HERITAGE FINANCIAL CORP /WA/
Form 10-Q
November 07, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012

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 x No ¨

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

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

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

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

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

As of October 22, 2012 there were 15,162,798 common shares outstanding, with no par value, of the registrant.

Table of Contents

HERITAGE FINANCIAL CORPORATION

FORM 10-Q

INDEX

FORWARD LOOKING STATEMENT

Table of Contents

Forward Looking Statements

Safe Harbor statement under the Private Securities Litigation Reform Act of 1995: This Form 10-Q contains forward-looking statements that are subject to risks and uncertainties, including, but not limited to: the credit and concentration risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; 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 (the Federal Reserve Board) and of our bank subsidiaries by the Federal Deposit Insurance Corporation (the FDIC), the Washington State Department of Financial Institutions, Division of Banks (the Washington DFI) or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, or impose additional requirements and restrictions on us, any of which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, including the interpretation of regulatory capital or other rules including changes related to Basel III; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act and implementing the regulations ; our ability to control operating costs and expenses; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; computer systems on which we depend could fail or experience a security breach; our ability to recruit and retain key members of our senior management team and staff; costs and effects of litigation, including settlements and judgments; our ability to implement our expansion strategy; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired including the Cowlitz Bank and Pierce Commercial Bank transactions or may in the future acquire into our operations, including the proposed acquisition of Northwest Commercial Bank, and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; risks relating to acquiring assets or entering markets in which we have not previously operated and may not be familiar; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services; and other risks detailed from time to time in our filings with the Securities and Exchange Commission.

The Company cautions readers not to place undue reliance on any forward-looking statements. Moreover, you should treat these statements as speaking only as of the date they are made and based only on information then actually known to the Company. The Company does not undertake and specifically disclaims any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements. These risks could cause our actual results for the remainder of 2012 and beyond to differ materially from those expressed in any forward-looking statements by, or on behalf of, us, and could negatively affect the Company s operating and stock price performance.

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

Table of Contents

ITEM 1. HERITAGE FINANCIAL CORPORATION

HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Dollars in thousands, except for per share amounts)

(Unaudited)

	September 30, 2012	December 31, 2011
Assets		
Cash on hand and in banks	$ 34,257	$ 30,193
Interest earning deposits	82,648	93,566
Cash and cash equivalents	116,905	123,759
Investment securities available for sale	147,682	144,602
Investment securities held to maturity (fair value of $11,773 and $12,881)	10,833	12,093
Loans held for sale	1,411	1,828
Originated loans receivable	871,959	837,924
Less: Allowance for loan losses	(20,533)	(22,317)
Originated loans receivable, net	851,426	815,607
Purchased covered loans receivable, net of allowance for loan losses of ($4,137 and $3,963)	89,005	105,394
Purchased non-covered loans receivable, net of allowance for loan losses of ($4,937 and $4,635)	65,592	83,479
Total loans receivable, net	1,006,023	1,004,480
FDIC indemnification asset	7,480	10,350
Other real estate owned ($260 and $774 covered by FDIC loss share, respectively)	7,285	4,484
Premises and equipment, net	22,886	22,975
Federal Home Loan Bank (FHLB) stock, at cost	5,545	5,594
Accrued interest receivable	5,178	5,117
Prepaid expenses and other assets	10,502	8,190
Deferred income taxes, net	10,647	10,988
Other intangible assets, net	1,193	1,513
Goodwill	13,012	13,012
Total assets	$ 1,366,582	$ 1,368,985
Liabilities and Stockholders Equity		
Deposits	$ 1,133,700	$ 1,136,044
Securities sold under agreement to repurchase	22,889	23,091
Accrued expenses and other liabilities	7,749	7,330
Total liabilities	1,164,338	1,166,465
Stockholders equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at September 30, 2012 and December 31, 2011		
Common stock, no par value, 50,000,000 shares authorized; 15,162,879 and 15,456,297 shares outstanding at September 30, 2012 and December 31, 2011, respectively	122,275	126,622
Unearned compensation Employee Stock Ownership Plan (ESOP)	(28)	(94)
Retained earnings	78,086	74,256
Accumulated other comprehensive income, net	1,911	1,736

Total stockholders equity	202,244	202,520
Total liabilities and stockholders equity	$ 1,366,582	$ 1,368,985

See Notes to Condensed Consolidated Financial Statements.

