

HERITAGE FINANCIAL CORP /WA/
Form 10-Q
August 08, 2014
Table of Contents

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934
For the quarterly period ended June 30, 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) (360) 943-1500 (Registrant's telephone number, including area code)	98501 (Zip 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 No

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

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

Edgar Filing: HERITAGE FINANCIAL CORP /WA/ - Form 10-Q

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

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.

Table of Contents

HERITAGE FINANCIAL CORPORATION
 FORM 10-Q
 INDEX
 June 30, 2014

	Page
<u>FORWARD LOOKING STATEMENTS</u>	
Part I. <u>FINANCIAL INFORMATION</u>	<u>4</u>
Item 1. <u>FINANCIAL STATEMENTS</u>	<u>4</u>
<u>Condensed Consolidated Statements of Financial Condition as of June 30, 2014 and December 31, 2013</u>	<u>4</u>
<u>Condensed Consolidated Statements of Income for the Three and Six Months Ended June 30, 2014 and 2013</u>	<u>5</u>
<u>Condensed Consolidated Statements of Comprehensive Income for the Three and Six Months Ended June 30, 2014 and 2013</u>	<u>6</u>
<u>Condensed Consolidated Statements of Stockholders' Equity for the Six Months Ended June 30, 2014 and 2013</u>	<u>7</u>
<u>Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 2014 and 2013</u>	<u>8</u>
<u>Notes to Condensed Consolidated Financial Statements</u>	<u>10</u>
Item 2. <u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	<u>55</u>
Item 3. <u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	<u>76</u>
Item 4. <u>CONTROLS AND PROCEDURES</u>	<u>76</u>
Part II. <u>OTHER INFORMATION</u>	<u>76</u>
Item 1. <u>LEGAL PROCEEDINGS</u>	<u>76</u>
Item 1A. <u>RISK FACTORS</u>	<u>77</u>
Item 2. <u>UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	<u>77</u>
Item 3. <u>DEFAULTS UPON SENIOR SECURITIES</u>	<u>78</u>
Item 4. <u>MINE SAFETY DISCLOSURES</u>	<u>78</u>
Item 5. <u>OTHER INFORMATION</u>	<u>78</u>
Item 6. <u>EXHIBITS</u>	<u>79</u>
<u>SIGNATURES</u>	<u>80</u>
<u>CERTIFICATIONS</u>	

Table of Contents

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.

Table of Contents

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.		

Table of ContentsHERITAGE 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		Six Months Ended	
	June 30,		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

Edgar Filing: HERITAGE FINANCIAL CORP /WA/ - Form 10-Q

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.

5

Table of ContentsHERITAGE 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		Six Months Ended	
	June 30,		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.				

Table of ContentsHERITAGE 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.

Table of ContentsHERITAGE 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

Edgar Filing: HERITAGE FINANCIAL CORP /WA/ - Form 10-Q

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	

8

Table of Contents

	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.			

Table of Contents

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

Table of Contents

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 conveying 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.

Table of Contents

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.

Table of Contents

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))

Table of Contents

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 accretible 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

Edgar Filing: HERITAGE FINANCIAL CORP /WA/ - Form 10-Q

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

14

Table of Contents

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.

Table of Contents

(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	Gross	Gross	Fair
	Cost	Unrecognized	Unrecognized	Value
		Gains	Losses	
	(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	Gross	Gross	Fair
	Cost	Unrecognized	Unrecognized	Value
		Gains	Losses	
	(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

Table of Contents

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

Table of Contents

(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)

Table of Contents

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		12 Months or		Total	
	Less than 12		12 Months or			
	Months	Unrealized	Longer	Unrealized	Fair	Unrealized
	Fair	Losses	Fair	Losses	Value	Losses
	Value		Value			
	(In thousands)					
Municipal securities	\$3,554	\$(49) \$—	\$—		