HERITAGE FINANCIAL CORP /WA/
Form 10-Q
August 08, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2014

OR

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

Commission File Number 0-29480

HERITAGE FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

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

(360) 943-1500
(Registrant’s telephone number, including area code)

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

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

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

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

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

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

As of August 1, 2014 there were 30,346,724 shares of the registrant's common stock, no par value per share, outstanding.

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FORWARD LOOKING STATEMENTS:

“Safe Harbor” statement under the Private Securities Litigation Reform Act of 1995: This Quarterly Report on Form 10-Q ("Form 10-Q") contains forward-looking statements that are subject to risks and uncertainties, including, but not limited to: our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired, including those from Cowlitz Bank, Pierce Commercial Bank, Northwest Commercial Bank, Valley Community Bancshares and Washington Banking Company transactions described in this Form 10-Q, or may in the future acquire, into our operations and our ability to realize related revenue synergies and cost savings within expected time frames or at all, and any goodwill charges related thereto and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, which might be greater than expected; the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be effected by deterioration in the housing and commercial real estate markets, which may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses no longer being adequate to cover actual losses, and require us to increase our allowance for loan losses; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Board of Governors of the Federal Reserve System ("Federal Reserve") and of our bank subsidiary by the Federal Deposit Insurance Corporation ("FDIC"), the Washington State Department of Financial Institutions, Division of Banks ("Division") or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our allowance for loan losses, write-down assets, or change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules including as a result of Basel III; our ability to control operating costs and expenses; the impact of the Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and the implementing regulations; further increases in premiums for deposit insurance; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our Condensed Consolidated Statements of Financial Condition; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; failure or security breach of computer systems on which we depend; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our expansion strategy of pursuing acquisitions and de novo branching; increased competitive pressures among financial service companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board ("FASB"), including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; and other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and other risks detailed from time to time in our filings with the Securities and Exchange Commission ("SEC") including our Annual Report on Form 10-K for the year ended December 31, 2013.

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

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

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
June 30, 2014 and December 31, 2013
(Dollars in thousands)
(Unaudited)

	June 30, 2014	December 31, 2013
ASSETS		
Cash on hand and in banks	$73,067	$40,162
Interest earning deposits	73,458	90,238
Cash and cash equivalents	146,525	130,400
Other interest earning deposits	14,138	15,662
Investment securities available for sale, at fair value	652,477	163,134
Investment securities held to maturity (fair value of $39,539 and $36,340, respectively)	38,768	36,154
Loans held for sale	7,378	—
Noncovered loans receivable, net	2,069,532	1,168,166
Allowance for loan losses for noncovered loans	(22,369)	(22,657)
Noncovered loans receivable, net of allowance for loan losses	2,047,163	1,145,509
Covered loans receivable, net	159,662	63,754
Allowance for loan losses for covered loans	(6,114)	(6,167)
Covered loans receivable, net of allowance for loan losses	153,548	57,587
Total loans receivable, net	2,200,711	1,203,096
Federal Deposit Insurance Corporation indemnification asset	9,120	4,382
Other real estate owned ($3,045 and $182 covered by FDIC shared-loss agreements, respectively)	8,106	4,559
Premises and equipment, net	66,255	34,348
Federal Home Loan Bank stock, at cost	12,547	5,741
Bank owned life insurance	32,614	—
Accrued interest receivable	9,315	5,462
Prepaid expenses and other assets	63,272	25,120
Other intangible assets, net	12,164	1,615
Goodwill	118,189	29,365
Total assets	$3,391,579	$1,659,038
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits	$2,866,542	$1,399,189
Junior subordinated debentures	18,973	—
Securities sold under agreement to repurchase	25,450	29,420
Accrued expenses and other liabilities	30,785	14,667
Total liabilities	2,941,750	1,443,276
Stockholders’ equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at June 30, 2014 and December 31, 2013	—	—
Common stock, no par value, 50,000,000 shares authorized; 30,213,363 and 16,210,747 shares issued and outstanding at June 30, 2014 and December 31,	366,158	138,659

2013, respectively		
Retained earnings	82,362	78,265
Accumulated other comprehensive income (loss), net	1,309	(1,162)
Total stockholders’ equity	449,829	215,762
Total liabilities and stockholders’ equity	$3,391,579	$1,659,038

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
For the Three and Six Months Ended June 30, 2014 and 2013
(Dollars in thousands, except per share amounts)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
INTEREST INCOME:				
Interest and fees on loans	$27,446	$16,028	$43,897	$32,747
Taxable interest on investment securities	1,812	404	2,451	777
Nontaxable interest on investment securities	638	345	1,074	680
Interest and dividends on other interest earning assets	127	82	214	139
Total interest income	30,023	16,859	47,636	34,343
INTEREST EXPENSE:				
Deposits	1,297	909	2,151	1,847
Junior subordinated debentures	115	—	115	—
Other borrowings	15	10	33	19
Total interest expense	1,427	919	2,299	1,866
Net interest income	28,596	15,940	45,337	32,477
Provision for loan losses for noncovered loans	370	209	349	709
Provision for loan losses for covered loans	321	1,099	800	1,457
Total provision for loan losses	691	1,308	1,149	2,166
Net interest income after provision for loan losses	27,905	14,632	44,188	30,311
NONINTEREST INCOME:				
Bargain purchase gain on bank acquisition	—	—	—	399
Service charges and other fees	2,777	1,432	4,175	2,785
Merchant Visa income, net	316	211	561	384
Change in FDIC indemnification asset	109	281	72	14
Gain on sale of investment securities, net	87	—	267	—
Gain on sale of loans, net	233	—	233	—
Other income	1,258	433	1,779	1,059
Total noninterest income	4,780	2,357	7,087	4,641
NONINTEREST EXPENSE:				
Compensation and employee benefits	12,779	7,617	20,790	15,206
Occupancy and equipment	2,816	1,995	5,433	3,915
Data processing	4,003	720	4,999	1,856
Marketing	496	386	1,001	712
Professional services	3,230	640	4,060	1,670
State and local taxes	554	305	803	584
Impairment loss on investment securities, net	37	24	45	26
Federal deposit insurance premium	460	275	712	507
Other real estate owned, net	214	5	266	(98)
Amortization of intangible assets	489	114	645	229
Other expense	1,915	926	3,018	2,120
Total noninterest expense	26,993	13,007	41,772	26,727
Income before income taxes	5,692	3,982	9,503	8,225
Income tax expense	1,544	1,292	2,812	2,650