4

Table of Contents

HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands, except for per share amounts)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	**2011**	**2012**	**2011**
INTEREST INCOME:				
Interest and fees on loans	$ 16,181	$ 17,850	$ 49,664	$ 53,252
Taxable interest on investment securities	525	792	1,781	2,223
Nontaxable interest on investment securities	274	214	797	592
Interest on interest earning deposits	51	65	167	206
Total interest income	17,031	18,921	52,409	56,273
INTEREST EXPENSE:				
Deposits	1,061	1,604	3,501	5,161
Other borrowings	15	18	49	61
Total interest expense	1,076	1,622	3,550	5,222
Net interest income	15,955	17,299	48,859	51,051
Provision for loan losses on originated loans	215	395	415	4,985
Provision for loan losses on purchased loans	592	2,821	902	6,128
Net interest income after provision for loan losses	15,148	14,083	47,542	39,938
NON-INTEREST INCOME:				
Gains on sales of loans, net	92	58	208	245
Service charges on deposits	933	892	2,748	2,723
Merchant Visa income, net	182	132	534	391
Change in FDIC indemnification asset	(492)	(1,666)	(687)	(2,578)
Other income	812	823	2,696	2,619
Total non-interest income	1,527	239	5,499	3,400
NON-INTEREST EXPENSE:				
Impairment loss on investment securities	14	28	112	93
Less: Portion recorded as other comprehensive loss	(14)		(52)	(20)
Impairment loss on investment securities, net		28	60	73
Salaries and employee benefits	7,224	6,495	21,709	20,207
Occupancy and equipment	1,880	1,749	5,497	5,314
Data processing	643	553	1,902	2,011
Marketing	435	390	1,207	1,084
Professional services	742	517	1,924	1,564
State and local taxes	295	290	925	1,015
Federal deposit insurance premium	245	384	783	1,272
Other real estate owned, net	35	31	487	596
Other expense	1,004	1,348	3,477	4,305
Total non-interest expense	12,503	11,785	37,971	37,441

Income before income taxes	4,172	2,537	15,070	5,897
Income tax expense	1,309	701	4,843	1,611
Net income	$ 2,863	$ 1,836	$ 10,227	$ 4,286
Earnings per common share:				
Basic	$ 0.19	$ 0.12	$ 0.67	$ 0.27
Diluted	$ 0.19	$ 0.12	$ 0.67	$ 0.27
Dividends declared per common share:	$ 0.08	$ 0.05	$ 0.42	$ 0.08

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in thousands, except for per share amounts)

(Unaudited)

Comprehensive Income	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Net income	$ 2,863	$ 1,836	$ 10,227	$ 4,286
Change in fair value of securities available for sale, net of tax of $51, $520, $69 and $695	95	400	128	1,294
Reclassification adjustment of net gain from sale of available for sale securities included in income, net of tax of $0, $0, $0 and $(8)				14
Other-than-temporary impairment on securities held to maturity, net of tax of $(5), $0, $(18) and $(7)	(9)		(34)	(13)
Accretion of other-than-temporary impairment on securities held to maturity, net of tax of $15, $18, $43 and $53	29	34	81	98
Other comprehensive income	$ 115	$ 434	$ 175	$ 1,393
Comprehensive income	$ 2,978	$ 2,270	$ 10,402	$ 5,679

See Notes to Condensed Consolidated Financial Statements.

6

HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY FOR THE NINE MONTHS ENDED

SEPTEMBER 30, 2012

(Dollars and shares in thousands)

(Unaudited)

	Number of common shares	Common stock	Unearned Compensation-ESOP	Retained earnings	Accumulated other comprehensive income, net	Total stockholders equity
Balance at December 31, 2011	15,456	$ 126,622	$ (94)	$ 74,256	$ 1,736	$ 202,520
Restricted stock awards issued, net of forfeitures	87					
Stock option compensation expense		83				83
Exercise of stock options (including tax benefits from nonqualified stock options)	5	53				53
Share based payment and earned ESOP	7	829	66			895
Tax associated with share based payment and unallocated ESOP		(34)				(34)
Common stock repurchased and retired	(392)	(5,278)				(5,278)
Net income				10,227		10,227
Other comprehensive income, net of tax					175	175
Cash dividends declared on common stock ($0.42 per share)				(6,397)		(6,397)
Balance at September 30, 2012	15,163	$ 122,275	$ (28)	$ 78,086	$ 1,911	$ 202,244

See Notes to Condensed Consolidated Financial Statements.

