs. 2003		
	Increase (Decrease) Due to Change In:		
(Dollars in thousands)	**Average Volume**	**Average Rate**	**Net Change**
Interest earning assets			
Loans, gross	$ 1,219	$ 352	$ 1,571
Investments securities	464	114	578
Interest bearing deposits in other financial institutions	(5)	3	(2)
Federal funds sold	(135)	65	(70)
Total interest earning assets	$ 1,543	$ 534	$ 2,077
Interest bearing liabilities			
Demand, interest bearing	23	5	28
Savings and money market	120	7	127
Time deposits, under $100	(14)	(25)	(39)
Time deposits, $100 and over	4	(25)	(21)
Brokered Deposits	(155)	14	(141)
Other borrowings	208	(47)	161
Total interest bearing liabilities	$ 186	$ (71)	$ 115
Net interest income	$ 1,357	$ 605	$ 1,962

	Nine Months Ended September 30, 2004 vs. 2003		
	Increase (Decrease) Due to Change In:		
(Dollars in thousands)	**Average Volume**	**Average Rate**	**Net Change**
Interest earning assets			
Loans, gross	$ 1,848	$ (834)	$ 1,014
Investments securities	1,714	(115)	1,599
Interest bearing deposits in other financial institutions	(28)	(5)	(33)
Federal funds sold	(140)	(10)	(150)
Total interest earning assets	$ 3,394	$ (964)	$ 2,430
Interest bearing liabilities			
Demand, interest bearing	$ 53	$ (74)	$ (21)
Savings and money market	324	(398)	(74)
Time deposits, under $100	(54)	(168)	(222)
Time deposits, $100 and over	(57)	(307)	(364)
Brokered Deposits	(633)	97	(536)
Other borrowings	1,005	(511)	494
Total interest bearing liabilities	$ 638	$ (1,361)	$ (723)
Net interest income	$ 2,756	$ 397	$ 3,153

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 nine months ended September 30, 2004, the provision for probable loan losses was $600,000 and $1,800,000, respectively, compared to $600,000 and $2,500,000 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:

	Three Months Ended September 30,		Increase (Decrease) 2004 versus 2003	
(Dollars in thousands)	**2004**	**2003**	**Amount**	**Percent**
Gain on sale of loans	$ 920	$ 561	$ 359	64 %
Servicing income	616	463	153	33 %
Service charges and other fees on deposit accounts	415	480	(65)	(14)%
Appreciation of company owned life insurance	236	254	(18)	(7)%
Gain on sale of securities available-for-sale	--	74	(74)	(100)%
Mortgage brokerage fees	19	210	(191)	(91)%
Other	157	421	(264)	(63)%
Total	$ 2,363	$ 2,463	$ (100)	(4)%

	Nine Months Ended September 30,		Increase (Decrease) 2004 versus 2003	
(Dollars in thousands)	**2004**	**2003**	**Amount**	**Percent**
Gain on sale of loans	$ 2,285	$ 1,705	$ 580	34 %
Servicing income	1,682	1,339	343	26 %
Service charges and other fees on deposit accounts	1,385	1,332	53	4 %
Appreciation of company owned life insurance	798	891	(93)	(10)%
Gain on sale of securities available-for-sale	476	532	(56)	(11)%
Mortgage brokerage fees	168	851	(683)	(80)%
Other	347	1,293	(946)	(73)%
Total	$ 7,141	$ 7,943	$ (802)	(10)%

Noninterest income for the three and nine months ended September 30, 2004 was $2,363,000 and $7,141,000, down 4% and 10% from $2,463,000 and $7,943,000 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. Mortgage brokerage fees decreased $191,000 and $683,000 for the three and nine months ended September 30, 2004 from the prior year for the same periods, as a result of a lower demand for mortgages as well as the Company discontinuing its residential mortgage operation in June 2004. An increase in gain on sales of loans of $359,000 and $580,000 and servicing income of $153,000 and $343,000 for the three and nine months ended September 30, 2004, from the prior period, was primarily the result of expansion of the SBA lending operation into additional geographic areas of California and an overall increase in the level of loans serviced. The Company has an onging program of originating SBA loans and selling the guarantee portion in the secondary market, which retaining the services of whole loans. Gain on sale of securities available-for-sale decreased $74,000 and $56,000, respectively, for the comparative three and nine months periods ended September 30, 2004. The appreciation of corporate owned life insurance decreased $18,000 and $93,000, respectively, for the comparative three and nine month periods ended September 30, 2004.