Net income	$4,148	$2,690	$6,691	$5,575
Basic earnings per common share	$0.16	$0.18	$0.32	$0.37
Diluted earnings per common share	$0.16	$0.18	$0.32	$0.37
Dividends declared per common share	$0.08	$0.08	$0.16	$0.16

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Three and Six Months Ended June 30, 2014 and 2013
(Dollars in thousands)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Net income	$4,148	$2,690	$6,691	$5,575
Change in fair value of securities available for sale, net of tax of $1,089, $(1,049), $1,410 and $(1,232), respectively	2,022	(1,947)	2,615	(2,289)
Reclassification adjustment of net gain from sale of available for sale securities included in income, net of tax of $(30), $0, $(93) and $0, respectively	(57)	—	(174)	—
Accretion of other-than-temporary impairment on securities held to maturity, net of tax of $8, $12, $16 and $19, respectively	15	22	30	36
Other comprehensive income (loss)	$1,980	$(1,925)	$2,471	$(2,253)
Comprehensive income	$6,128	$765	$9,162	$3,322

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the Six Months Ended June 30, 2014 and 2013
(In thousands, except per share amounts)
(Unaudited)

	Number of common shares	Common stock	Retained earnings	Accumulated other comprehensive income (loss), net	Total stock-holders' equity
Balance at December 31, 2012	15,118	$121,832	$75,362	$1,744	$198,938
Restricted and unrestricted stock awards issued, net of forfeitures	99	—	—	—	—
Stock option compensation expense	—	42	—	—	42
Exercise of stock options (including excess tax benefits from nonqualified stock options)	3	37	—	—	37
Restricted stock compensation expense	—	722	—	—	722
Excess tax benefits from restricted stock	—	68	—	—	68
Common stock repurchased	(12)	(182)	—	—	(182)
Net income	—	—	5,575	—	5,575
Other comprehensive loss, net of tax	—	—	—	(2,253)	(2,253)
Cash dividends declared on common stock ($0.16 per share)	—	—	(2,422)	—	(2,422)
Balance at June 30, 2013	15,208	$122,519	$78,515	$(509)	$200,525
Balance at December 31, 2013	16,211	$138,659	$78,265	$(1,162)	$215,762
Restricted and unrestricted stock awards issued, net of forfeitures	6	—	—	—	—
Stock option compensation expense	—	20	—	—	20
Exercise of stock options (including excess tax benefits from nonqualified stock options)	38	427	—	—	427
Restricted stock compensation expense	—	539	—	—	539
Excess tax benefits from restricted stock	—	33	—	—	33
Common stock repurchased	(17)	(271)	—	—	(271)
Net income	—	—	6,691	—	6,691
Other comprehensive income, net of tax	—	—	—	2,471	2,471
Common stock issued in business combination	13,975	226,751	—	—	226,751
Cash dividends declared on common stock ($0.16 per share)	—	—	(2,594)	—	(2,594)
Balance at June 30, 2014	30,213	$366,158	$82,362	$1,309	$449,829

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Six Months Ended June 30, 2014 and 2013
(Dollars in thousands)
(Unaudited)

	Six Months Ended June 30,	
	2014	2013
Cash flows from operating activities:		
Net income	$6,691	$5,575
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,829	2,572
Changes in net deferred loan fees, net of amortization	(393)	397
Provision for loan losses	1,149	2,166
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities	(3,176)	(156)
Restricted and unrestricted stock compensation expense	539	722
Stock option compensation expense	20	42
Excess tax benefits from stock options and restricted and unrestricted stock	(33)	(68)
Amortization of intangible assets	645	229
Bargain purchase gain on bank acquisition	—	(399)
Gain on sale of investment securities, net	(267)	—
Impairment loss on investment of securities	45	26
Origination of loans held for sale	(12,592)	(6,784)
Gain on sale of loans	(233)	(142)
Proceeds from sale of loans	9,329	8,602
Earnings on bank owned life insurance	(95)	—
Valuation adjustment on other real estate owned	—	(22)
Gain on other real estate owned, net	(65)	(232)
Write-off of furniture, equipment and leasehold improvements	421	—
Net cash provided by operating activities	6,814	12,528
Cash flows from investing activities:		
Loans originated, net of principal payments	4,969	(39,426)
Maturities of other interest earning deposits	1,494	—
Maturities of investment securities available for sale	17,916	31,369
Maturities of investment securities held to maturity	521	784
Purchase of investment securities available for sale	(206,075)	(32,508)
Purchase of investment securities held to maturity	(3,313)	(3,733)
Purchase of premises and equipment	(1,978)	(3,451)
Proceeds from sales of other real estate owned	3,857	4,666
Proceeds from sales of investment securities available for sale	157,987	—
Proceeds from redemption of FHLB stock	258	101
Investment in new market tax credit partnership	(25,000)	—
Net cash received from acquisitions	31,591	748
Net cash used in investing activities	(17,773)	(41,450)
Cash flows from financing activities:		
Net increase in deposits	33,459	18,118
Common stock cash dividends paid	(2,594)	(2,422)
Net (decrease) increase in securities sold under agreement to repurchase	(3,970)	339

Proceeds from exercise of stock options	427	37
Excess tax benefits from stock options and restricted and unrestricted stock	33	68
Repurchase of common stock	(271)	(182)
Net cash provided by financing activities	27,084	15,958