7

Table of Contents

HERITAGE FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the nine months ended September 30, 2012 and 2011

(Dollars in thousands)

(Unaudited)

	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Cash flows from operating activities:		
Net income	$ 10,227	$ 4,286
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,027	1,255
Change in net deferred loan fees	56	249
Provision for loan losses	1,317	11,113
Net change in accrued interest receivable, prepaid expenses and other assets and accrued expenses and other liabilities	882	(2,470)
Recognition of compensation related to ESOP shares and share based payment	895	681
Stock option compensation expense	83	122
Excess tax benefit realized from stock options exercised, share based payment and dividends on unallocated ESOP shares	34	153
Amortization of intangible assets	320	333
Deferred income taxes	247	94
Gain on sale of investment securities		(23)
Impairment loss on investment securities	60	73
Origination of loans held for sale	(15,136)	(11,331)
Gains on sales of loans, net	(208)	(245)
Proceeds from sale of loans	15,761	11,417
Valuation adjustment on other real estate owned	483	595
Losses on sale of other real estate owned, net		75
Losses on sale of premises and equipment, net	2	1
Net cash provided by operating activities	18,050	16,378
Cash flows from investing activities:		
Loans originated, net of principal payments	(8,895)	(19,046)
Maturities of investment securities available for sale	37,765	21,159
Maturities of investment securities held to maturity	1,424	1,805
Purchases of investment securities available for sale	(42,276)	(36,144)
Purchases of investment securities held to maturity		(271)
Purchases of premises and equipment	(1,464)	(2,414)
Proceeds from sales of other real estate owned	2,695	2,866
Proceeds from sales of investment securities available for sale		412
Proceeds from repurchase of FHLB stock	49	
Net cash used in investing activities	(10,702)	(31,633)
Cash flows from financing activities:		
Net (decrease) increase in deposits	(2,344)	1,169
Common stock cash dividends paid	(6,397)	(1,253)

Net decrease in securities sold under agreement to repurchase	(202)	(257)
Proceeds from exercise of stock options	53	
Excess tax benefits realized from stock options exercised, share based payment and dividends on unallocated ESOP shares	(34)	(153)
Repurchase of common stock	(5,278)	(790)
Repurchase of common stock warrants		(450)
Net cash used in financing activities	(14,202)	(1,734)
Net decrease in cash and cash equivalents	(6,854)	(16,989)
Cash and cash equivalents at beginning of period	123,759	168,991
Cash and cash equivalents at end of period	$ 116,905	$ 152,002
Supplemental disclosures of cash flow information:		
Cash paid for interest	$ 3,608	$ 5,334
Cash paid for income taxes	7,848	5,985
Loans transferred to other real estate owned	$ 5,979	$ 3,096

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

HERITAGE FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

NOTE 1. Description of Business and Basis of Presentation

(a) Description of Business

Heritage Financial Corporation (the Company) is a bank holding company incorporated in the State of Washington in August 1997. The Company is primarily engaged in the business of planning, directing and coordinating the business activities of its wholly owned subsidiaries: Heritage Bank and Central Valley Bank (the Banks). The Banks are Washington-chartered commercial banks and their deposits are insured by the FDIC under the Deposit Insurance Fund (DIF). Heritage Bank conducts business from its main office in Olympia, Washington and its twenty-six branch offices located in western Washington and the greater Portland, Oregon area. Central Valley Bank conducts business from its main office in Toppenish, Washington and its five branch offices located in Yakima and Kittitas counties of Washington State.

The Company s business consists primarily of lending and deposit relationships with small businesses and their owners in its market areas and attracting deposits from the general public. The Company also makes real estate construction and land development loans, one-to-four family residential loans, and consumer loans and originates for sale or investment purposes first mortgage loans on residential properties located in western and central Washington State and the greater Portland, Oregon area.

Effective July 30, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Cowlitz Bank, a Washington state-chartered bank headquartered in Longview, Washington (the Cowlitz Acquisition). The Cowlitz Acquisition included nine branches of Cowlitz Bank, including its division Bay Bank, which opened as branches of Heritage Bank as of August 2, 2010. It also included the Trust Services Division of Cowlitz Bank. Effective November 5, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Pierce Commercial Bank, a Washington state-chartered bank headquartered in Tacoma, Washington (the Pierce Commercial Acquisition). The Pierce Commercial Acquisition included one branch, which opened as a branch of Heritage Bank as of November 8, 2010. The Cowlitz Acquisition and the Pierce Commercial Acquisition are collectively referred to as the Cowlitz and Pierce Acquisitions.