Noninterest Expense

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

	Three Months Ended September 30,		Increase (Decrease) 2004 versus 2003	
(Dollars in thousands)	**2004**	**2003**	**Amount**	**Percent**
Salaries and employee benefits	$ 4,301	$ 4,423	$ (122)	(3)%
Occupancy	883	857	26	3 %
Professional fees	670	338	332	98 %
Retirement plan expense	358	17	341	2,006 %
Loan origination costs	426	369	57	15 %
Advertising and promotion	364	209	155	74 %
Furniture and equipment	206	385	(179)	(46)%
Client services	228	239	(11)	(5)%
Data processing expense	170	26	144	554 %
Stationery & supplies	140	83	57	69 %
Telephone	72	85	(13)	(15)%
Other	1,071	1,279	(208)	(16)%
Total	$ 8,889	$ 8,310	$ 579	7 %

	Nine Months Ended September 30,		Increase (Decrease) 2004 versus 2003	
(Dollars in thousands)	**2004**	**2003**	**Amount**	**Percent**
Salaries and employee benefits	$ 14,477	$ 13,664	$ 813	6 %
Occupancy	2,813	2,511	302	12 %
Professional fees	1,986	1,028	958	93 %
Retirement plan expense	1,576	528	1,048	198 %
Loan origination costs	1,194	1,046	148	14 %
Advertising and promotion	862	608	254	42 %
Furniture and equipment	698	1,143	(445)	(39)%
Client services	644	714	(70)	(10)%
Data processing expense	492	71	421	593 %
Stationery & supplies	292	246	46	19 %
Telephone	271	235	36	15 %
Other	3,212	3,502	(290)	(8)%
Total	$ 28,517	$ 25,296	$ 3,221	13 %

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

	For The Three Months Ended September 30,			
(Dollars in thousands)	2004	Percent of Total	2003	Percent of Total
Salaries and employee benefits	$ 4,301	48 %	$ 4,423	53 %
Occupancy	883	10 %	857	10 %
Professional fees	670	7 %	338	4 %
Retirement plan expense	358	4 %	17	0 %
Loan origination costs	426	5 %	369	4 %
Advertising and promotion	364	4 %	209	3 %
Furniture and equipment	206	2 %	385	5 %
Client services	228	3 %	239	3 %
Data processing expense	170	2 %	26	0 %
Stationery & supplies	140	2 %	83	1 %
Telephone	72	1 %	85	1 %
Other	1,071	12 %	1,279	16 %
Total	$ 8,889	100 %	$ 8,310	100 %

	For The Nine Months Ended September 30,			
(Dollars in thousands)	2004	Percent of Total	2003	Percent of Total
Salaries and employee benefits	$ 14,477	51 %	$ 13,664	54 %
Occupancy	2,813	10 %	2,511	10 %
Professional fees	1,986	7 %	1,028	4 %
Retirement plan expense	1,576	6 %	528	2 %
Loan origination costs	1,194	4 %	1,046	4 %
Advertising and promotion	862	3 %	608	2 %
Furniture and equipment	698	2 %	1,143	5 %
Client services	644	2 %	714	3 %
Data processing expense	492	2 %	71	0 %
Stationery & supplies	292	1 %	246	1 %
Telephone	271	1 %	235	1 %
Other	3,212	11 %	3,502	14 %
Total	$ 28,517	100 %	$ 25,296	100 %

Noninterest expenses for the three and nine months ended September 30, 2004 were $8,889,000 and $28,517,000, up $579,000 and $3,221,000, or 7% and 13%, from $8,310,000 and $25,296,000 for the same period in the prior year. The efficiency ratio was 65.79% and 74.11% for the three and nine months ended September 30, 2004, compared to 71.33% and 70.02% for the three and nine months ended September 30, 2003.