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	Six Months Ended June 30,	
	2014	2013
Net increase (decrease) in cash and cash equivalents	16,125	(12,964)
Cash and cash equivalents at beginning of period	130,400	107,086
Cash and cash equivalents at end of period	$146,525	$94,122
Supplemental disclosures of cash flow information:		
Cash paid for interest	$1,848	$1,874
Cash paid for income taxes	7,000	3,074
Transfers of loans receivable to other real estate owned	218	513
Seller-financed sale of other real estate owned	—	250
Common stock issued for Washington Banking Merger	226,751	—
Assets acquired (liabilities assumed) in acquisitions:		
Investment securities available for sale	458,312	2,753
Loans held for sale	3,923	—
Noncovered loans receivable	893,824	51,509
Covered loans receivable	109,693	—
Other real estate owned	7,121	2,279
Premises and equipment	31,776	214
Federal Home Loan Bank stock	7,064	88
FDIC indemnification asset	7,407	—
Accrued interest receivable	4,943	232
Bank owned life insurance	32,519	—
Prepaid expenses and other assets	14,942	4,048
Other intangible asset	11,194	156
Deposits	(1,433,894)	(60,442)
Junior subordinated debentures	(18,937)	—
Accrued expenses and other liabilities	(23,551)	(1,186)

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
For the Three and Six Months Ended June 30, 2014 and 2013
(Unaudited)

(1) Description of Business, Basis of Presentation and Significant Accounting Policies

(a) Description of Business

Heritage Financial Corporation ("Heritage" or the “Company”) is a bank holding company that was incorporated in the State of Washington in August 1997. The Company is primarily engaged in the business of planning, directing and coordinating the business activities of its wholly-owned subsidiary Heritage Bank (the “Bank”). The Bank is a Washington-chartered commercial bank and its deposits are insured by the FDIC under the Deposit Insurance Fund. The Bank is headquartered in Olympia, Washington and conducts business from its sixty-seven branch offices located throughout Washington State and the greater Portland, Oregon area. The Bank’s business consists primarily of lending and deposit relationships with small businesses and their owners in its market areas and attracting deposits from the general public. The Bank also makes real estate construction and land development loans and consumer loans and originates first mortgage loans on residential properties primarily located in its market area.

The Company has expanded its footprint through mergers and acquisitions beginning with its first acquisition in July 2010. The largest of these transactions was the strategic merger with Washington Banking Company (“Washington Banking”) and its wholly owned subsidiary bank, Whidbey Island Bank ("Whidbey") which was effective on May 1, 2014. The merger is referred to as the "Washington Banking Merger". The Washington Banking results since May 1, 2014 are included in this Quarterly Report on Form 10-Q. The strategic merger is described in more detail in "Note 2 - Business Combinations."

(b) Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with Generally Accepted Accounting Principles (“GAAP”), for interim financial information, pursuant to the rules and regulations of the SEC. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These Condensed Consolidated Financial Statements and accompanying Notes should be read with the Company's December 31, 2013 audited Consolidated Financial Statements and the accompanying Notes included in the Company's Annual Report on Form 10-K (“2013 Annual Form 10-K”). In management's opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. In preparing the Condensed Consolidated Financial Statements, management is required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates. Estimates related to the allowance for loan losses, other than temporary impairments in the fair value of investment securities, expected cash flows of purchased credit impaired loans and related indemnification asset, fair value measurements, stock-based compensation, impairment of goodwill and other intangible assets and income taxes are particularly subject to change.

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

As a result of the Washington Banking Merger, the Company reclassified its loan portfolio. Total loans receivable are now presented in two categories: noncovered loans receivable and covered loans receivable. A description of the categories is included below.

Noncovered Loans Receivable: Noncovered loans are those that are not covered by FDIC shared-loss agreements and can include loans originated by the Company or acquired in mergers and acquisitions. Loans are stated at the unpaid principal balance, net of premiums, unearned discounts and net deferred loan origination fees and costs. The premiums and unearned discounts may include values determined in purchase accounting. The loans purchased in

acquisitions included in this category include those accounted for under Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality, or those accounted for under ASC 310-20, Receivables - Nonrefundable fees and Other Costs.
Covered Loans Receivable: Covered loans are those that are covered by FDIC shared-loss agreements. These include the majority of loans from the Company's acquisition of Cowlitz Bank, as well as loans from Washington Banking's acquisitions of City Bank and North County Bank, as then acquired by the Company in the Washington

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Banking Merger. The same accounting principles applicable to noncovered loans receivable apply to covered loans, with the added benefit of shared-loss agreements.

(c) Significant Accounting Policies

The significant accounting policies used in preparation of our Condensed Consolidated Financial Statements are disclosed in our 2013 Annual Form 10-K. There have not been any material changes in our significant accounting policies from those contained in our 2013 Annual Form 10-K. As a result of the Washington Banking Merger, the Company has added an additional significant accounting policy which is described below.

Bank Owned Life Insurance: The Company acquired in the Washington Banking Merger fair value of $32.5 million in bank owned life insurance ("BOLI"). These policies insure the lives of certain current or former Whidbey officers, and name the Bank as beneficiary. Noninterest income is generated tax-free (subject to certain limitations) from the increase in the policies' underlying investments made by the insurance company. The Bank is capitalizing on the ability to partially offset costs associated with employee compensation and benefit programs with the BOLI. BOLI is recorded at the amount that can be realized under the issuance contract at the statement of financial condition date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

(d) Recently Issued Accounting Pronouncements

FASB ASU 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, A Similar Tax Loss, or a Tax Credit Carryforward Exists, was issued in July 2013. This Update provides that an unrecognized tax benefit, or a portion thereof, be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent that a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from disallowance of a tax position, or the tax law does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, then the unrecognized tax benefit should be presented as a liability. These amendments are effective for interim and annual reporting periods beginning after December 15, 2013. The adoption of this amendment did not have a material impact on the Company's Condensed Consolidated Financial Statements.

FASB ASU No. 2014-01, Accounting for Investments in Qualified Affordable Housing Projects, was issued in January 2014. The objective of this amendment is to provide guidance on accounting for investments by a reporting entity in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for the low-income housing tax credit. The amendments in the standard permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The standard will be effective for the Company beginning January 1, 2015; however, early adoption is permitted. The Company is currently reviewing the provisions of this Update to determine the impacts it may have on the Company's financial condition or results of operations.