(b) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with Generally Accepted Accounting Principles (GAAP), for interim financial information, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These condensed consolidated financial statements should be read with our December 31, 2011 audited consolidated financial statements and its accompanying notes included in our Annual Report on Form 10-K (Form 10-K). In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. In preparing the condensed consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates. Estimates related to fair value measurements, the allowance for loan losses, expected cash flows from, and indemnification asset related to, purchased loans, other real estate owned, other-than-temporary impairment of investment securities, goodwill and other intangible assets, stock-based compensation 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 period net income or stockholders equity.

(c) Significant Accounting Policies

The significant accounting policies used in preparation of our consolidated financial statements are disclosed in our 2011 Annual Form 10-K. There have not been any material changes in our significant accounting policies compared to those contained in our Form 10-K disclosure for the year ended December 31, 2011.

(d) Recently Issued Accounting Pronouncements

Financial Accounting Standards Board (FASB) Accounting Standards Updates (ASU) 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, was issued in May 2011 as a result of the FASB and International Accounting Standards Board s (IASB) goal to develop common requirements for measuring fair value and

9

for disclosing information about fair value measurements in accordance with U.S. GAAP and International Financial Reporting Standards. The provisions of this Update are effective during the interim or annual periods beginning after December 15, 2011, and are to be applied prospectively. The adoption of the Update did not have a material effect on the Company s consolidated financial statements, however, the additional disclosures are included in Note 10.

FASB ASU 2011-05, *Presentation of Comprehensive Income*, was issued in June 2011 requiring that all non-owner changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This Update also requires that reclassification adjustments for items that are reclassified from other comprehensive income to net income be presented on the face of the financial statements. The provisions of this Update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, and are to be applied retrospectively. Early adoption is permitted. The adoption of the Update did not have a material effect on the Company s consolidated financial statements at the date of adoption. The Company has presented condensed consolidated statements of comprehensive income for the three and nine months ended September 30, 2012 and 2011 as a separate statement immediately following the condensed consolidated statements of income for the three and nine months ended September 30, 2012 and 2011.

FASB ASU 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*, was issued in December 2011 updating and superseding certain pending paragraphs relating to the presentation on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income. This Update is effective concurrent with ASU 2011-05, *Presentation of Comprehensive Income,* and did not have a material effect on the Company s consolidated financial statements at the date of adoption.

FASB ASU 2012-06, *Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution*, was issued in October 2012. The objective of the Update is to address the diversity in practice about how to interpret the terms on the same basis and contractual limitations when subsequently measuring an indemnification asset. This Update is effective for fiscal years and interim periods beginning on or after December 15, 2012. Early adoption is permitted, and adoption should be applied prospectively to indemnification assets existing as of the date of adoption. This Update will not have a material effect on the Company s consolidated financial statements at the date of adoption.

NOTE 2. Loans Receivable

The Company originates loans under the normal course of business. These loans are identified as originated loans. Disclosures related to the Company s recorded investment in originated loans receivable generally exclude accrued interest receivable and net deferred loan origination fees and costs due to their insignificance. The Company has also acquired loans through FDIC-assisted transactions. Loans acquired in a business acquisition are designated as purchased loans. The Company refers to the purchased loans subject to the shared-loss agreements as covered loans, and those loans without a shared-loss agreement are referred to as non-covered loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are accounted for under FASB Accounting Standards Codification (FASB ASC) 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*. These loans are identified as purchased impaired loans. Loans purchased that are not accounted for under FASB ASC 310-30 are accounted for under FASB ASC 310-20, *Receivables Nonrefundable fees and Other Costs*. These loans are identified as purchased other loans.

(a) Loan Origination/Risk Management

The Company originates loans in one of the four segments of the total loan portfolio: commercial business, real estate construction and land development, one-to-four family residential, and consumer. Within these segments are classes of loans to which management monitors and assesses credit risk in the loan portfolios. The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, and nonperforming and potential problem loans. The Company also conducts external loan reviews and validates the credit risk assessment on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company s policies and procedures.

A discussion of the risk characteristics of each portfolio segments is as follows:

Commercial Business: There are three significant classes of loans in the commercial portfolio segment, including commercial and industrial loans, owner-occupied commercial real estate, and non-owner occupied commercial real estate. The owner and non-owner occupied commercial real estate are both considered commercial real estate loans. As 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 in that the lending typically involves higher loan principal amounts, and payments on loans secured by real estate properties are dependent on successful operation and management of the properties. Repayment of these loans may be more adversely affected by conditions in the real estate market or the economy.

One-to-Four Family Residential: The majority of the Company s one-to four-family residential loans are secured by single-family residences located in its primary market areas. The Company s underwriting standards require that single-family portfolio loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms typically range from 15 to 30 years. The Company generally sells most single-family loans in the secondary market. Management determines to what extent the Company will retain or sell these loans and other fixed rate mortgages in order to control the Banks interest rate sensitivity position, growth and liquidity.

Real Estate Construction and Land Development: The Company originates construction loans for one-to-four family residential and for five or more residential properties and commercial properties. The one-to-four family residential construction loans generally include construction of custom homes whereby the home buyer is the borrower. The Company also provides financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Substantially all construction loans are short-term in nature and priced with a variable rate of interest. Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project s completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, the Company s estimates with regards to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If the Company s estimate of the value of a project at completion proves to be overstated, it may have inadequate security for repayment of the loan and may incur a loss 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 sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

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

Table of Contents

Originated loans receivable at September 30, 2012 and December 31, 2011 consisted of the following portfolio segments and classes:

	September 30, 2012	December 31, 2011
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 280,513	$ 273,590
Owner-occupied commercial real estate	191,798	166,881
Non-owner occupied commercial real estate	256,670	251,049
Total commercial business	728,981	691,520
One-to-four family residential	39,431	37,960
Real estate construction and land development:		
One-to-four family residential	25,045	22,369
Five or more family residential and commercial properties	50,442	54,954
Total real estate construction and land development	75,487	77,323
Consumer	29,976	32,981
Gross originated loans receivable	873,875	839,784
Net deferred loan fees	(1,916)	(1,860)
Total originated loans receivable	$ 871,959	$ 837,924

The recorded investment in purchased covered loans receivable at September 30, 2012 and December 31, 2011 consisted of the following portfolio segments and classes:

	September 30, 2012	December 31, 2011
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 29,198	$ 38,607
Owner-occupied commercial real estate	35,231	38,067
Non-owner occupied commercial real estate	14,027	15,753
Total commercial business	78,456	92,427
One-to-four family residential	5,042	5,197
Real estate construction and land development:		
One-to-four family residential	4,373	5,786
Five or more family residential and commercial properties		
Total real estate construction and land development	4,373	5,786
Consumer	5,271	5,947
Total purchased covered loans receivable	93,142	109,357
Allowance for loan losses	(4,137)	(3,963)
Purchased covered loans receivable, net	$ 89,005	$ 105,394

The September 30, 2012 and December 31, 2011 gross recorded investment balance of purchased impaired covered loans accounted for under FASB ASC 310-30 was $64.0 million and $78.7 million, respectively. The gross recorded investment balance of purchased other covered loans was $29.1 million and $30.7 million at September 30, 2012 and December 31, 2011, respectively. As of September 30, 2012 and December 31, 2011, the recorded investment balance of purchased covered loans which are no longer covered under the FDIC loss-sharing agreements was

$3.2 million and $3.8 million, respectively.

Funds advanced on the purchased covered loans subsequent to acquisition are referred to as subsequent advances and are included in the purchased covered loan balances as these subsequent advances are covered under the loss-sharing agreements. These subsequent advances are not accounted for under FASB ASC 310-30. The total balance of subsequent advances on the purchased covered loans was $9.4 million and $13.5 million as of September 30, 2012 and December 31, 2011, respectively.

Table of Contents

The recorded investment in purchased non-covered loans receivable at September 30, 2012 and December 31, 2011 consisted of the following portfolio segments and classes:

	September 30, 2012	December 31, 2011
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 26,384	$ 35,607
Owner-occupied commercial real estate	16,045	17,052
Non-owner occupied commercial real estate	12,484	12,833
Total commercial business	54,913	65,492
One-to-four family residential	3,036	2,743
Real estate construction and land development:		
One-to-four family residential	667	1,381
Five or more family residential and commercial properties	949	1,078
Total real estate construction and land development	1,616	2,459
Consumer	10,964	17,420
Total purchased non-covered loans receivable	70,529	88,114
Allowance for loan losses	(4,937)	(4,635)
Purchased non-covered loans receivable, net	$ 65,592	$ 83,479

The September 30, 2012 and December 31, 2011 gross recorded investment balance of purchased impaired non-covered loans accounted for under FASB ASC 310-30 was $43.7 million and $56.1 million, respectively. The recorded investment balance of purchased other non-covered loans was $26.8 million and $32.0 million at September 30, 2012 and December 31, 2011, respectively.

(b) Concentrations of Credit

Most of the Company s lending activity occurs within the State of Washington, and to a lesser extent the State of Oregon. The primary market areas include Thurston, Pierce, King, Mason, Cowlitz and Clark counties in Washington and Multnomah County in Oregon, as well as other markets. The majority of the Company s loan portfolio consists of commercial and industrial, non-owner occupied commercial real estate, and owner occupied commercial real estate. As of September 30, 2012 and December 31, 2011, there were no concentrations of loans related to any single industry in excess of 10% of total loans.

(c) Credit Quality Indicators

As part of the on-going monitoring of the credit quality of the Company s loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grade of the loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) nonperforming loans, and (v) the general economic conditions of the United States of America, and specifically the states of Washington and Oregon. The Company utilizes a risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 0 to 9, and a W . A description of the general characteristics of the risk grades is as follows:

Grades 0 to 5: These grades are considered pass grade with negligible to above average but acceptable risk. These borrowers generally have strong to acceptable capital levels and consistent earnings and debt service capacity. Loans with the higher grades within the pass category may include borrowers who are experiencing unusual operating difficulties, but have acceptable payment performance to date. Increased monitoring of financials and/or collateral may be appropriate. Overall, loans with this grade show no immediate loss exposure.

Grade W : This grade is considered pass grade and includes loans on management s watch list and 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 6: 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 7: This grade includes Substandard loans, in accordance with regulatory guidelines, for which the loan has a high risk.

The loan also has 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 are apt to be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business. Loans with this grade can be accrual or nonaccrual status based on the Company s accrual policy.

Grade 8: This grade includes Doubtful loans in accordance with regulatory guidelines, and the Company has determined these loans to have excessive risk. Such loans are placed on nonaccrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Additionally, these loans generally have a specific valuation allowance.

Grade 9: This grade includes Loss loans in accordance with regulatory guidelines. These loans are determined to have the highest risk of loss. Such loans are charged-off or charged-down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be determined. Loss is not intended to imply that the loan or some portion of it will never be paid, nor does it in any way imply that there has been a forgiveness of debt.

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 graded as a 0 to 9 at origination date as these loans are determined to be pass graded loans. These non-commercial loans may subsequently require a 0-9 risk grade if the credit department has evaluated the credit and determined it necessary to classify the loan. Loan grades are reviewed on a quarterly basis, or more frequently if necessary, by the credit department. Typically, an individual loan grade will not be changed from the prior period unless there is a specific indication of credit deterioration or improvement. Credit deterioration is evidenced by delinquency, direct communications with the borrower, or other borrower information that becomes 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 inherent losses in the portfolios, but to a lesser extent than the other loan grades. These pass graded loans may also have a zero percent loss based on historical experience and current market trends. The OAEM loan grade is transitory in that the Company is waiting on additional information to determine the likelihood and extent of the potential loss. However, the likelihood of loss is greater than Watch grade because there has been measurable credit deterioration. Loans with a Substandard grade are generally loans for which the Company has individually analyzed for potential impairment. For Doubtful and Loss graded loans, the Company is almost certain of the losses, and the unpaid principal balances are generally charged-off.

The following tables present the balance of the originated loans receivable by credit quality indicator as of September 30, 2012 and December 31, 2011.

	September 30, 2012				
	Pass	OAEM	Substandard	Doubtful	Total
			(In thousands)		
Commercial business:					
Commercial and industrial	$ 254,046	$ 3,665	$ 21,733	$ 1,069	$ 280,513
Owner-occupied commercial real estate	185,948	1,943	3,907		191,798
Non-owner occupied commercial real estate	246,948	4,064	5,289	369	256,670
Total commercial business	686,942	9,672	30,929	1,438	728,981
One-to-four family residential	38,005	699	323	404	39,431
Real estate construction and land development:					
One-to-four family residential	15,515	1,815	7,715		25,045
Five or more family residential and commercial properties	45,826		4,616		50,442
Total real estate construction and land development	61,341	1,815	12,331		75,487
Consumer	29,889		87		29,976
Gross originated loans	$ 816,177	$ 12,186	$ 43,670	$ 1,842	$ 873,875

	December 31, 2011				
	Pass	OAEM	Substandard	Doubtful	Total
			(In thousands)		
Commercial business:					
Commercial and industrial	$ 247,503	$ 2,770	$ 22,887	$ 430	$ 273,590
Owner-occupied commercial real estate	162,536	1,225	3,120		166,881
Non-owner occupied commercial real estate	240,096	2,063	8,890		251,049
Total commercial business	650,135	6,058	34,897	430	691,520

One-to-four family residential	36,997	431	532		37,960
Real estate construction and land development:					
One-to-four family residential	10,725	2,828	8,816		22,369
Five or more family residential and commercial properties	42,541		12,413		54,954
Total real estate construction and land development	53,266	2,828	21,229		77,323
Consumer	32,629		346	6	32,981
Gross originated loans	$ 773,027	$ 9,317	$ 57,004	$ 436	$ 839,784

Table of Contents

The tables above include $30.9 million and $37.1 million of impaired loans as of September 30, 2012 and December 31, 2011, respectively, as detailed in the impaired loans section below. These impaired loans have been individually reviewed for potential losses and have specific valuation allowance, as necessary. The tables above also include potential problem loans. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which management is monitoring because the financial information of the borrower causes concern as to their ability to meet their loan repayment terms. Potential problem originated loans as of September 30, 2012 and December 31, 2011 were $29.4 million and $29.7 million, respectively. The balance of potential problem originated loans guaranteed by a governmental agency was $3.1 million and $2.8 million as of September 30, 2012 and December 31, 2011, respectively. This guarantee reduces the Company s credit exposure.

The following tables present the recorded balance of the purchased other covered and non-covered loans receivable by credit quality indicator as of September 30, 2012 and December 31, 2011.

	September 30, 2012				
	Pass	OAEM	Substandard (In thousands)	Doubtful	Total
Commercial business:					
Commercial and industrial	$ 12,470	$ 83	$ 494	$	$ 13,047
Owner-occupied commercial real estate	25,630	2,414	339		28,383
Non-owner occupied commercial real estate	4,470	487	977		5,934
Total commercial business	42,570	2,984	1,810		47,364
One-to-four family residential	924	468			1,392
Real estate construction and land development:					
One-to-four family residential	47				47
Five or more family residential and commercial properties					
Total real estate construction and land development	47				47
Consumer	6,860	3	172	31	7,066
Gross purchased other loans	$ 50,401	$ 3,455	$ 1,982	$ 31	$ 55,869

	December 31, 2011				
	Pass	OAEM	Substandard (In thousands)	Doubtful	Total
Commercial business:					
Commercial and industrial	$ 11,781	$ 125	$ 780	$	$ 12,686
Owner-occupied commercial real estate	29,791		587		30,378
Non-owner occupied commercial real estate	4,427	1,046	441		5,914
Total commercial business	45,999	1,171	1,808		48,978
One-to-four family residential	1,529		42		1,571
Real estate construction and land development:					
One-to-four family residential	50				50
Five or more family residential and commercial properties					
Total real estate construction and land development	50				50
Consumer	11,435		674		12,109
Gross purchased other loans	$ 59,013	$ 1,171	$ 2,524	$	$ 62,708

Table of Contents

(d) Nonaccrual loans

Originated nonaccrual loans, segregated by segments and classes of loans, were as follows as of September 30, 2012 and December 31, 2011:

	September 30, 2012(1)	December 31, 2011(1)
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 5,937	$ 6,946
Owner-occupied commercial real estate	856	399
Non-owner occupied commercial real estate	369	921
Total commercial business	7,162	8,266
One-to-four family residential	425	
Real estate construction and land development:		
One-to-four family residential	3,392	5,150
Five or more family residential and commercial properties	4,616	9,797
Total real estate construction and land development	8,008	14,947
Consumer	87	125
Gross originated nonaccrual loans	$ 15,682	$ 23,338

(1) $2.0 million and $1.8 million of nonaccrual originated loans were guaranteed by governmental agencies at September 30, 2012 and December 31, 2011, respectively.

The recorded investment balance of purchased other nonaccrual loans, segregated by segments and classes of loans, were as follows as of September 30, 2012 and December 31, 2011:

	September 30, 2012	December 31, 2011
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 254	$
Owner-occupied commercial real estate	142	
Non-owner occupied commercial real estate	437	
Total commercial business	833	
Consumer	38	497
Gross purchased other nonaccrual loans	$ 871	$ 497

(e) Past due loans

The Company performs aging analysis of past due loans using the categories of 30-89 days past due and 90 or more days past due. This policy is consistent with regulatory reporting requirements. The balances of originated past due loans, segregated by segments and classes of loans, as of September 30, 2012 and December 31, 2011 were as follows:

	September 30, 2012					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$ 1,509	$ 3,680	$ 5,189	$ 275,324	$ 280,513	$ 500
Owner-occupied commercial real estate	251	283	534	191,264	191,798	
Non-owner occupied commercial real estate		369	369	256,301	256,670	
Total commercial business	1,760	4,332	6,092	722,889	728,981	500
One-to-four family residential	390	404	794	38,637	39,431	
Real estate construction and land development:						
One-to-four family residential	377	3,392	3,769	21,276	25,045	
Five or more family residential and commercial properties		4,271	4,271	46,171	50,442	
Total real estate construction and land development	377	7,663	8,040	67,447	75,487	
Consumer	50	47	97	29,879	29,976	
Gross originated loans	$ 2,577	$ 12,446	$ 15,023	$ 858,852	$ 873,875	$ 500

Table of Contents

	December 31, 2011					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$ 3,716	$ 4,769	$ 8,485	$ 265,105	$ 273,590	$ 921
Owner-occupied commercial real estate	1,903	398	2,301	164,580	166,881	
Non-owner occupied commercial real estate	369		369	250,680	251,049	
Total commercial business	5,988	5,167	11,155	680,365	691,520	921
One-to-four family residential	1,251	404	1,655	36,305	37,960	404
Real estate construction and land development:						
One-to-four family residential	582	5,150	5,732	16,637	22,369	
Five or more family residential and commercial properties	369	9,428	9,797	45,157	54,954	
Total real estate construction and land development	951	14,578	15,529	61,794	77,323	
Consumer	465	60	525	32,456	32,981	3
Gross originated loans	$ 8,655	$ 20,209	$ 28,864	$ 810,920	$ 839,784	$ 1,328

The balances of purchased other past due loans, segregated by segments and classes of loans, as of September 30, 2012 and December 31, 2011 are as follows:

	September 30, 2012					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$	$	$	$ 13,047	$ 13,047	$
Owner-occupied commercial real estate				28,383	28,383	
Non-owner occupied commercial real estate		557	557	5,377	5,934	120
Total commercial business		557	557	46,807	47,364	120
One-to-four family residential	150		150	1,242	1,392	
Real estate construction and land development:						
One-to-four family residential				47	47	
Five or more family residential and commercial properties						
Total real estate construction and land development				47	47	
Consumer	409	31	440	6,626	7,066	
Gross purchased other loans	$ 559	$ 588	$ 1,147	$ 54,722	$ 55,869	$ 120

	December 31, 2011					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$ 243	$ 15	$ 258	$ 12,428	$ 12,686	$ 15
Owner-occupied commercial real estate	151		151	30,227	30,378	
Non-owner occupied commercial real estate	441		441	5,473	5,914	
Total commercial business	835	15	850	48,128	48,978	15
One-to-four family residential	42		42	1,529	1,571	
Real estate construction and land development:						
One-to-four family residential				50	50	
Five or more family residential and commercial properties						
Total real estate construction and land development				50	50	
Consumer	757	490	1,247	10,862	12,109	
Gross purchased other loans	$ 1,634	$ 505	$ 2,139	$ 60,569	$ 62,708	$ 15

Table of Contents

(f) Impaired loans

Impaired originated loans (including restructured loans) at September 30, 2012 and December 31, 2011 are set forth in the following tables.

	September 30, 2012				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
			(In thousands)		
Commercial business:					
Commercial and industrial	$ 8,289	$ 3,858	$ 12,147	$ 13,209	$ 1,071
Owner-occupied commercial real estate	417	1,886	2,303	3,878	591
Non-owner occupied commercial real estate	2,952	4,252	7,204	7,204	1,411
Total commercial business	11,658	9,996	21,654	24,291	3,073
One-to-four family residential	424	425	849	1,767	91
Real estate construction and land development:					
One-to-four family residential	701	3,053	3,754	4,926	860
Five or more family residential and commercial properties		4,616	4,616	4,685	997
Total real estate construction and land development	701	7,669	8,370	9,611	1,857
Consumer	47	40	87	127	40
Gross impaired originated loans	$ 12,830	$ 18,130	$ 30,960	$ 35,796	$ 5,061

	December 31, 2011				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
			(In thousands)		
Commercial business:					
Commercial and industrial	$ 4,532	$ 6,139	$ 10,671	$ 10,586	$ 1,488
Owner-occupied commercial real estate	603	1,368	1,971	2,271	107
Non-owner occupied commercial real estate	3,915	4,314	8,229	9,980	764
Total commercial business	9,050	11,821	20,871	22,837	2,359
One-to-four family residential		835	835	1,046	187
Real estate construction and land development:					
One-to-four family residential	748	4,765	5,513	6,813	1,436
Five or more family residential and commercial properties	963	8,835	9,798	14,219	530
Total real estate construction and land development	1,711	13,600	15,311	21,032	1,966
Consumer	120	6	126		