For the three months ended September 30, 2004, salaries and employee benefits decreased $122,000, or 3%, to $4,301,000, as compared to the same period in the prior year. Salaries and employee benefits increased $813,000, or 6%, to $14,477,000 for the nine months ended September 30, 2004, as compared to the prior year. The increase for the nine months period was primarily related to severance payments of $580,000 incurred as the result of the elimination of 12 full time positions and $521,000 associated with the resignation of the former CEO, partially offset by a decrease of $361,000 in loan officer commissions. Salaries and employee benefits, as a percentage of total noninterest expenses decreased to 48% and 51% from 53% and 54%, respectively, over the comparative three and nine months periods.

For the comparative three month periods, occupancy increased by $26,000, or 3%, to $883,000, and for the nine month periods the increase was $302,000, or 12%, to $2,813,000, 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 remained fairly constant over the comparative three and nine month periods.

For the comparative three month periods, professional fees increased $332,000, or 98%, to $670,000, and for the nine month periods the increase was $958,000, or 93%, to $1,986,000, primarily due to increased audit and consulting expenses, legal expenses related to the proxy solicitation for the 2004 annual meetings and other corporate governance matters. Professional fees, as a percentage of total noninterest expenses increased to 7% from 4% over the comparative three and nine month periods.

For the comparative three month periods, retirement plan expense increased $341,000, or 2,006%, to $358,000, and for the nine month periods the increase was $1,048,000, or 198%, to $1,576,000, primarily due to the elimination of certain full time positions and the resignation of the former CEO. Retirement plan expense as a percentage of total noninterest expenses increased to 4% and 6% from less than 1% and 2% over the comparative three and nine month periods.

For the comparative three month periods, loan origination costs increased by $57,000, or 15%, to $426,000, and for the nine month periods the increase was $148,000, or 14%, to $1,194,000, primarily due to continued growth in the loan portfolio. Loan origination costs as a percentage of total noninterest expenses increased to 5% from 4% over the comparative three month periods and remained fairly constant over the comparative nine month periods.

For the comparative three month periods, advertising and promotion increased $155,000, or 74%, to $364,000, and for the nine month periods the increase was $254,000, or 42%, to $862,000, primarily due to several new promotions and sponsorships in 2004 as well as expenses associated with the consolidation of the Company's operations under the common brand Heritage Bank of Commerce in the third quarter. Prior to the third quarter of 2004, the Company had operated under 4 different trade names; Heritage Bank of Commerce, Heritage Bank East Bay, Heritage Bank South Valley and Bank of Los Altos. Advertising and promotion as a percentage of total noninterest expenses increased to 4% and 3% from 3% and 2% over the comparative three and nine month periods.

For the comparative three month periods, furniture and equipment decreased by $179,000, or 46%, to $206,000, and for the nine month periods the decrease was $445,000, or 39%, to $698,000, 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 5% over the comparative three and nine month periods.

For the comparative three month periods, client services decreased by $11,000, or 5%, to $228,000 and for the nine month periods decreased by $70,000, or 10%, to $644,000 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 remained fairly constant over the comparative three month periods but decreased to 2% from 3% over the comparative nine month periods.

For the comparative three month periods, data processing expense increased by $144,000, or 554%, to $170,000 and for the nine month periods increased by $421,000, or 593%, to $492,000 primarily due to outsourcing of the core data and item processing functions in the first quarter of 2004. As a result of the outsourcing arrangement, contracted data processing costs are shown as data processing expenses in 2004. When the data processing function was internal, prior to the first quarter of 2004, staffing and depreciation costs, the two major expenses associated with this function, were included in salaries and employee benefits and furniture and equipment expense, respectively. The Company estimates that the outsourcing of core data and item processing has reduced costs by an approximate pre-tax amount of $50,000 per quarter, beginning with the second quarter of 2004.

For the comparative three month periods, stationery and supplies increased by $57,000, or 69%, to $140,000, and for the nine month periods the increase was $46,000, or 19%, to $292,000. Stationery and supply costs increased in the third quarter of 2004 as a result of the consolidation of the Company's operations under the common brand Heritage Bank of Commerce. Stationery and supplies as a percentage of total noninterest expenses increased to 2% from 1% over the comparative three month periods, but remained fairly constant over the comparative nine month periods.

For the comparative three month periods, telephone expense decreased by $13,000, or 15%, to $72,000, but for the nine month periods increased by $36,000, or 15%, to $271,000. Telephone expense as a percentage of total noninterest expenses remained fairly constant over the comparative three and nine month periods.

For the comparative three month period, other noninterest expenses decreased $209,000, or 16%, to $1,071,000, and for the nine month periods the decrease was $290,000, or 8%, to $3,212,000 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 the amortization of the equipment was previously reported in other noninterest expense. Other noninterest expenses as a percentage of total noninterest expenses decrease to 12% and 11% from 16% and 14%, respectively, over the comparative three and nine months periods.

Income Taxes

The provision for income taxes for the three and nine months ended September 30, 2004 was $1,135,000 and $2,465,000, as compared to $800,000 and $2,590,000 for the same periods in the prior year. The following table shows the effective income tax rate for each period indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Effective income tax rate	28.21 %	29.20 %	30.21 %	31.09 %

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 Company 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 $79,131,000, or 8%, to $1,082,332,000 at September 30, 2004, from $1,003,201,000 at December 31, 2003, and increased $97,612,000, or 10%, from $984,720,000 at September 30, 2003. Total securities available-for-sale increased $75,010,000, or 49%, to $228,483,000 at September 30, 2004, from $153,473,000 at December 31, 2003, and increased $56,473,000, or 33%, from $172,010,000 at September 30, 2003. Total loan portfolio increased $61,527,000, or 9%, to $727,615,000 at September 30, 2004, from $666,088,000 at December 31, 2003, and increased $85,435,000, or 13%, from $642,180,000 at September 30, 2003. Total deposits increased $67,246,000, or 8%, to $902,656,000 at September 30, 2004, from $835,410,000 at December 31, 2003, and increased $66,709,000, or 8%, from $835,947,000 at September 30, 2003. Other borrowings increased $4,200,000, or 10%, to $47,800,000 at September 30, 2004, from $43,600,000 at December 31, 2003, and increased $19,200,000, or 67%, from $28,600,000 at September 30, 2003.

Securities Portfolio

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

	September 30,		December 31,
(Dollars in thousands)	**2004**	**2003**	**2003**
Securities available-for-sale (at fair value)			
U.S. Treasury	$ 5,964	$ 8,564	$ 7,015
U.S. Government Agencies	91,041	46,797	36,115
Mortgage-Backed Securities	102,511	74,741	79,615
Municipals	9,250	16,748	15,704
Mutual Funds	--	10,036	--
CMOs	19,717	15,124	15,024
Total securities available-for-sale	$ 228,483	$ 172,010	$ 153,473

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

	September 30, 2004 Maturity									
	Within One Year		After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
(Dollars in thousands)	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Securities available-for-sale:										
U.S. Treasury........................	$ --	-- %	$ 5,964	1.67 %	$ --	-- %	$ --	-- %	$ 5,964	1.67 %
U.S. Government Agencies...	5,589	1.75 %	85,452	2.35 %	--	-- %	--	-- %	91,041	2.31 %
Mortgage-Backed Securities.	--	-- %	238	5.06 %	11,905	3.85 %	90,368	3.96 %	102,511	3.95 %
Municipals - Nontaxable......	458	4.71 %	8,792	2.30 %	--	-- %	--	-- %	9,250	2.42 %
CMOs..................................	--	-- %	--	-- %	--	-- %	19,717	3.07 %	19,717	3.07 %
Total available-for-sale.........	$ 6,047	1.97 %	$ 100,446	2.31 %	$ 11,905	3.85 %	$ 110,085	3.80 %	$ 228,483	3.10 %

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

Loans

Total loans increased $61,527,000, or 9%, to $727,615,000 as of September 30, 2004, from $666,088,000 as of December 31, 2003, and increased $85,435,000, or 13%, from $642,180,000, as of September 30, 2003.

For the three and nine months ended September 30, 2004, $24,189,000 and $57,936,000 in loans guaranteed by the U.S. Small Business Administration (SBA) were generated and held for sale, and $16,895,000 and $42,921,000 of SBA loans held for sale were sold into the secondary market. Gain on sale of SBA loans was $920,000 and $2,285,000, respectively, for the three and nine months ended September 30, 2004, compared to $561,000 and $1,705,000, respectively, for the three and nine months ended September 30, 2003.

At September 30, 2004 and December 31, 2003, the Company serviced SBA loans of approximately $143,269,000 and $117,770,000, respectively, which it had sold into the secondary market. At September 30, 2004 and December 31, 2003, the carrying amount of the servicing assets was $2,221,000 and $1,876,000, respectively. There was no valuation allowance as of September 30, 2004 or December 31, 2003. The carrying amount of Interest-Only (I/O) strip receivable at September 30, 2004 and December 31, 2003 was $3,854,000, net of unrealized gain of $1,471,000, 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 $616,000 and $1,682,000 for the three and nine months ended September 30, 2004, compared to $463,000 and $1,339,000 for the same periods in 2003. Amortization of the related assets was $393,000 and $1,138,000, for the three and nine months ended September 30, 2004, compared to $332,000 and $978,000 for the same periods in 2003. HBC is a preferred lender with the SBA, 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)		September 30, 2004	% of Total		September 30, 2003	% of Total		December 31, 2003	% of Total
Commercial	$	314,007	43 %	$	268,607	42 %	$	281,561	42 %
Real estate - mortgage		301,249	41 %		252,664	39 %		276,908	42 %
Real estate - land and construction		106,303	15 %		117,441	18 %		101,082	15 %
Direct financing lease		3,538	1 %		0	0 %		3,931	1 %
Consumer		2,051	0 %		2,487	1 %		1,743	0 %
Total loans		727,148	100 %		641,199	100 %		665,225	100 %
Deferred loan costs		467			981			863	
Allowance for loan losses		(13,381)			(13,039)			(13,451)	
Loans, net	$	714,234		$	629,141		$	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 September 30, 2004, real estate mortgage loans consists of loans secured by commercial property of $246,231,000, loans secured by first mortgages on 1 – 4 family residential properties of $2,260,000, and home equity lines of credit secured by junior deeds of trust on 1 – 4 family residential properties of $52,758,000. Although construction loans outstanding are down from September 30, 2003, unfunded construction loan commitments have increased to $75 million from $56 million, reflecting increased activity in this segment of the loan portfolio from September 30, 2003. 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 September 30, 2004:

(Dollars in thousands)		Due in One Year or Less		Over One Year But Less Than Five Years		Over Five Years		Total
Commercial	$	297,557	$	10,705	$	5,745	$	314,007
Real estate - mortgage		199,851		53,761		47,637		301,249
Real estate - land and construction		106,254		49		--		106,303
Direct financing lease		999		2,500		39		3,538
Consumer		1,841		210		--		2,051
Total loans	$	606,502	$	67,225	$	53,421	$	727,148
Loans with variable interest rates	$	587,425	$	23,079	$	229	$	610,733
Loans with fixed interest rates		19,077		44,146		53,192		116,415
Total loans	$	606,502	$	67,225	$	53,421	$	727,148

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 September 30, 2004, approximately 84% 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:

	September 30,		December 31,
(Dollars in thousands)	**2004**	**2003**	**2003**
Nonaccrual loans	$ 1,926	$ 6,497	$ 3,972
Loans 90 days past due and still accruing	711	395	608
Restructured loans	--	--	--
Total nonperforming loans	2,637	6,892	4,580
Other real estate owned	--	652	--
Total nonperforming assets	$ 2,637	$ 7,544	$ 4,580
Nonperforming assets as a percentage of period end loans plus other real estate owned	0.36 %	1.17 %	0.69 %

As of September 30, 2004, the Company had $1,926,000 loans on nonaccrual status, compared to $6,497,000 in the same period of the prior year, which were considered impaired loans. The impaired loans had a related valuation allowance of $238,000 at September 30, 2004 and $1,139,000 at September 30, 2003. The Company had $711,000 loans past due 90 days or more and still accruing interest, no restructured loans and no other real estate owned assets as of September 30, 2004, compared to $395,000 loans past due 90 days or more and still accruing interest, no restructured loans and $652,000 other real estate owned assets as of September 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. As of September 30, 2004, the Company had $303,000 foregone interest income on nonaccrual loans. For the three and nine months ended September 30, 2004, the Company recognized zero and $27,000 in interest income for cash payments received on nonaccrual loans. The Company recognized $3,000 interest income for cash payments received on nonaccrual loans for the three and nine months ended September 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 can 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:

	Nine Months Ended September 30,		For the Year Ended December 31,
(Dollars in thousands)	**2004**	**2003**	**2003**
Balance, beginning of period / year	$ 13,451	$ 13,227	$ 13,227
Net charge-offs	(1,870)	(2,688)	(2,676)
Provision for probable loan losses	1,800	2,500	2,900
Balance, end of period / year	$ 13,381	$ 13,039	$ 13,451
Ratios:			
Net charge-offs to average loans outstanding	0.36 %	0.55 %	0.41 %
Allowance for loan losses to average loans	1.94 %	2.01 %	2.07 %
Allowance for loan losses to total loans	1.84 %	2.03 %	2.02 %
Allowance for loan losses to nonperforming assets	507 %	173 %	294 %

Charge-offs reflect the realization of losses in the portfolio that were recognized previously though provisions for probable loan losses. The net charge-offs for the nine months ended September 30, 2004 were $1,870,000, compared to $2,688,000 for the nine months ended September 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)	September 30, 2004 Amount	Percent of ALL by category to total loans by category	September 30, 2003 Amount	Percent of ALL by category to total loans by category	December 31, 2003 Amount	Percent of ALL by category to total loans by category
Commercial	$ 9,452	3.01 %	$ 8,814	3.27 %	$ 9,628	3.42 %
Real estate - mortgage	1,857	0.62 %	1,908	0.76 %	2,003	0.72 %
Real estate - land and construction	1,436	1.35 %	2,259	1.92 %	1,714	1.70 %
Direct financing lease	408	11.54 %	--	-- %	39	0.99 %
Consumer	41	2.00 %	58	2.33 %	37	2.12 %
Unallocated	187	-- %	--	-- %	30	-- %
Total	$ 13,381	1.84 %	$ 13,039	2.03 %	$ 13,451	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 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 September 30, 2004, the Company has not identified any potential problem loans. The increase in the allowance related to direct financing lease is a result of a downgrade of a lease loan from special mention to substandard during September 2004.

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 September 30, 2004, nonperforming loans had a related specific valuation allowance of $342,000, 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 September 30, 2004 was $12,852,000, 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 September 30, 2004, the Company’s unallocated allowance was $187,000, 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 $902,656,000 at September 30, 2004, up 8%, compared to deposits of $835,410,000 and $835,947,000, respectively, at December 31, 2003 and September 30, 2003. Compared to December 31, 2003, noninterest bearing demand deposits increased $52,422,000, or 22%, interest bearing demand deposits increased $10,651,000, or 10%, savings and money market accounts increased $3,118,000, or 1%, total time deposits increased $9,061,000, or 7%, and brokered deposits decreased $8,006,000, or 67%.

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

	Nine Months Ended September 30, 2004		Nine Months Ended September 30, 2003		Year Ended December 31, 2003	
(Dollars in thousands)	**Average Balance**	**Average Rate Paid**	**Average Balance**	**Average Rate Paid**	**Average Balance**	**Average Rate Paid**
Demand, noninterest bearing	$ 268,749	-- %	$ 237,396	-- %	$ 238,467	-- %
Demand, interest bearing	110,909	0.44 %	94,967	0.55 %	96,772	0.51 %
Saving and money market	352,402	1.03 %	310,391	1.20 %	318,774	1.16 %
Time deposits, under $100	38,943	1.44 %	43,884	1.95 %	43,060	1.85 %
Time deposits, $100 and over	97,962	1.47 %	103,135	1.87 %	101,406	1.79 %
Brokered deposits	9,166	4.46 %	28,124	4.00 %	24,559	4.05 %
Total average deposits	$ 878,131	0.74 %	$ 817,897	1.00 %	$ 823,038	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 September 30, 2004:

(Dollars in thousands)	**Balance**	**% of Total**
Three months or less	$ 48,841	45 %
Over three months through twelve months	49,996	46 %
Over twelve months	9,889	9 %
Total	$ 108,726	100 %

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 September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Return on average assets	1.05%	0.78%	0.73%	0.81%
Return on average equity	12.19%	8.80%	8.20%	8.95%
Average equity to average assets ratio	8.61%	8.84%	8.86%	9.05%

Annualized return on average assets and return on average equity for the quarter ended September 30, 2004 were 1.05% and 12.19%, respectively, compared with returns of 0.78% and 8.80%, respectively, for the same period in 2003. The average equity to average asset ratio for the quarter ended September 30, 2004 was 8.61%, compared to 8.84% for the same period in 2003.

Annualized return on average assets and return on average equity for the nine months ended September 30, 2004 were 0.73% and 8.20%, respectively, compared with returns of 0.81% and 8.95%, respectively, for the same period in 2003. The average equity to average asset ratio for the nine months ended September 30, 2004 was 8.86%, compared to 9.05% for the same period in 2003.

The decrease in return on average assets and return on average equity for the nine months ended September 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 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 September 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:

(Dollars in thousands)	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	$ 5,800	$ --	$ --	$ --	$ --	$ 5,800
Interest bearing deposits in other financial Institutions	1,292	--	--	--	--	1,292
Securities	--	6,046	100,446	121,991	--	228,483
Total loans	540,178	95,574	67,225	53,420	--	756,397
Total interest earning assets	547,270	101,620	167,671	175,411	--	991,972
Cash and due from banks	--	--	--	--	46,055	46,055
Other assets	--	26,072	--	--	18,233	44,305
Total assets	$ 547,270	$ 127,692	$ 167,671	$ 175,411	$ 64,288	$ 1,082,332
Interest bearing liabilities:						
Demand, interest bearing	$ 115,911	$ --	$ --	$ --	$ --	$ 115,911
Savings and money market	349,004	--	--	--	--	349,004
Time deposits	62,628	69,520	14,748	--	--	146,896
Other borrowings	--	15,100	32,700	--	--	47,800
Notes payable to subsidiary grantor trusts	9,279	--	--	14,423	--	23,702
Total interest bearing liabilities	536,822	84,620	47,448	14,423	--	683,313
Noninterest demand deposits	79,533	--	--	--	211,312	290,845
Accrual interest payable and other liabilities	--	--	--	--	11,539	11,539
Shareholders' equity	--	--	--	--	96,635	96,635
Total liabilities and shareholders' equity	$ 616,355	$ 84,620	$ 47,448	$ 14,423	$ 319,486	$ 1,082,332
Interest rate sensitivity GAP	$ (69,085)	$ 43,072	$ 120,223	$ 160,988	$ (255,198)	$ --
Cumulative interest rate sensitivity GAP	$ (69,085)	$ (26,013)	$ 94,210	$ 255,198	$ --	$ --
Cumulative interest rate sensitivity GAP ratio	(6.38)%	(2.40)%	8.70 %	23.58 %	-- %	-- %

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 September 30, 2004, the Company’s primary liquidity ratio was 16.06%. The liquidity ratio comprised of $106,492,000 of investment securities available-for-sale with maturities (or probable calls) of up to five years, Federal funds sold of $5,800,000, and $46,055,000 in cash and due from banks less $15,907,000 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 $886,749,000. The Company has lines of credit of approximately $139,706,000 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 September 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)	September 30, 2004	September 30, 2003	December 31, 2003	Minimum Regulatory Requirements
Capital components:				
Tier 1 Capital	$ 117,686	$ 108,764	$ 110,891	
Tier 2 Capital	11,295	10,286	10,403	
Total risk-based capital	$ 128,981	$ 119,050	$ 121,294	
Risk-weighted assets	$ 902,687	$ 820,875	$ 830,537	
Average assets	$ 1,098,123	$ 989,285	$ 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 %	11.0 %	11.2 %	4.0 %

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

At September 30, 2004 and 2003, and December 31, 2003, the Company's capital met all minimum regulatory requirements. As of September 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. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

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 September 30, 2004, repurchases of equity securities are presented in the table below:

Settlement 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 10, 2004	5,664	$ 14.29	5,664	$ 9,919,061
June 14, 2004	1,100	$ 14.30	1,100	$ 9,903,331
June 15, 2004	40,000	$ 14.62	40,000	$ 9,318,531
June 17, 2004	4,325	$ 14.40	4,325	$ 9,256,251
June 18, 2004	900	$ 14.40	900	$ 9,243,291
June 21, 2004	5,300	$ 14.48	5,300	$ 9,166,547
June 22, 2004	23,000	$ 14.90	23,000	$ 8,823,847
June 23, 2004	5,300	$ 14.51	5,300	$ 8,746,944
June 24, 2004	6,800	$ 14.48	6,800	$ 8,648,480
June 25, 2004	20,000	$ 14.40	20,000	$ 8,360,480
June 28, 2004	6,800	$ 14.31	6,800	$ 8,263,172
June 29, 2004	6,800	$ 14.50	6,800	$ 8,164,572
June 30, 2004	6,800	$ 14.51	6,800	$ 8,065,904
August 23, 2004	20,000	$ 14.68	20,000	$ 7,772,304
August 24, 2004	2,800	$ 14.67	2,800	$ 7,731,228
August 25, 2004	2,800	$ 14.73	2,800	$ 7,689,984
August 26, 2004	2,900	$ 14.87	2,900	$ 7,646,861
August 27, 2004	1,600	$ 14.85	1,600	$ 7,623,101
August 31, 2004	7,550	$ 14.90	7,550	$ 7,510,606
September 1, 2004	2,900	$ 15.00	2,900	$ 7,467,106
September 2, 2004	3,189	$ 15.00	3,189	$ 7,419,271
Total	176,528		176,528	

ITEM 5. OTHER INFORMATION

Report 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.

ITEM 6. EXHIBITS

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

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.

Heritage Commerce Corp
(Registrant)

November 8, 2004 Date	/s/ William Del Biaggio, Jr. William Del Biaggio, Jr. Interim Chief Executive Officer
November 8, 2004 Date	/s/ Lawrence D. McGovern Lawrence D. McGovern Chief Financial Officer

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