FASB ASU 2014-04, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure, was issued in January 2014. This Update intends to reduce diversity in practice by clarifying when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The amendment states that the real estate property should be recognized upon either the creditor obtaining legal title or the borrower convening all interest through a deed in lieu of foreclosure or similar legal agreement. These amendments are effective for interim and annual reporting periods beginning after December 15, 2014. Early adoption is permitted. The Company adopted the amendments in first quarter of 2014. The adoption did not have an impact on the Company's Condensed Consolidated Financial Statements.

FASB ASU 2014-09, Revenue from Contracts with Customers, was issued in May 2014. Under this Update, FASB created a new Topic 606 which is in response to a joint initiative of FASB and the International Accounting Standards

Board to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. generally accepted accounting principles and international financial reporting standards that would:

1. Remove inconsistencies and weaknesses in revenue requirements.
2. Provide a more robust framework for addressing revenue issues.
3. Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.

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4. Provide more useful information to users of financial statements through improved disclosure requirements.
5. Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

The amendments in this Update are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. The Company is currently evaluating the impact this new accounting standard will have on its Condensed Consolidated Financial Statements.
FASB ASU 2014-11, Transfers and Servicing: Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures, was issued in June 2014. This Update aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements, such as secured borrowings. The guidance eliminates sale accounting and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement. The amendments in this ASU require new and expanded disclosures. These amendments are effective for interim or annual reporting periods beginning after December 15, 2014. Early adoption for a public company is prohibited. The Company does not anticipate the adoption will have a material impact on its Condensed Consolidated Financial Statements.

(2) Business Combination

On October 23, 2013, the Company, along with the Bank, and Washington Banking and its wholly owned subsidiary bank, Whidbey, jointly announced the signing of a merger agreement for the Washington Banking Merger. The Washington Banking Merger was effective on May 1, 2014. Pursuant to the terms of the Washington Banking Merger, Washington Banking branches adopted the Heritage Bank name in all markets, with the exception of six branches in the Whidbey Island markets which will continue to operate using the Whidbey Island Bank name. The primary reasons for the merger were to expand the Company's geographic footprint consistent with its ongoing growth strategy and to achieve operational scale and realize efficiencies of a larger combined organization.
Under the terms of the merger agreement, Washington Banking shareholders received 0.89000 shares of Heritage common stock and $2.75 in cash for each share of Washington Banking common stock. Based on the closing price of Heritage common stock of $16.16 on April 30, 2014, the fair value of the per share merger consideration paid to Washington Banking shareholders was approximately $224.2 million for 13,872,567 shares issued. The Company also paid $42.9 million in cash and incurred $489,000 in capitalized stock issuance costs. The terms of the merger agreement also stipulated immediate vesting of the Washington Banking options and restricted stock awards units. The estimated fair value of the 90,358 converted options issued was $481,000. The estimated fair value of the converted 129,462 restricted stock award units, of which 26,783 shares were surrendered at the request of the shareholder to pay applicable taxes, was approximately $2.1 million. The total consideration paid by the Company in conjunction with the Washington Banking Merger was $270.1 million and the total shares issued was 13,975,246.
The transaction qualified as a tax-free reorganization for U.S. federal income tax purposes and Washington Banking shareholders did not recognize any taxable gain or loss in connection with the share exchange and the stock consideration received.
The Washington Banking Merger resulted in $88.8 million of goodwill. This goodwill is not deductible for tax purposes.
During the three and six months ended June 30, 2014, the Company incurred Washington Banking merger-related costs (including conversion costs) of approximately $5.3 million and $5.6 million, respectively. There were no Washington Banking merger-related costs during the three or six months ended June 30, 2013. However, the Company did incur $312,000 and $1.3 million of costs for the three and six months ended June 30, 2013, respectively, related to the Northwest Commercial and Valley Acquisitions and the Central Valley Bank merger, as discussed in the Annual Report on Form 10-K.

Business Combination Accounting

The Washington Banking Merger constitutes a business acquisition as defined by FASB ASC 805, Business Combinations. FASB ASC 805 establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired and the liabilities assumed. Heritage was considered the acquirer in this transaction. Accordingly, the preliminary estimates of fair values of the Washington Banking assets, including the identifiable intangible assets, and the assumed liabilities in the Washington Banking Merger were measured and recorded as of May 1, 2014. The Company expects to finalize the purchase price allocation by the end of 2014 when the valuation of acquired noncovered and covered loans is complete.

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The preliminary fair value estimates of the assets acquired and liabilities assumed in the Washington Banking Merger were as follows:

	May 1, 2014 (In thousands)
Assets	
Cash and cash equivalents	$74,947
Investment securities available for sale	458,312
Loans held for sale	3,923
Noncovered loans receivable	893,824
Covered loans receivable	109,693
FDIC indemnification asset	7,407
Other real estate owned ($5,122 covered by FDIC shared-loss agreements)	7,121
Federal Home Loan Bank stock	7,064
Premises and equipment	31,776
Bank owned life insurance	32,519
Other intangible assets	11,194
Prepaid expenses and other assets	19,885
Total assets acquired	1,657,665
Liabilities	
Deposits	1,433,894
Junior subordinated debentures	18,937
Accrued expenses and other liabilities	23,551
Total liabilities assumed	1,476,382
Net assets acquired	$181,283

A summary of the net assets purchased and the preliminary estimated fair value adjustments and resulting goodwill recognized from the Washington Banking Merger are presented in the following tables. Goodwill represents the excess of the consideration transferred over the estimated fair value of the net assets acquired and liabilities assumed.

	May 1, 2014 (In thousands)	
Cost basis of net assets on merger date	$181,782	
Consideration transferred	(270,107	)
Fair value adjustments:		
Noncovered loans receivable	(11,941	)
Covered loans receivable	6,003	
FDIC indemnification asset	590	
Other real estate owned	387	
Premises and equipment	(1,540	)
Other intangible assets	10,216	
Prepaid expenses and other assets	(6,241	)
Deposits	(1,737	)
Junior subordinated debentures	6,837	
Accrued expenses and other liabilities	(3,073	)
Goodwill recognized from the Washington Banking Merger	$(88,824	)

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The operating results of the Company for the three and six months ended June 30, 2014 include the operating results produced by the net assets acquired in the Washington Banking Merger since the May 1, 2014 merger date. The Company has considered the requirement of FASB ASC 805 related to the contribution of the Washington Banking Merger to the Company’s results of operations. The table below presents only the significant results for the acquired business since the May 1, 2014 merger date.

	Three and Six Months Ended (1)
	(In thousands)
Interest income: Interest and fees on loans (2)	$9,010
Interest income: Interest and fees on loans (3)	1,832
Interest income: Securities and other interest earning assets	1,277
Interest expense	(469)
Provision for loan losses for noncovered loans	(131)
Noninterest income	2,282
Noninterest expense (4)	(7,887)
Net effect, pre-tax	$5,914

(1) The Washington Banking Merger was completed on May 1, 2014.
(2) Includes the contractual interest income on the purchased loans.
(3) Includes the accretion of the accretable yield on the purchased credit impaired loans and the accretion of the discount on the purchased non-credit impaired loans.
(4) Excludes certain compensation and employee benefits for management as it is impracticable to determine due to the integration of the operations for this merger. Also includes certain merger-related costs incurred by the Company.

The Company also considered the pro forma requirements of FASB ASC 805. The following tables presents certain unaudited pro forma information, for illustrative purposes only, for the six month periods ended June 30, 2014 and 2013 as if Washington Banking had been acquired on January 1, 2013. The unaudited estimated pro forma information combines the historical results of Washington Banking with the Company's consolidated historical results and includes certain adjustments reflecting the estimated impact of certain fair value adjustments for the respective periods. The pro forma information is not indicative of what would have occurred had the Washington Banking Merger occurred on January 1, 2013. In particular, no adjustments have been made to eliminate the impact of the Washington Banking loans which were previously accounted for under ASC 310-30 that may have been necessary had they been recorded at fair value at January 1, 2013. Additionally, Heritage expects to achieve further operating savings and other business synergies, including interest income growth, as a result of the Washington Banking Merger which are not reflective in the pro forma amounts that follow. As a result, actual amounts will differ from the unaudited pro forma information presented.

	Unaudited Pro Forma for the Six Months Ended June 30, 2014				
	Company	Washington Banking	Pro Forma Adjustments		Pro Forma Combined
	(In thousands, except per share amounts)				
Interest income	$47,636	$25,091	$2,376	A	$75,103
Interest expense	2,299	1,484	323	B	4,106
Provision for loan losses	1,149	(2,150)	—	C	(1,001)
Noninterest income	7,087	1,812	17	D	8,916
Noninterest expense	41,772	19,514	(5,020)	E	56,266
Income before income taxes	9,503	8,055	7,090		24,648
Income tax expense	2,812	2,609	2,774	F	8,195

Net income	$6,691	$5,446	$4,316		$16,453
Basic earnings per common share	$0.32			G	$0.55
Diluted earnings per common share	$0.32			G	$0.55

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	Unaudited Pro Forma for the Six Months Ended June 30, 2013				
	Company	Washington Banking	Pro Forma Adjustments		Pro Forma Combined
	(In thousands, except per share amounts)				
Interest income	$34,343	$38,336	$2,976	A	$75,655
Interest expense	1,866	2,797	1,019	B	5,682
Provision for loan losses	2,166	13,714	—	C	15,880
Noninterest income	4,641	16,043	17	D	20,701
Noninterest expense	26,727	26,793	102	E	53,622
Income before income taxes	8,225	11,075	1,872		21,172
Income tax expense	2,650	3,583	655	F	6,888
Net income	$5,575	$7,492	$1,217		$14,284
Basic earnings per common share	$0.37			G	$0.49
Diluted earnings per common share	$0.37			G	$0.49

(A) Adjustment of interest income from loans due to the estimated amortization of the new interest rate mark and the accretion of the acquisition accounting adjustment relating to the credit mark. The Washington Banking credit and interest rate marks and accretion recorded during the six months ended June 30, 2014 and 2013 as a result of its prior acquisitions were not adjusted.

(B) Adjustments to reflect the amortization of the premium resulting from the fair value adjustment of the fixed rate maturities and the discount resulting from the fair value adjustment of the junior subordinated debentures.

(C) As acquired loans and leases are recorded at fair value, the Company would expect a reduction in the historical provision for loan and leases losses from legacy Washington Banking; however, no adjustment to the historical amount of Washington Banking's provision for loan and lease losses is reflected in these pro forma statements.

(D) Adjustment to reflect the amortization of the interest component of the fair value adjustment of the FDIC indemnification asset.

(E) In connection with the Washington Banking Merger, Heritage recognized $5.6 million of direct merger-related expenses for the six month period ended June 30, 2014, which were excluded in this adjustment. Also, adjustment reflects the decrease in the depreciation expense as a result of the fair value adjustment to the premises and equipment, which effectively increased non-depreciable assets and decreased depreciable assets. Adjustment additionally reflects the amortization of assumed liabilities included in the the fair value adjustment of accrued expenses and other liabilities.

(F) Income tax effect of pro forma adjustments at Company's statutory rate of 35%, excluding certain nondeductible costs included in the proforma adjustments.

(G) Earnings per common share, basic and diluted, were calculated using the calculated pro forma net income less dividends and undistributed earnings allocated to participating securities divided by the calculated pro forma basic and diluted weighted average shares outstanding. Basic and diluted weighted average common shares outstanding for the six months ended June 30, 2014 and 2013 were calculated by adding the applicable weighted average of the 13,975,246 shares issued by Heritage in conjunction with the Washington Banking Merger to the historical weighted average Heritage shares outstanding for the six months ended June 30, 2014 and 2013, respectively.

(3) Cash and Cash Equivalents

From October 2013 through May 2014, the Company was required to maintain an average reserve balance with the Federal Reserve Bank of San Francisco ("Federal Reserve Bank") or maintain such reserve balance in the form of cash. The Company did not have a cash reserve requirement at June 30, 2014. The required reserve balance at December 31, 2013 was $46.3 million, and was met by holding cash and maintaining an average balance with the Federal Reserve Bank.

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(4) Investment Securities

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

(a) Securities by Type and Maturity

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

	Securities Available for Sale June 30, 2014			
	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	$14,215	$42	$(29)	$14,228
Municipal securities	143,980	1,895	(673)	145,202
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	486,967	2,372	(1,271)	488,068
Corporate obligations	3,014	—	(11)	3,003
Mutual funds and other equities	1,962	14	—	1,976
Total	$650,138	$4,323	$(1,984)	$652,477

	Securities Available for Sale December 31, 2013			
	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	$6,098	$3	$(62)	$6,039
Municipal securities	49,989	806	(1,735)	49,060
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government agencies	108,466	898	(1,329)	108,035
Total	$164,553	$1,707	$(3,126)	$163,134

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

	Securities Held to Maturity June 30, 2014			
	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	$1,600	$174	$—	$1,774
Municipal securities	24,852	568	(49)	25,371
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	11,370	295	(137)	11,528
Private residential collateralized mortgage obligations	946	58	(138)	866
Total	$38,768	$1,095	$(324)	$39,539

	Securities Held to Maturity December 31, 2013			
	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	$1,687	$153	$—	$1,840
Municipal securities	24,290	200	(184)	24,306
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	9,129	144	(284)	8,989
Private residential collateralized mortgage obligations	1,048	185	(28)	1,205
Total	$36,154	$682	$(496)	$36,340

There were no securities classified as trading at June 30, 2014 or December 31, 2013.

The amortized cost and fair value of securities at June 30, 2014, by contractual maturity, are set forth below. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Securities Available for Sale		Securities Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Due in one year or less	$4,727	$4,754	$2,080	$2,088
Due after one year through three years	18,601	18,701	6,264	6,329
Due after three years through five years	31,134	31,432	4,732	4,817
Due after five years through ten years	137,414	138,031	17,493	18,093
Due after ten years	458,262	459,559	8,199	8,212
Total	$650,138	$652,477	$38,768	$39,539

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(b) Unrealized Losses and Other-Than-Temporary Impairments
Available for sale investment securities with unrealized losses as of June 30, 2014 and December 31, 2013 were as follows:

	Securities Available for Sale June 30, 2014					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
U.S. Treasury and U.S. Government-sponsored agencies	$5,556	$(29)	$—	$—	$5,556	$(29)
Municipal securities	42,608	(673)	—	—	42,608	(673)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	142,252	(1,271)	—	—	142,252	(1,271)
Corporate obligations	3,003	(11)	—	—	3,003	(11)
Total	$193,419	$(1,984)	$—	$—	$193,419	$(1,984)

	Securities Available for Sale December 31, 2013					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
U.S. Treasury and U.S. Government-sponsored agencies	$3,031	$(62)	$—	$—	$3,031	$(62)
Municipal securities	21,471	(1,242)	4,644	(493)	26,115	(1,735)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	56,327	(1,184)	7,758	(145)	64,085	(1,329)
Total	$80,829	$(2,488)	$12,402	$(638)	$93,231	$(3,126)

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Held to maturity investment securities with unrealized losses as of June 30, 2014 and December 31, 2013 were as follows:

	Securities Held to Maturity June 30, 2014					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Municipal securities	$3,554	$(49)	$—	$—	$3,554	$(49)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	2,465	(137)	—	—	2,465	(137)
Private residential collateralized mortgage obligations	926	(138)	—	—	926	(138)
Total	$6,945	$(324)	$—	$—	$6,945	$(324)

	Securities Held to Maturity December 31, 2013					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Municipal securities	$10,967	$(184)	$—	$—	$10,967	$(184)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	4,869	(284)	—	—	4,869	(284)
Private residential collateralized mortgage obligations	211	(5)	124	(23)	335	(28)
Total	$16,047	$(473)	$124	$(23)	$16,171	$(496)

The Company has evaluated these securities and has determined that, other than certain private residential collateralized mortgage obligations discussed below, the decline in their value is temporary. The unrealized losses are primarily due to increases in market interest rates and larger spreads in the market for mortgage-related products. The fair value of these securities is expected to recover as the securities approach their maturity date and/or as the pricing spreads narrow on mortgage-related securities. The Company has the ability and intent to hold the investments until recovery of the market value which may be the maturity date of the securities.

To analyze the unrealized losses, the Company estimated expected future cash flows of the private residential collateralized mortgage obligations by estimating the expected future cash flows of the underlying collateral and applying those collateral cash flows, together with any credit enhancements such as subordination interests owned by third parties, to the security. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which considers current delinquencies and nonperforming assets, future expected default rates and collateral value by vintage and geographic region) and prepayments. The expected cash flows of the security are then discounted at the interest rate used to recognize interest income on the security to arrive at a present value amount. The average discount interest rate used in the valuations of the present value as of June 30, 2014 and 2013 was 9.4% and 6.4%, respectively, and the average prepayment rate for each period was 6.0%.

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For the six months ended June 30, 2014, there were four private residential collateralized mortgage obligations determined to be other-than-temporarily impaired. All unrealized losses for the three and six months ended June 30, 2014 were deemed to be credit related, and the Company recorded the impairment in earnings. For the six months ended June 30, 2013, there were six private residential collateralized mortgage obligations determined to be other-than-temporarily impaired. The impairment for the three and six months ended June 30, 2013 was considered credit related and was recorded in earnings. No impairment for the three and six months ended June 30, 2014 and 2013 was recorded through other comprehensive income (loss).

The following table summarizes activity for the six months ended June 30, 2014 and 2013 related to the amount of impairments on held to maturity securities:

	Life-to-Date Gross Other-Than-Temporary Impairments	Life-to-Date Other-Than-Temporary Impairments Included in Other Comprehensive Income (Loss)	Life-to-Date Net Other-Than-Temporary Impairments Included in Earnings
	(In thousands)		
December 31, 2012	$2,565	$1,152	$1,413
Subsequent impairments	26	—	26
June 30, 2013	$2,591	$1,152	$1,439
December 31, 2013	$2,603	$1,152	$1,451
Subsequent impairments	45	—	45
June 30, 2014	$2,648	$1,152	$1,496

(c) Pledged Securities

The following table summarizes the amortized cost and fair value of available for sale and held to maturity securities that are pledged as collateral for the following obligations at June 30, 2014 and December 31, 2013:

	June 30, 2014		December 31, 2013	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Washington and Oregon state to secure public deposits	$148,052	$149,917	$80,386	$80,881
Federal Reserve Bank and FHLB to secure borrowing arrangements	9,031	9,051	—	—
Repurchase agreements	34,248	34,579	34,170	33,893
Other securities pledged, principally to secure public deposits	12,940	12,969	—	—
Total	$204,271	$206,516	$114,556	$114,774

(5) Noncovered Loans Receivable

The Company originates loans in the ordinary course of business and has also acquired loans through FDIC-assisted and open bank transactions. Loans that are not covered by FDIC shared-loss agreements are referred to as "noncovered loans." Disclosures related to the Company’s recorded investment in noncovered loans receivable generally exclude accrued interest receivable and net deferred loan origination fees and costs because they are insignificant.

Loans acquired in a business combination may be further classified as “purchased” loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that not all contractually required payments will be collected are accounted for under FASB ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality. These loans are identified as “purchased credit impaired” ("PCI") loans. Loans purchased that are not accounted for under FASB ASC 310-30 are accounted for under FASB ASC 310-20, Receivables—Nonrefundable Fees and Other Costs.

(a) Loan Origination/Risk Management

The Company categorizes loans in one of the four segments of the total loan portfolio: commercial business, real estate construction and land development, one-to-four family residential and consumer. Within these segments

are classes of loans to which management monitors and assesses credit risk in the loan portfolios. The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, and nonperforming and potential problem loans. The Company also conducts internal loan reviews and validates the credit risk assessment on a periodic basis and presents the results of these reviews to management. The loan review process complements and reinforces the risk identification and assessment decisions made by loan officers and credit personnel, as well as the Company's policies and procedures.
A discussion of the risk characteristics of each loan portfolio segment is as follows:
Commercial Business:
There are three significant classes of loans in the commercial portfolio segment, including commercial and industrial loans, owner-occupied commercial real estate and non-owner occupied commercial real estate. The owner and non-owner occupied commercial real estate are both considered commercial real estate loans. As the commercial and industrial loans carry different risk characteristics than the commercial real estate loans, they are discussed separately below.
Commercial and industrial. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may include a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.
Commercial real estate. The Company originates commercial real estate loans within its primary market areas. These loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate involves more risk than other classes of loans in that the lending typically involves higher loan principal amounts, and payments on loans secured by real estate properties are dependent on successful operation and management of the properties. Repayment of these loans may be more adversely affected by conditions in the real estate market or the economy.
One-to-Four Family Residential:
The majority of the Company's one-to-four family residential loans are secured by single-family residences located in its primary market areas. The Company's underwriting standards require that single-family portfolio loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms of maturity typically range from 15 to 30 years. Historically, the Company sold most single-family loans in the secondary market and retained a smaller portion in its loan portfolio. For the second quarter of 2013 until May 1, 2014, the Company only originated single-family loans for its loan portfolio. With the merger of Washington Banking, the Company again began originating and selling a majority of the single-family mortgages.
Real Estate Construction and Land Development:
The Company originates construction loans for one-to-four family residential and for five or more family residential and commercial properties. The one-to-four family residential construction loans generally include construction of custom homes whereby the home buyer is the borrower. The Company also provides financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Substantially all construction loans are short-term in nature and priced with variable rates of interest. Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project's completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, the Company's estimates with regard to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans

often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If the Company's estimate of the value of a project at completion proves to be overstated, it may have inadequate security for repayment of the loan and may incur a loss if the borrower does not repay the loan. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being

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dependent upon successful completion of the construction project, interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

Consumer:

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

As a result of the Washington Banking Merger, the Company now originates indirect consumer loans. The Company makes loans for new and used automobile and recreational vehicles that are originated indirectly by selected dealers located in the Company's market areas. The Company has limited its indirect loan purchased primarily to dealerships that are established and well known in their market areas and to applicants that are not classified as sub-prime.

Noncovered loans receivable at June 30, 2014 and December 31, 2013 consisted of the following portfolio segments and classes:

	June 30, 2014	December 31, 2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$534,458	$336,540
Owner-occupied commercial real estate	473,603	281,309
Non-owner occupied commercial real estate	637,067	399,979
Total commercial business	1,645,128	1,017,828
One-to-four family residential	86,422	43,082
Real estate construction and land development:		
One-to-four family residential	55,477	19,724
Five or more family residential and commercial properties	74,552	48,655
Total real estate construction and land development	130,029	68,379
Consumer	210,230	41,547
Gross noncovered loans receivable	2,071,809	1,170,836
Net deferred loan fees	(2,277)	(2,670)
Noncovered loans receivable, net	2,069,532	1,168,166
Allowance for loan losses	(22,369)	(22,657)
Noncovered loans receivable, net of allowance for loan losses	$2,047,163	$1,145,509

(b) Concentrations of Credit

Most of the Company’s lending activity occurs within Washington State, and to a lesser extent Oregon. The Company’s primary market areas have been concentrated along the I-5 corridor from Whatcom to Clark County in Washington State and Multnomah County in Oregon, as well as other contiguous markets. The Washington Banking Merger has allowed the expansion of the market area north of Seattle, Washington to the Canadian border. The majority of the Company’s loan portfolio consists of (in order of balances at June 30, 2014) non-owner occupied commercial real estate, commercial and industrial and owner-occupied commercial real estate. As of June 30, 2014 and December 31, 2013, there were no concentrations of loans related to any single industry in excess of 10% of the Company’s total loans.

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(c) Credit Quality Indicators

As part of the on-going monitoring of the credit quality of the Company’s loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grade of the loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) nonperforming loans, and (v) the general economic conditions of the United States of America, and specifically the states of Washington and Oregon. The Company utilizes a risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 0 to 10. A description of the general characteristics of the risk grades is as follows:

- Grades 0 to 5: These grades are considered “pass grade” and include loans with negligible to above average but acceptable risk. These borrowers generally have strong to acceptable capital levels and consistent earnings and debt service capacity. Loans with the higher grades within the “pass” category may include borrowers who are experiencing unusual operating difficulties, but have acceptable payment performance to date. Increased monitoring of financials and/or collateral may be appropriate. Loans with this grade show no immediate loss exposure.
- Grade 6: This grade includes "Watch" loans and is considered a “pass grade”. The grade is intended to be utilized on a temporary basis for pass grade borrowers where a potentially significant risk-modifying action is anticipated in the near term.
- Grade 7: This grade includes “Other Assets Especially Mentioned” (“OAEM”) loans in accordance with regulatory guidelines, and is intended to highlight loans with elevated risks. Loans with this grade show signs of deteriorating profits and capital, and the borrower might not be strong enough to sustain a major setback. The borrower is typically higher than normally leveraged, and outside support might be modest and likely illiquid. The loan is at risk of further decline unless active measures are taken to correct the situation.
- Grade 8: This grade includes “Substandard” loans in accordance with regulatory guidelines, which the Company has determined have a high credit risk. These loans also have well-defined weaknesses which make payment default or principal exposure likely, but not yet certain. The borrower may have shown serious negative trends in financial ratios and performance. Such loans may be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business. Loans with this grade can be placed on accrual or nonaccrual status based on the Company’s accrual policy.
- Grade 9: This grade includes “Doubtful” loans in accordance with regulatory guidelines, and the Company has determined these loans to have excessive credit risk. Such loans are placed on nonaccrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Additionally, these loans generally have a specific valuation allowance.
- Grade 10: This grade includes “Loss” loans in accordance with regulatory guidelines, and the Company has determined these loans have the highest risk of loss. Such loans are charged-off or charged-down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be determined. “Loss” is not intended to imply that the loan or some portion of it will never be paid, nor does it in any way imply that there has been a forgiveness of debt.

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

The loan grades relate to the likelihood of losses in that the higher the grade, the greater the loss potential. Loans with a pass grade may have some estimated inherent losses, but to a lesser extent than the other loan grades. The OAEM loan grade is transitory in that the Company is waiting on additional information to determine the likelihood and extent of the potential loss. The likelihood of loss for OAEM graded loans, however, is greater than Watch graded loans because there has been measurable credit deterioration. Loans with a Substandard grade are generally loans for which the Company has individually analyzed for potential impairment. For Doubtful and Loss graded loans, the

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Company is almost certain of the losses, and the unpaid principal balances are generally charged-off to the realizable value.
The following tables present the balance of the noncovered loans receivable by credit quality indicator as of June 30, 2014 and December 31, 2013.

	June 30, 2014				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$489,729	$18,708	$25,313	$708	$534,458
Owner-occupied commercial real estate	443,482	13,449	16,672	—	473,603
Non-owner occupied commercial real estate	587,455	24,029	25,583	—	637,067
Total commercial business	1,520,666	56,186	67,568	708	1,645,128
One-to-four family residential	81,682	486	4,254	—	86,422
Real estate construction and land development:					
One-to-four family residential	40,169	3,033	12,275	—	55,477
Five or more family residential and commercial properties	60,270	382	13,900	—	74,552
Total real estate construction and land development	100,439	3,415	26,175	—	130,029
Consumer	202,380	1,388	6,462	—	210,230
Gross noncovered loans	$1,905,167	$61,475	$104,459	$708	$2,071,809

	December 31, 2013				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$304,959	$9,183	$20,849	$1,549	$336,540
Owner-occupied commercial real estate	269,130	3,814	8,365	—	281,309
Non-owner occupied commercial real estate	381,355	9,037	8,723	864	399,979
Total commercial business	955,444	22,034	37,937	2,413	1,017,828
One-to-four family residential	40,245	269	2,568	—	43,082
Real estate construction and land development:					
One-to-four family residential	11,582	4,159	3,983	—	19,724
Five or more family residential and commercial properties	45,332	—	3,323	—	48,655
Total real estate construction and land development	56,914	4,159	7,306	—	68,379
Consumer	39,432	248	1,867	—	41,547
Gross noncovered loans	$1,092,035	$26,710	$49,678	$2,413	$1,170,836

Noncovered potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which management is monitoring because the financial information of the borrower causes concern as to their ability to meet their loan repayment terms. Noncovered potential problem loans also include PCI loans as these loans continue to accrete loan discounts established at acquisition based on the guidance of ASC 310-30. Noncovered potential problem loans as of June 30, 2014 and December 31, 2013 were $137.0 million and $52.8 million, respectively. The balance of noncovered potential problem loans guaranteed by a governmental agency, which guarantee reduces the Company's credit exposure, was $921,000 and $1.8 million as of June 30, 2014 and December 31, 2013, respectively.

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(d) Nonaccrual Loans

Noncovered nonaccrual loans, segregated by segments and classes of loans, were as follows as of June 30, 2014 and December 31, 2013:

	June 30, 2014	December 31, 2013
	(In thousands)	
Commercial business:		
Commercial and industrial	$6,741	$4,648
Owner-occupied commercial real estate	2,146	1,024
Non-owner occupied commercial real estate	2	3
Total commercial business	8,889	5,675
One-to-four family residential	328	340
Real estate construction and land development:		
One-to-four family residential	3,673	1,045
Total real estate construction and land development	3,673	1,045
Consumer	698	678
Gross noncovered nonaccrual loans	$13,588	$7,738

The Company had $2.3 million and $1.7 million of noncovered nonaccrual loans guaranteed by governmental agencies at June 30, 2014 and December 31, 2013, respectively.

Noncovered PCI loans are not included in the nonaccrual table above because the loans are accounted for under ASC 310-30, whereby accretable yield is calculated based on a loan's expected cash flow even if the loan is not performing under its conventional terms.

(e) Past due loans

The Company performs an aging analysis of past due loans using the categories of 30-89 days past due and 90 or more days past due. This policy is consistent with regulatory reporting requirements.

The balances of noncovered past due loans, segregated by segments and classes of loans, as of June 30, 2014 and December 31, 2013 were as follows: