

HERITAGE FINANCIAL CORP /WA/  
Form 10-Q  
May 06, 2015  
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 March 31, 2015  
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 April 27, 2015 there were 30,243,417 shares of the registrant's common stock, no par value per share, outstanding.

---

Table of Contents

HERITAGE FINANCIAL CORPORATION  
 FORM 10-Q  
 INDEX  
 March 31, 2015

	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 March 31, 2015 and December 31, 2014</u>	<u>4</u>
<u>Condensed Consolidated Statements of Income for the Three Months Ended March 31, 2015 and 2014</u>	<u>5</u>
<u>Condensed Consolidated Statements of Comprehensive Income for the Three Months Ended March 31, 2015 and 2014</u>	<u>6</u>
<u>Condensed Consolidated Statements of Stockholders' Equity for the Three Months Ended March 31, 2015 and 2014</u>	<u>7</u>
<u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2015 and 2014</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>49</u>
Item 3. <u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	<u>66</u>
Item 4. <u>CONTROLS AND PROCEDURES</u>	<u>66</u>
Part II. <u>OTHER INFORMATION</u>	<u>66</u>
Item 1. <u>LEGAL PROCEEDINGS</u>	<u>66</u>
Item 1A. <u>RISK FACTORS</u>	<u>67</u>
Item 2. <u>UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	<u>67</u>
Item 3. <u>DEFAULTS UPON SENIOR SECURITIES</u>	<u>68</u>
Item 4. <u>MINE SAFETY DISCLOSURES</u>	<u>68</u>
Item 5. <u>OTHER INFORMATION</u>	<u>68</u>
Item 6. <u>EXHIBITS</u>	<u>68</u>
<u>SIGNATURES</u>	<u>70</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 the 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 and of our bank subsidiary by the Federal Deposit Insurance Corporation (“FDIC”), the Washington State Department of Financial Institutions, Division of Banks 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 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, 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 including our Annual Report on Form 10-K for the year ended December 31, 2014.

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 subsidiaries, unless the context otherwise requires.

Table of Contents

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

March 31, 2015 and December 31, 2014

(Dollars in thousands)

(Unaudited)

	March 31, 2015	December 31, 2014
<b>ASSETS</b>		
Cash on hand and in banks	\$60,205	\$74,028
Interest earning deposits	19,859	47,608
Cash and cash equivalents	80,064	121,636
Other interest earning deposits	9,364	10,126
Investment securities available for sale, at fair value	747,299	742,846
Investment securities held to maturity (fair value of \$36,633 and \$36,874, respectively)	35,425	35,814
Loans held for sale	8,742	5,582
Noncovered loans receivable, net	2,170,693	2,124,877
Allowance for loan losses on noncovered loans	(22,317	) (22,153
Noncovered loans receivable, net of allowance for loan losses	2,148,376	2,102,724
Covered loans receivable, net	117,621	126,200
Allowance for loan losses on covered loans	(5,499	) (5,576
Covered loans receivable, net of allowance for loan losses	112,122	120,624
Total loans receivable, net	2,260,498	2,223,348
FDIC indemnification asset	692	1,116
Other real estate owned (\$2,772 and \$1,177 covered by FDIC shared-loss agreements, respectively)	4,094	3,355
Premises and equipment, net	64,547	64,938
Federal Home Loan Bank stock, at cost	12,022	12,188
Bank owned life insurance	35,346	35,176
Accrued interest receivable	10,132	9,836
Prepaid expenses and other assets	61,733	61,871
Other intangible assets, net	10,362	10,889
Goodwill	119,029	119,029
Total assets	\$3,459,349	\$3,457,750
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Deposits	\$2,912,458	\$2,906,331
Federal Home Loan Bank advances	7,420	—
Junior subordinated debentures	19,205	19,082
Securities sold under agreement to repurchase	23,177	32,181
Accrued expenses and other liabilities	34,563	45,650
Total liabilities	2,996,823	3,003,244
Stockholders' equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at March 31, 2015 and December 31, 2014	—	—
	363,202	364,741

Common stock, no par value, 50,000,000 shares authorized; 30,238,591 and 30,259,838 shares issued and outstanding at March 31, 2015 and December 31, 2014, respectively

Retained earnings	93,140	86,387
Accumulated other comprehensive income, net	6,184	3,378
Total stockholders' equity	462,526	454,506
Total liabilities and stockholders' equity	\$3,459,349	\$3,457,750

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of ContentsHERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

For the Three Months Ended March 31, 2015 and 2014

(Dollars in thousands, except per share amounts)

(Unaudited)

	Three Months Ended March 31,	
	2015	2014
<b>INTEREST INCOME:</b>		
Interest and fees on loans	\$30,481	\$16,451
Taxable interest on investment securities	2,684	639
Nontaxable interest on investment securities	1,033	436
Interest and dividends on other interest earning assets	51	87
Total interest income	34,249	17,613
<b>INTEREST EXPENSE:</b>		
Deposits	1,318	854
Junior subordinated debentures	239	—
Other borrowings	18	18
Total interest expense	1,575	872
Net interest income	32,674	16,741
Provision for loan losses on noncovered loans	1,285	(21
Provision for loan losses on covered loans	(77	) 479
Total provision for loan losses	1,208	458
Net interest income after provision for loan losses	31,466	16,283
<b>NONINTEREST INCOME:</b>		
Service charges and other fees	3,295	1,398
Merchant Visa income, net	198	245
Change in FDIC indemnification asset	(193	) (37
Gain on sale of investment securities, net	544	180
Gain on sale of loans, net	1,135	—
Other income	3,366	521
Total noninterest income	8,345	2,307
<b>NONINTEREST EXPENSE:</b>		
Compensation and employee benefits	14,225	8,011
Occupancy and equipment	3,691	2,617
Data processing	1,627	996
Marketing	633	505
Professional services	805	830
State and local taxes	620	249
Impairment loss on investment securities, net	—	8
Federal deposit insurance premium	516	252
Other real estate owned, net	658	52
Amortization of intangible assets	527	156
Other expense	2,736	1,103
Total noninterest expense	26,038	14,779
Income before income taxes	13,773	3,811
Income tax expense	3,994	1,268
Net income	\$9,779	\$2,543
Basic earnings per common share	\$0.32	\$0.16



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

Diluted earnings per common share	\$0.32	\$0.16
Dividends declared per common share	\$0.10	\$0.16
See accompanying Notes to Condensed Consolidated Financial Statements.		

Table of ContentsHERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Three Months Ended March 31, 2015 and 2014

(Dollars in thousands)

(Unaudited)

	Three Months Ended March 31,	
	2015	2014
Net income	\$9,779	\$2,543
Change in fair value of securities available for sale, net of tax of \$1,705 and \$319, respectively	3,152	593
Reclassification adjustment of net gain from sale of available for sale securities included in income, net of tax of \$(190) and \$(63), respectively	(354	) (117
Accretion of other-than-temporary impairment on securities held to maturity, net of tax of \$4 and \$8, respectively	8	15
Other comprehensive income	2,806	491
Comprehensive income	\$12,585	\$3,034
See accompanying Notes to Condensed Consolidated Financial Statements.		

Table of ContentsHERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

For the Three Months Ended March 31, 2015 and 2014

(In thousands, except per share amounts)

(Unaudited)

	Number of common shares	Common stock	Retained earnings	Accumulated other comprehensive (loss) income, net	Total stock- holders' equity
Balance at December 31, 2013	16,211	\$138,659	\$78,265	\$(1,162)	) \$215,762
Restricted and unrestricted stock awards issued, net of forfeitures	5	—	—	—	—
Stock option compensation expense	—	15	—	—	15
Exercise of stock options (including excess tax benefits from nonqualified stock options)	4	57	—	—	57
Restricted stock compensation expense	—	276	—	—	276
Excess tax benefits from restricted stock	—	32	—	—	32
Common stock repurchased	(9)	) (165)	) —	—	(165)
Net income	—	—	2,543	—	2,543
Other comprehensive income, net of tax	—	—	—	491	491
Cash dividends declared on common stock (\$0.16 per share)	—	—	(2,594)	) —	(2,594)
Balance at March 31, 2014	16,211	\$138,874	\$78,214	\$(671)	) \$216,417
Balance at December 31, 2014	30,260	\$364,741	\$86,387	\$3,378	\$454,506
Restricted and unrestricted stock awards issued, net of forfeitures	89	—	—	—	—
Exercise of stock options (including excess tax benefits from nonqualified stock options)	37	461	—	—	461
Restricted stock compensation expense	—	348	—	—	348
Excess tax benefits from restricted stock	—	26	—	—	26
Common stock repurchased	(147)	) (2,374)	) —	—	(2,374)
Net income	—	—	9,779	—	9,779
Other comprehensive income, net of tax	—	—	—	2,806	2,806
Cash dividends declared on common stock (\$0.10 per share)	—	—	(3,026)	) —	(3,026)
Balance at March 31, 2015	30,239	\$363,202	\$93,140	\$6,184	\$462,526

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of ContentsHERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three Months Ended March 31, 2015 and 2014

(Dollars in thousands)

(Unaudited)

	Three Months Ended March 31,	
	2015	2014
Cash flows from operating activities:		
Net income	\$9,779	\$2,543
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,392	2,666
Changes in net deferred loan fees, net of amortization	(630	) (48
Provision for loan losses	1,208	458
Net change in accrued interest receivable, FDIC indemnification asset, prepaid expenses and other assets, accrued expenses and other liabilities	(10,948	) (751
Restricted and unrestricted stock compensation expense	348	276
Stock option compensation expense	—	15
Excess tax benefits from stock options and restricted and unrestricted stock	(41	) (32
Amortization of intangible assets	527	156
Gain on sale of investment securities, net	(544	) (180
Impairment loss on investment of securities, net	—	8
Origination of loans held for sale	(29,150	) —
Gain on sale of loans, net	(1,135	) —
Proceeds from sale of loans held for sale	27,125	—
Earnings on bank owned life insurance	(170	) (25
Valuation adjustment on other real estate owned	330	—
Loss (gain) on sale of other real estate owned, net	70	(27
Loss on sale or write-off of furniture, equipment and leasehold improvements	—	421
Net cash provided by operating activities	161	5,480
Cash flows from investing activities:		
Loans originated, net of principal payments	(39,456	) (5,180
Maturities of other interest earning deposits	747	497
Maturities of investment securities available for sale	28,899	7,343
Maturities of investment securities held to maturity	314	241
Purchase of investment securities available for sale	(55,728	) (24,443
Purchase of investment securities held to maturity	—	(3,294
Purchase of premises and equipment	(545	) (584
Proceeds from sales of other real estate owned	589	520
Proceeds from sales of investment securities available for sale	23,887	40,318
Proceeds from redemption of FHLB stock	166	75
Investment in low-income housing tax credit partnership	(236	) —
Net cash (used in) provided by investing activities	(41,363	) 15,493

Table of Contents

	Three Months Ended March 31,	
	2015	2014
Cash flows from financing activities:		
Net increase in deposits	6,127	5,025
Net increase in Federal Home Loan Bank advances	7,420	—
Common stock cash dividends paid	(3,026	) (1,297
Net decrease in securities sold under agreement to repurchase	(9,004	) (630
Proceeds from exercise of stock options	446	57
Excess tax benefits from stock options and restricted and unrestricted stock	41	32
Repurchase of common stock	(2,374	) (165
Net cash (used in) provided by financing activities	(370	) 3,022
Net (decrease) increase in cash and cash equivalents	(41,572	) 23,995
Cash and cash equivalents at beginning of period	121,636	130,400
Cash and cash equivalents at end of period	\$80,064	\$154,395
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$1,720	\$887
Cash paid for income taxes	8,256	7
Supplemental non-cash disclosures of cash flow information:		
Transfers of loans receivable to other real estate owned	\$1,728	\$218
Cash dividends declared but not paid	—	1,297
See accompanying Notes to Condensed Consolidated Financial Statements.		

Table of Contents

HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

For the Three Months Ended March 31, 2015 and 2014

(Unaudited)

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

(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-six branch offices located throughout Washington State and the greater Portland, Oregon area. The Bank's business consists primarily of commercial 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. 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"). Effective May 1, 2014, Washington Banking merged with an into Heritage and Whidbey merged with an into Heritage Bank and is referred to herein as the "Washington Banking Merger".

(b) Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with the accounting principles generally accepted in the United States ("GAAP") for interim financial information and 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. It is recommended that these unaudited Condensed Consolidated Financial Statements and accompanying Notes be read with the audited Consolidated Financial Statements and the accompanying Notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014 ("2014 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 months ended March 31, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. In preparing the unaudited Condensed Consolidated Financial Statements, management is required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Management believes that the judgments, estimates and assumptions used in the preparation of the financial statements are appropriate based on the facts and circumstances at the time. Actual results, however, could differ from those estimates.

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.

(c) Significant Accounting Policies

The significant accounting policies used in preparation of the Company's Condensed Consolidated Financial Statements are disclosed in the 2014 Annual Form 10-K. There have not been any material changes in the Company's significant accounting policies from those contained in the 2014 Annual Form 10-K.

(d) Recently Issued Accounting Pronouncements

Financial Accounting Standards Board ("FASB") Accounting Standards Update ("ASU" or "Update") 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. GAAP and international financial reporting standards that would:

Remove inconsistencies and weaknesses in revenue requirements.

Provide a more robust framework for addressing revenue issues.

Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.

Provide more useful information to users of financial statements through improved disclosure requirements.

Table of Contents

Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer. The Update is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early application is not permitted. The Company is currently evaluating the impact that this Update 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 Update requires new and expanded disclosures that are effective for interim or annual reporting periods beginning after December 15, 2014, with certain requirements applicable for periods beginning after March 31, 2015. The adoption of this Update did not have a material impact on the Company's Condensed Consolidated Financial Statements.

**(2) 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 unrealized gains, gross unrealized losses and fair values of investment securities available for sale at the dates indicated were as follows:

	Securities Available for Sale March 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	\$22,377	\$142	\$—	\$22,519
Municipal securities	182,056	3,931	(156)	) 185,831
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	524,832	6,773	(899)	) 530,706
Corporate obligations	6,264	5	(10)	) 6,259
Mutual funds and other equities	1,956	28	—	1,984
Total	\$737,485	\$10,879	\$(1,065)	) \$747,299
	Securities Available for Sale December 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	\$21,414	\$44	\$(31)	) \$21,427
Municipal securities	170,082	3,139	(184)	) 173,037
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government agencies	539,859	4,015	(1,475)	) 542,399



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

Corporate obligations	4,034	—	(24	) 4,010
Mutual funds and other equities	1,956	17	—	1,973
Total	\$737,345	\$7,215	\$(1,714	) \$742,846

11

---

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 March 31, 2015			
	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	\$1,586	\$183	\$—	\$1,769
Municipal securities	22,331	643	(12)	22,962
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	10,665	449	(48)	11,066
Private residential collateralized mortgage obligations	843	80	(87)	836
Total	\$35,425	\$1,355	\$(147)	\$36,633
	Securities Held to Maturity December 31, 2014			
	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	\$1,591	\$167	\$—	\$1,758
Municipal securities	22,486	643	(11)	23,118
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	10,866	364	(74)	11,156
Private residential collateralized mortgage obligations	871	75	(104)	842
Total	\$35,814	\$1,249	\$(189)	\$36,874

There were no securities classified as trading at March 31, 2015 or December 31, 2014.

The amortized cost and fair value of securities at March 31, 2015, 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	\$5,127	\$5,144	\$2,880	\$2,889
Due after one year through three years	34,103	34,347	4,240	4,280
Due after three years through five years	33,231	33,647	6,571	6,899
Due after five years through ten years	159,099	161,551	17,277	18,086
Due after ten years	503,969	510,626	4,457	4,479
Investment securities with no stated maturities	1,956	1,984	—	—
Total	\$737,485	\$747,299	\$35,425	\$36,633



Table of Contents

## (b) Unrealized Losses and Other-Than-Temporary Impairments

Available for sale investment securities with unrealized losses as of March 31, 2015 and December 31, 2014 were as follows:

	Securities Available for Sale					
	March 31, 2015					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Municipal securities	\$23,537	\$(156)	\$—	\$—	\$23,537	\$(156)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	110,318	(899)	—	—	110,318	(899)
Corporate obligations	4,023	(10)	—	—	4,023	(10)
Total	\$137,878	\$(1,065)	\$—	\$—	\$137,878	\$(1,065)
	Securities Available for Sale					
	December 31, 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	\$3,567	\$(31)	\$—	\$—	\$3,567	\$(31)
Municipal securities	25,176	(184)	—	—	25,176	(184)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	182,970	(1,475)	—	—	182,970	(1,475)
Corporate obligations	2,119	(24)	—	—	2,119	(24)
Total	\$213,832	\$(1,714)	\$—	\$—	\$213,832	\$(1,714)

Table of Contents

Held to maturity investment securities with unrecognized losses as of March 31, 2015 and December 31, 2014 were as follows:

	Securities Held to Maturity March 31, 2015					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrecognized Losses	Fair Value	Unrecognized Losses	Fair Value	Unrecognized Losses
	(In thousands)					
Municipal securities	\$1,554	\$(12 )	\$—	\$—	\$1,554	\$(12 )
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	2,556	(48 )	—	—	2,556	(48 )
Private residential collateralized mortgage obligations	554	(87 )	—	—	554	(87 )
Total	\$4,664	\$(147 )	\$—	\$—	\$4,664	\$(147 )

	Securities Held to Maturity December 31, 2014					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrecognized Losses	Fair Value	Unrecognized Losses	Fair Value	Unrecognized Losses
	(In thousands)					
Municipal securities	\$2,196	\$(11 )	\$—	\$—	\$2,196	\$(11 )
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	2,553	(74 )	—	—	2,553	(74 )
Private residential collateralized mortgage obligations	558	(104 )	—	—	558	(104 )
Total	\$5,307	\$(189 )	\$—	\$—	\$5,307	\$(189 )

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

To analyze the unrealized losses, the Company estimated expected future cash flows of the private residential collateralized mortgage obligations by estimating the expected future cash flows of the underlying collateral and applying those collateral cash flows, together with any credit enhancements such as subordination interests owned by third parties, to the security. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which considers current delinquencies and

nonperforming assets, future expected default rates and collateral value by vintage and geographic region) and prepayments. The expected cash flows of the security are then discounted at the interest rate used to recognize interest income on the security to arrive at a present value amount. The Company did not use any impairment assumptions as of March 31, 2015 as the unrealized losses were insignificant. The average prepayment rate and average discount rate used in the valuation of the present value as of March 31, 2014 were 6.0% and 6.7%, respectively.

Table of Contents

For the three months ended March 31, 2015, there were no private residential collateralized mortgage obligations determined to be other-than-temporarily impaired and the Company recorded no unrealized losses for the three months ended March 31, 2015 in earnings or other comprehensive income. In comparison, for the three months ended March 31, 2014, there were two private residential collateralized mortgage obligations determined to be other-than-temporarily impaired. All unrealized losses for the three months ended March 31, 2014 were deemed to be credit related, and the Company recorded the impairment in earnings.

The following table summarizes activity for the three months ended March 31, 2015 and 2014 related to the amount of impairments on held to maturity securities:

	Life-to-Date Gross Other-Than-Temporary Impairments	Life-to-Date Other-Than-Temporary Impairments Included in Other Comprehensive Income	Life-to-Date Net Other-Than-Temporary Impairments Included in Earnings
	(In thousands)		
December 31, 2013	\$2,603	\$1,152	\$1,451
Subsequent impairments March 31, 2014	8 \$2,611	— \$1,152	8 \$1,459
December 31, 2014	\$2,648	\$1,152	\$1,496
Subsequent impairments March 31, 2015	— \$2,648	— \$1,152	— \$1,496

## (c) Pledged Securities

The following table summarizes the amortized cost and fair value of available for sale and held to maturity securities that are pledged as collateral for the following obligations at March 31, 2015 and December 31, 2014:

	March 31, 2015		December 31, 2014	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Washington and Oregon state to secure public deposits	\$159,797	\$163,456	\$150,507	\$153,785
Federal Reserve Bank of San Francisco and FHLB to secure borrowing arrangements	516	517	4,430	4,460
Repurchase agreements	41,729	42,723	43,676	44,457
Other securities pledged	14,789	14,902	14,828	14,922
Total	\$216,831	\$221,598	\$213,441	\$217,624

At March 31, 2015 and December 31, 2014, the total carrying value of pledged securities was \$220.4 million and \$216.7 million, respectively.

## (3) Noncovered Loans Receivable

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

Loans acquired in a business combination may be further classified as "purchased" loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that not all contractually required payments

will be collected are accounted for under FASB Accounting Standards Codification ("ASC") 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality. These loans are identified as "purchased credit impaired" ("PCI") loans. Loans purchased that are not accounted for under FASB ASC 310-30 are accounted for under FASB ASC 310-20, Receivables—Nonrefundable Fees and Other Costs and are referred to as "non-PCI" loans.

(a) Loan Origination/Risk Management

15

---



## Table of Contents

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

### Commercial Business:

There are three significant classes of loans in the commercial portfolio segment: commercial and industrial loans, owner-occupied commercial real estate and non-owner occupied commercial real estate. The owner and non-owner occupied commercial real estate are both considered commercial real estate loans. As the commercial and industrial loans carry different risk characteristics than the commercial real estate loans, they are discussed separately below. Commercial and industrial. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may include a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate. The Company originates commercial real estate loans within its primary market areas. These loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate involves more risk than other classes of loans in that the lending typically involves higher loan principal amounts, and payments on loans secured by real estate properties are dependent on successful operation and management of the properties. Repayment of these loans may be more adversely affected by conditions in the real estate market or the economy. Owner-occupied commercial real estate loans are generally of lower credit risk than non-owner occupied commercial real estate loans as the borrowers' businesses are likely dependent on the properties.

### One-to-Four Family Residential:

The majority of the Company's one-to-four family residential loans are secured by single-family residences located in its primary market areas. The Company's underwriting standards require that single-family portfolio loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms of maturity typically range from 15 to 30 years. Historically, the Company sold most single-family loans in the secondary market and retained a smaller portion in its loan portfolio. From the second quarter of 2013 until May 1, 2014, the Company only originated single-family loans for its loan portfolio. As a result of the Washington Banking Merger, since May 1, 2014 the Company has once again begun originating and selling a majority of its single-family mortgages.

### Real Estate Construction and Land Development:

The Company originates construction loans for one-to-four family residential and for five or more family residential and commercial properties. The one-to-four family residential construction loans generally include construction of custom homes whereby the home buyer is the borrower. The Company also provides financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Substantially all construction loans are short-term in nature and priced with variable rates of interest. Construction lending can involve a higher level of risk than other types of lending because funds are advanced

partially based upon the value of the project, which is uncertain prior to the project's completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, the Company's estimates with regard to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If the Company's estimate

Table of Contents

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

**Consumer:**

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

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

Noncovered loans receivable at March 31, 2015 and December 31, 2014 consisted of the following portfolio segments and classes:

	March 31, 2015 (In thousands)	December 31, 2014
<b>Commercial business:</b>		
Commercial and industrial	\$559,363	\$551,343
Owner-occupied commercial real estate	558,198	535,742
Non-owner occupied commercial real estate	631,627	616,757
Total commercial business	1,749,188	1,703,842
One-to-four family residential	63,944	63,540
<b>Real estate construction and land development:</b>		
One-to-four family residential	42,993	46,749
Five or more family residential and commercial properties	57,898	61,360
Total real estate construction and land development	100,891	108,109
<b>Consumer</b>		
Gross noncovered loans receivable	2,171,000	2,125,814
Net deferred loan fees	(307	) (937
Noncovered loans receivable, net	2,170,693	2,124,877
Allowance for loan losses	(22,317	) (22,153
Noncovered loans receivable, net of allowance for loan losses	\$2,148,376	\$2,102,724

**(b) Concentrations of Credit**

Most of the Company's lending activity occurs within Washington State, and to a lesser extent Oregon. The Company's primary market areas have been concentrated along the I-5 corridor from Whatcom County to Clark County in Washington State and Multnomah County in Oregon, as well as other contiguous markets. The Washington Banking Merger has allowed the expansion of the market area north of Seattle, Washington to the Canadian border. The majority of the Company's loan portfolio consists of (in order of balances at March 31, 2015) non-owner occupied commercial real estate, commercial and industrial and owner-occupied commercial real estate. As of March 31, 2015 and December 31, 2014, there were no concentrations of loans related to any single industry in excess of 10% of the

Company's total loans.

17

---

Table of Contents

## (c) Credit Quality Indicators

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

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

Grade 6: This grade includes "Watch" loans and is considered a "pass grade". The grade is intended to be utilized on a temporary basis for pass grade borrowers where a potentially significant risk-modifying action is anticipated in the near term.

Grade 7: This grade includes "Other Assets Especially Mentioned" ("OAEM") loans in accordance with regulatory guidelines, and is intended to highlight loans with elevated risks. Loans with this grade show signs of deteriorating profits and capital, and the borrower might not be strong enough to sustain a major setback. The borrower is typically higher than normally leveraged, and outside support might be modest and likely illiquid. The loan is at risk of further decline unless active measures are taken to correct the situation.

Grade 8: This grade includes "Substandard" loans in accordance with regulatory guidelines, which the Company has determined have a high credit risk. These loans also have well-defined weaknesses which make payment default or principal exposure likely, but not yet certain. The borrower may have shown serious negative trends in financial ratios and performance. Such loans may be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business. Loans with this grade can be placed on accrual or nonaccrual status based on the Company's accrual policy.

Grade 9: This grade includes "Doubtful" loans in accordance with regulatory guidelines, and the Company has determined these loans to have excessive credit risk. Such loans are placed on nonaccrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Additionally, these loans generally have a specific valuation allowance or have been partially charged-off for the amount considered uncollectible.

Grade 10: This grade includes "Loss" loans in accordance with regulatory guidelines, and the Company has determined these loans have the highest risk of loss. Such loans are charged-off or charged-down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be determined. "Loss" is not intended to imply that the loan or some portion of it will never be paid, nor does it in any way imply that there has been a forgiveness of debt. Numerical loan grades for all commercial business loans and real estate construction and land development loans are established at the origination of the loan. Prior to November 2014, one-to-four family residential loans and consumer loans ("non-commercial loans") were not numerically graded at origination date as these loans were determined to be "pass graded" loans. A numeric grade was assigned to these non-commercial loans if subsequent to origination, the credit department evaluated the credit and determined it necessary to classify the loan. Subsequent to November 2014, the non-commercial loans were designated a loan grade "4" at origination date to reflect a "pass grade". The Bank follows the FDIC's Uniform Retail Credit Classification and Account Management Policy for subsequent classification in the event of payment delinquencies or default. Loan grades are reviewed on a quarterly basis, or more frequently if necessary, by the credit department. Typically, an individual loan grade will not be changed from the prior period unless there is a specific indication of credit deterioration or improvement. Credit deterioration is evidenced by delinquency, direct communications with the borrower, or other borrower information that becomes known to management. Credit improvements are evidenced by known facts regarding the borrower or the collateral property.

The loan grades relate to the likelihood of losses in that the higher the grade, the greater the loss potential. Loans with a pass grade may have some estimated inherent losses, but to a lesser extent than the other loan grades. The OAEM loan grade is transitory in that the Company is waiting on additional information to determine the likelihood and extent of the potential loss. The likelihood of loss for OAEM graded loans, however, is greater than Watch graded

Table of Contents

loans because there has been measurable credit deterioration. Loans with a Substandard grade are generally loans for which the Company has individually analyzed for potential impairment. For Doubtful and Loss graded loans, the Company is almost certain of the losses, and the unpaid principal balances are generally charged-off to the realizable value.

The following tables present the balance of the noncovered loans receivable by credit quality indicator as of March 31, 2015 and December 31, 2014.

	March 31, 2015				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	\$526,439	\$12,784	\$19,826	\$314	\$559,363
Owner-occupied commercial real estate	526,401	18,660	13,137	—	558,198
Non-owner occupied commercial real estate	600,563	16,297	14,767	—	631,627
Total commercial business	1,653,403	47,741	47,730	314	1,749,188
One-to-four family residential	61,534	313	2,097	—	63,944
Real estate construction and land development:					
One-to-four family residential	32,778	3,355	6,860	—	42,993
Five or more family residential and commercial properties	54,011	—	3,887	—	57,898
Total real estate construction and land development	86,789	3,355	10,747	—	100,891
Consumer	249,831	—	7,146	—	256,977
Gross noncovered loans	\$2,051,557	\$51,409	\$67,720	\$314	\$2,171,000
	December 31, 2014				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	\$509,483	\$14,487	\$27,049	\$324	\$551,343
Owner-occupied commercial real estate	496,234	22,946	16,562	—	535,742
Non-owner occupied commercial real estate	584,262	17,643	14,852	—	616,757
Total commercial business	1,589,979	55,076	58,463	324	1,703,842
One-to-four family residential	61,185	315	2,040	—	63,540
Real estate construction and land development:					
One-to-four family residential	34,356	3,977	8,416	—	46,749
Five or more family residential and commercial properties	57,025	—	4,335	—	61,360
Total real estate construction and land development	91,381	3,977	12,751	—	108,109
Consumer	242,836	—	7,487	—	250,323
Gross noncovered loans	\$1,985,381	\$59,368	\$80,741	\$324	\$2,125,814

Noncovered potential problem loans are loans classified as OAEM or worse that are currently accruing interest and are not considered impaired, but which management is monitoring because the financial information of the borrower causes concern as to their ability to meet their loan repayment terms. Noncovered potential problem loans also include

19

---



Table of Contents

PCI loans as these loans continue to accrete loan discounts established at acquisition based on the guidance of ASC 310-30. Noncovered potential problem loans as of March 31, 2015 and December 31, 2014 were \$100.4 million and \$117.3 million, respectively. The balance of noncovered potential problem loans guaranteed by a governmental agency, which guarantee reduces the Company's credit exposure, was \$576,000 and \$2.0 million as of March 31, 2015 and December 31, 2014, respectively.

## (d) Nonaccrual Loans

Nonaccrual noncovered loans, segregated by segments and classes of loans, were as follows as of March 31, 2015 and December 31, 2014:

	March 31, 2015 (In thousands)	December 31, 2014
Commercial business:		
Commercial and industrial	\$3,852	\$3,463
Owner-occupied commercial real estate	1,066	1,163
Non-owner occupied commercial real estate	—	93
Total commercial business	4,918	4,719
One-to-four family residential	—	—
Real estate construction and land development:		
One-to-four family residential	2,513	2,652
Total real estate construction and land development	2,513	2,652
Consumer	21	139
Gross nonaccrual noncovered loans	\$7,452	\$7,510

The Company had \$1.7 million and \$1.6 million of nonaccrual noncovered loans guaranteed by governmental agencies at March 31, 2015 and December 31, 2014, respectively.

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

## (e) Past due loans

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

Table of Contents

The balances of past due noncovered loans, segregated by segments and classes of loans, as of March 31, 2015 and December 31, 2014 were as follows:

	March 31, 2015					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing (1)
	(In thousands)					
Commercial business:						
Commercial and industrial	\$1,081	\$2,770	\$3,851	\$555,512	\$559,363	\$ —
Owner-occupied commercial real estate	2,063	333	2,396	555,802	558,198	—
Non-owner occupied commercial real estate	5,167	—	5,167	626,460	631,627	—
Total commercial business	8,311	3,103	11,414	1,737,774	1,749,188	—
One-to-four family residential	391	—	391	63,553	63,944	—
Real estate construction and land development:						
One-to-four family residential	760	1,964	2,724	40,269	42,993	—
Five or more family residential and commercial properties	—	—	—	57,898	57,898	—
Total real estate construction and land development	760	1,964	2,724	98,167	100,891	—
Consumer	2,181	—	2,181	254,796	256,977	—
Gross noncovered loans	\$11,643	\$5,067	\$16,710	\$2,154,290	\$2,171,000	\$ —
(1) Excludes PCI loans.						
	December 31, 2014					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing (1)
	(In thousands)					
Commercial business:						
Commercial and industrial	\$2,503	\$1,962	\$4,465	\$546,878	\$551,343	\$ —
Owner-occupied commercial real estate	1,038	100	1,138	534,604	535,742	—
Non-owner occupied commercial real estate	113	75	188	616,569	616,757	—
Total commercial business	3,654	2,137	5,791	1,698,051	1,703,842	—
One-to-four family residential	200	—	200	63,340	63,540	—
Real estate construction and land development:						
One-to-four family residential	62	2,135	2,197	44,552	46,749	—
Five or more family residential and commercial properties	—	376	376	60,984	61,360	—
Total real estate construction and land development	62	2,511	2,573	105,536	108,109	—
Consumer	2,413	125	2,538	247,785	250,323	—
Gross noncovered loans	\$6,329	\$4,773	\$11,102	\$2,114,712	\$2,125,814	\$ —
(1) Excludes PCI loans.						



Table of Contents

## (f) Impaired loans

Impaired noncovered loans includes nonaccrual noncovered loans and performing troubled debt restructured noncovered loans ("TDRs") and excludes certain performing troubled debt restructured noncovered loans classified as PCI as these loans are recorded at the recorded investment balance and may not have further impairment. The balance of impaired noncovered loans as of March 31, 2015 and December 31, 2014 are set forth in the following tables.

	March 31, 2015					
	Recorded Investment With No Specific Valuation Allowance (In thousands)	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance	
Commercial business:						
Commercial and industrial	\$2,129	\$6,199	\$8,328	\$9,341	\$797	
Owner-occupied commercial real estate	—	2,339	2,339	2,669	629	
Non-owner occupied commercial real estate	2,441	4,660	7,101	7,093	783	
Total commercial business	4,570	13,198	17,768	19,103	2,209	
One-to-four family residential	—	244	244	244	75	
Real estate construction and land development:						
One-to-four family residential	2,589	994	3,583	4,152	152	
Five or more family residential and commercial properties	—	2,032	2,032	2,032	204	
Total real estate construction and land development	2,589	3,026	5,615	6,184	356	
Consumer	—	125	125	127	22	
Total	\$7,159	\$16,593	\$23,752	\$25,658	\$2,662	
	December 31, 2014					
	Recorded Investment With No Specific Valuation Allowance (In thousands)	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance	
Commercial business:						
Commercial and industrial	\$1,134	\$7,906	\$9,040	\$9,349	\$1,325	
Owner-occupied commercial real estate	360	2,421	2,781	2,781	684	
Non-owner occupied commercial real estate	2,459	4,846	7,305	7,279	465	
Total commercial business	3,953	15,173	19,126	19,409	2,474	
One-to-four family residential	—	245	245	245	75	
Real estate construction and land development:						

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

One-to-four family residential	2,307	2,217	4,524	4,964	396
Five or more family residential and commercial properties	—	2,056	2,056	2,056	234
Total real estate construction and land development	2,307	4,273	6,580	7,020	630
Consumer	33	172	205	208	56
Total	\$6,293	\$19,863	\$26,156	\$26,882	\$3,235

Table of Contents

The Company had governmental guarantees of \$2.2 million and \$2.4 million related to the impaired noncovered loan balances at March 31, 2015 and December 31, 2014, respectively.

The average recorded investment of impaired noncovered loans for the three months ended March 31, 2015 and 2014 are set forth in the following table.

	Three Months Ended March 31,	
	2015	2014
	(In thousands)	
Commercial business:		
Commercial and industrial	\$8,684	\$14,935
Owner-occupied commercial real estate	2,560	3,189
Non-owner occupied commercial real estate	7,203	7,396
Total commercial business	18,447	25,520
One-to-four family residential	244	380
Real estate construction and land development:		
One-to-four family residential	4,053	5,591
Five or more family residential and commercial properties	2,044	2,265
Total real estate construction and land development	6,097	7,856
Consumer	166	889
Total	\$24,954	\$34,645

For the three months ended March 31, 2015 and 2014, no interest income was recognized subsequent to a loan's classification as nonaccrual. For the three months ended March 31, 2015 and 2014, the Bank recorded \$196,000 and \$247,000, respectively, of interest income related to performing TDR noncovered loans.

(g) Troubled Debt Restructured Loans

A troubled debt restructured loan is a restructuring in which the Bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. TDRs are considered impaired and are separately measured for impairment under FASB ASC 310-10-35, whether on accrual ("performing") or nonaccrual ("nonperforming") status.

The majority of the Bank's TDR noncovered loans are a result of granting extensions of maturity on troubled credits which have already been adversely classified. The Bank grants such extensions to reassess the borrower's financial status and to develop a plan for repayment. Certain modifications with extensions also include interest rate reductions, which is the second most prevalent concession. Certain TDRs were additionally re-amortized over a longer period of time. The Bank additionally advanced funds to a troubled speculative home builder to complete established projects. These modifications would all be considered a concession for a borrower that could not obtain similar financing terms from another source other than from the Bank.

The financial effects of each modification will vary based on the specific restructure. For the majority of the Bank's TDRs, the noncovered loans were interest-only with a balloon payment at maturity. If the interest rate is not adjusted and the modified terms are consistent with other similar credits being offered, the Bank may not experience any loss associated with the restructure. If, however, the restructure involves forbearance agreements or interest rate modifications, the Bank may not collect all the principal and interest based on the original contractual terms. The Bank estimates the necessary allowance for loan losses on noncovered TDRs using the same guidance as used for other noncovered impaired loans.

The recorded investment balance and related allowance for loan losses of performing and nonaccrual TDR noncovered loans as of March 31, 2015 and December 31, 2014 were as follows:

	March 31, 2015		December 31, 2014	
	Performing	Nonaccrual	Performing	Nonaccrual
	TDRs	TDRs	TDRs	TDRs
	(In thousands)			
TDR noncovered loans	\$16,736	\$5,325	\$18,764	\$5,010

Allowance for loan losses on TDR noncovered loans	1,989	497	1,908	1,033
---------------------------------------------------	-------	-----	-------	-------

Table of Contents

The unfunded commitment to borrowers related to noncovered TDRs was \$1.0 million and \$1.8 million at March 31, 2015 and December 31, 2014, respectively.

Noncovered loans that were modified as TDRs during the three months ended March 31, 2015 and 2014 are set forth in the following table:

	Three Months Ended March 31,		2014	
	2015		2014	
	Number of	Outstanding	Number of	Outstanding
	Contracts	Principal	Contracts	Principal
	(1)	Balance	(1)	Balance
		(1)(2)		(1)(2)
	(Dollars in thousands)			
Commercial business:				
Commercial and industrial	8	\$1,069	9	\$2,213
Owner-occupied commercial real estate	—	—	1	351
Total commercial business	8	1,069	10	2,564
Real estate construction and land development:				
One-to-four family residential	4	2,520	1	190
Total real estate construction and land development	4	2,520	1	190
Consumer	1	39	3	222
Total TDR noncovered loans	13	\$3,628	14	\$2,976

(1) Number of contracts and outstanding principal balance represent loans which have balances as of period end as certain loans may have been paid-down or charged-off during the three months ended March 31, 2015 and 2014.

(2) Includes subsequent payments after modifications and reflects the balance as of period end. As the Bank did not forgive any principal or interest balance as part of the loan modification, the Bank's recorded investment in each loan at the date of modification (pre-modification) did not change as a result of the modification

(2) (post-modification), except when the modification was the initial advance on a one-to-four family residential real estate construction and land development loan under a master guidance line. There were no advances on these types of loans during the three months ended March 31, 2015 or 2014.

Of the 13 noncovered loans modified during the three months ended March 31, 2015, six loans with a total outstanding principal balance of \$925,000 had no prior modifications. Of the 14 noncovered loans modified during the three months ended March 31, 2014, four loans with a total outstanding principal balance of \$761,000 had no prior modifications. The remaining noncovered loans included in the tables above for the three months ended March 31, 2015 and 2014 were previously reported as noncovered TDRs. The Bank typically grants shorter extension periods to continually monitor the troubled credits despite the fact that the extended date might not be the date the Bank expects the cash flow. The Company does not consider these modifications a subsequent default of a noncovered TDR as new loan terms, specifically maturity dates, were granted. The potential losses related to these loans would have been considered in the period the loan was first reported as a noncovered TDR and adjusted, as necessary, in the current periods based on more recent information. The related specific valuation allowance at March 31, 2015 for noncovered loans that were modified as TDRs during the three months ended March 31, 2015 was \$286,000.

The noncovered loans modified during the previous twelve months ended March 31, 2015 and 2014 that subsequently defaulted during the three months ended March 31, 2015 and 2014 are included in the following table:



Table of Contents

	Three Months Ended March 31, 2015		Three Months Ended March 31, 2014	
	Number of Contracts	Outstanding Principal Balance	Number of Contracts	Outstanding Principal Balance
	(Dollars in thousands)			
Commercial business:				
Commercial and industrial	1	\$77	3	\$799
Non-owner occupied commercial real estate	—	—	1	3
Total commercial business	1	77	4	802
Real estate construction and land development:				
One-to-four family residential	1	865	—	—
Total real estate construction and land development	1	865	—	—
Total	2	\$942	4	\$802

The one-to-four family residential real estate construction loan totaling \$865,000 included in the above table defaulted during the three months ended March 31, 2015 because it was past its modified maturity date, and the borrower had not repaid the credit. The Bank does not intend to extend the maturity date. All other loans included in the table above for both periods defaulted as the loans were greater than 90 days past due. The Bank had a specific valuation allowance at March 31, 2015 related to the credits which defaulted during the three months ended March 31, 2015 of \$8,000.

**(h) Purchased Credit Impaired Loans**

The Company acquired PCI noncovered loans in the Washington Banking Merger and in previously completed acquisitions which are accounted for under FASB ASC 310-30. These previous acquisitions include the FDIC-assisted acquisitions of Cowlitz Bank ("Cowlitz") and Pierce Commercial Bank ("Pierce") on July 30, 2010 and November 8, 2010, respectively. In addition, the Company completed the acquisitions of Northwest Commercial Bank ("NCB") on January 9, 2013 and Valley Community Bancshares, Inc. ("Valley") on July 15, 2013.

The following table reflects the outstanding principal balance and recorded investment at March 31, 2015 and December 31, 2014 of the PCI noncovered loans:

	March 31, 2015		December 31, 2014	
	Outstanding Principal	Recorded Investment	Outstanding Principal	Recorded Investment
	(In thousands)			
Commercial business:				
Commercial and industrial	\$20,400	\$17,162	\$22,144	\$18,040
Owner-occupied commercial real estate	15,980	14,448	18,165	16,208
Non-owner occupied commercial real estate	12,482	11,043	12,684	11,185
Total commercial business	48,862	42,653	52,993	45,433
One-to-four family residential	2,250	2,229	2,269	2,235
Real estate construction and land development:				
One-to-four family residential	8,123	3,816	8,456	4,223
Five or more family residential and commercial properties	2,272	2,492	2,721	2,963
Total real estate construction and land development	10,395	6,308	11,177	7,186
Consumer	5,574	6,680	5,983	7,055

Gross PCI noncovered loans	\$67,081	\$57,870	\$72,422	\$61,909
----------------------------	----------	----------	----------	----------

25

---

Table of Contents

On the acquisition dates, the amount by which the undiscounted expected cash flows of the PCI noncovered loans exceeded the estimate fair value of the loan is the "accretable yield". The accretable yield is then measured at each financial reporting date and represents the difference between the remaining undiscounted expected cash flows and the current carrying value of the PCI noncovered loans.

The following table summarizes the accretable yield on the PCI noncovered loans resulting from the Pierce, NCB, Valley and Washington Banking acquisitions for the three months ended March 31, 2015 and 2014.

	Three Months Ended March 31,	
	2015	2014
	(In thousands)	
Balance at the beginning of the period	\$12,572	\$7,714
Accretion	(1,012	) (828
Disposal and other	(284	) (633
Change in accretable yield	2,739	836
Balance at the end of the period	\$14,015	\$7,089

**(4) Covered Loans Receivable**

The Company acquired loans through FDIC-assisted transactions which are covered by FDIC shared-loss agreements. These loans are referred to as "covered loans." Covered loans were acquired in the Cowlitz acquisition in July 2010 and in the Washington Banking Merger in May 2014. Included in the covered loans acquired from Washington Banking were loans Washington Banking had acquired from City Bank in April 2010 and North County Bank in September 2010. As part of the Washington Banking Merger, the shared-loss agreements with these acquisitions were transferred to Heritage Bank.

Loans purchased with evidence of credit deterioration since origination for which it is probable that not all contractually required payments will be collected are accounted for under FASB ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality and are identified as PCI loans. Loans purchased that are not accounted for under FASB ASC 310-30 are accounted for under FASB ASC 310-20, Receivables—Nonrefundable Fees and Other Costs and are referred to as "non-PCI" loans.

Disclosures related to the Company's recorded investment in covered loans receivable generally exclude accrued interest receivable because it is insignificant.

Table of Contents

## (a) Risk Management

The Company categorizes covered loans in the same four segments as the noncovered portfolio: commercial business, real estate construction and land development, one-to-four family residential and consumer.

The recorded investment of covered loans receivable at March 31, 2015 and December 31, 2014 consisted of the following portfolio segments and classes:

	March 31, 2015 (In thousands)	December 31, 2014
Commercial business:		
Commercial and industrial	\$ 19,389	\$ 19,110
Owner-occupied commercial real estate	55,389	59,244
Non-owner occupied commercial real estate	23,279	26,879
Total commercial business	98,057	105,233
One-to-four family residential	5,775	5,990
Real estate construction and land development:		
One-to-four family residential	2,338	2,446
Five or more family residential and commercial properties	3,152	3,560
Total real estate construction and land development	5,490	6,006
Consumer	8,299	8,971
Gross covered loans receivable	117,621	126,200
Allowance for loan losses	(5,499	) (5,576
Covered loans receivable, net	\$ 112,122	\$ 120,624

At March 31, 2015 and December 31, 2014, the recorded investment balance of loans which are no longer covered under the FDIC shared-loss agreements, but are included in the covered loan table above as they are included in the loan pool established at the time of acquisition, was \$1.2 million and \$872,000, respectively.

## (b) Credit Quality Indicators

The following tables present the recorded invested balance of the covered loans receivable by credit quality indicator as of March 31, 2015 and December 31, 2014.

	March 31, 2015				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	\$ 12,254	\$ 105	\$ 4,850	\$ 2,180	\$ 19,389
Owner-occupied commercial real estate	39,628	3,983	11,529	249	55,389
Non-owner occupied commercial real estate	8,427	36	13,691	1,125	23,279
Total commercial business	60,309	4,124	30,070	3,554	98,057
One-to-four family residential	5,432	—	343		5,775
Real estate construction and land development:					
One-to-four family residential	2,075	—	263	—	2,338
Five or more family residential and commercial properties	1,534	—	1,618	—	3,152
Total real estate construction and land development	3,609	—	1,881	—	5,490
Consumer	6,369	—	1,930	—	8,299
Gross covered loans receivable	\$ 75,719	\$ 4,124	\$ 34,224	\$ 3,554	\$ 117,621



Table of Contents

	December 31, 2014				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	\$11,297	\$131	\$5,442	\$2,240	\$19,110
Owner-occupied commercial real estate	40,357	4,957	13,583	347	59,244
Non-owner occupied commercial real estate	9,656	40	17,183	—	26,879
Total commercial business	61,310	5,128	36,208	2,587	105,233
One-to-four family residential	5,414	425	151	—	5,990
Real estate construction and land development:					
One-to-four family residential	2,178	—	268	—	2,446
Five or more family residential and commercial properties	1,758	—	1,802	—	3,560
Total real estate construction and land development	3,936	—	2,070	—	6,006
Consumer	7,030	—	1,941	—	8,971
Gross covered loans receivable	\$77,690	\$5,553	\$40,370	\$2,587	\$126,200

## (c) Nonaccrual Loans

The recorded investment balance of nonaccrual covered loans, segregated by segments and classes of loans, were as follows as of March 31, 2015 and December 31, 2014:

	March 31, 2015	December 31, 2014
	(In thousands)	
Commercial business:		
Commercial and industrial	\$2,180	\$2,321
Owner -occupied commercial real estate	1,111	1,132
Non-owner-occupied commercial real estate	413	424
Total commercial business	3,704	3,877
One-to-four family residential	174	179
Consumer	6	6
Gross nonaccrual covered loans	\$3,884	\$4,062

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

Table of Contents

## (d) Past Due Loans

The balances of past due covered loans, segregated by segments and classes of loans, as of March 31, 2015 and December 31, 2014 were as follows:

	March 31, 2015					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing (1)
	(In thousands)					
Commercial business:						
Commercial and industrial	\$222	\$2,803	\$3,025	\$16,364	\$19,389	\$ —
Owner-occupied commercial real estate	353	570	923	54,466	55,389	—
Non-owner occupied commercial real estate	—	460	460	22,819	23,279	—
Total commercial business	575	3,833	4,408	93,649	98,057	—
One-to-four family residential	111	—	111	5,664	5,775	—
Real estate construction and land development:						
One-to-four family residential	—	89	89	2,249	2,338	—
Five or more family residential and commercial properties	—	40	40	3,112	3,152	—
Total real estate construction and land development	—	129	129	5,361	5,490	—
Consumer	140	736	876	7,423	8,299	—
Gross covered loans receivable	\$826	\$4,698	\$5,524	\$112,097	\$117,621	\$ —
(1) Excludes covered PCI loans.						
	December 31, 2014					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing (1)
	(In thousands)					
Commercial business:						
Commercial and industrial	\$2,262	\$1,163	\$3,425	\$15,685	\$19,110	\$ —
Owner-occupied commercial real estate	645	2,680	3,325	55,919	59,244	—
Non-owner occupied commercial real estate	1,713	456	2,169	24,710	26,879	—
Total commercial business	4,620	4,299	8,919	96,314	105,233	—
One-to-four family residential	112	—	112	5,878	5,990	—
Real estate construction and land development:						
One-to-four family residential	178	90	268	2,178	2,446	—
Five or more family residential and commercial properties	—	220	220	3,340	3,560	—
Total real estate construction and land development	178	310	488	5,518	6,006	—
Consumer	263	727	990	7,981	8,971	—
Gross covered loans receivable	\$5,173	\$5,336	\$10,509	\$115,691	\$126,200	\$ —

(1) Excludes covered PCI loans.

29

---



Table of Contents

## (e) Impaired Loans

A covered loan, not initially classified as PCI, generally becomes impaired when classified as nonaccrual or when its modification results in a TDR. Impaired covered loans as of March 31, 2015 and December 31, 2014 are set forth in the following tables.

	March 31, 2015				
	Recorded Investment With No Specific Valuation Allowance (In thousands)	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
Commercial business:					
Commercial and industrial	\$2,180	\$—	\$2,180	\$3,577	\$—
Owner-occupied commercial real estate	—	1,419	1,419	1,452	302
Non-owner occupied commercial real estate	—	413	413	438	57
Total commercial business	2,180	1,832	4,012	5,467	359
Real estate construction and land development:					
One-to-four family residential	—	174	174	180	48
Total real estate construction and land development	—	174	174	180	48
Consumer	—	6	6	8	2
Total	\$2,180	\$2,012	\$4,192	\$5,655	\$409

	December 31, 2014				
	Recorded Investment With No Specific Valuation Allowance (In thousands)	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
Commercial business:					
Commercial and industrial	\$2,240	\$94	\$2,334	\$3,696	\$9
Owner-occupied commercial real estate	—	1,132	1,132	1,156	295
Non-owner occupied commercial real estate	—	424	424	440	66
Total commercial business	2,240	1,650	3,890	5,292	370
Real estate construction and land development:					
One-to-four family residential	—	179	179	182	51
Total real estate construction and land development	—	179	179	182	51
Consumer	—	6	6	8	2
Total	\$2,240	\$1,835	\$4,075	\$5,482	\$423



Table of Contents

The average recorded investment of impaired covered loans for the three months ended March 31, 2015 and 2014 are set forth in the following table.

	Three Months Ended March 31,	
	2015	2014
	(In thousands)	
Commercial business:		
Commercial and industrial	\$2,257	\$3,706
Owner-occupied commercial real estate	1,276	214
Non-owner occupied commercial real estate	418	—
Total commercial business	3,951	3,920
One-to-four family residential	—	225
Real estate construction and land development:		
One-to-four family residential	177	—
Total real estate construction and land development	177	—
Consumer	6	7
Total	\$4,134	\$4,152

For the three months ended March 31, 2015 and 2014, no interest income was recognized subsequent to a covered loan's classification as nonaccrual. For the three months ended March 31, 2015 and 2014, the Bank recorded \$3,000 and \$48,000, respectively, of interest income related to performing TDR covered loans.

## (f) Troubled Debt Restructured Loans

The recorded investment balance and related allowance for loan losses of performing and nonaccrual covered TDRs as of March 31, 2015 and December 31, 2014 were as follows:

	March 31, 2015		December 31, 2014	
	Performing TDRs	Nonaccrual TDRs	Performing TDRs	Nonaccrual TDRs
	(In thousands)			
TDR covered loans	\$10,419	\$2,186	\$10,289	\$2,246
Allowance for loan losses on TDR covered loans	28	2	1	2

There were no unfunded commitments related to credits classified as covered TDRs at March 31, 2015 and December 31, 2014.

Covered loans that were modified as TDRs during the three months ended March 31, 2015 and 2014 are set forth in the following table:

	Three Months Ended March 31,		2014	
	2015			
	Number of Contracts (1)	Outstanding Principal Balance (1)(2)	Number of Contracts (1)	Outstanding Principal Balance (1)(2)
	(Dollars in thousands)			
Commercial business:				
Commercial and industrial	1	\$126	1	\$3,626
Owner-occupied commercial real estate	1	308	—	—
Total commercial business	2	434	1	3,626
Consumer	1	105	—	—
Total TDR covered loans	3	\$539	1	\$3,626

(1) Number of contracts and outstanding principal balance represent loans which have balances as of period end as certain loans may have been paid-down or charged-off during the three months ended March 31, 2015 and 2014.



Table of Contents

- (2) Includes subsequent payments after modifications and reflects the balance as of period end. As the Bank did not forgive any principal or interest balance as part of the loan modification, the Bank's recorded investment in each loan at the date of modification (pre-modification) did not change as a result of the modification (post-modification).

All covered loan modified as a TDRs during the three months ended March 31, 2015 and 2014 included in the table above were extensions of credits to borrowers with financial difficulties. At March 31, 2015, the loans modified during the three months ended March 31, 2015 had a specific valuation allowance of \$28,000.

There was one commercial and industrial loan of \$2.2 million at March 31, 2015 that was modified during the previous twelve months and subsequently defaulted during the three months ended March 31, 2015 as the borrower did not make specific curtailment payments. The defaulted loan had been written down to net realizable value at December 31, 2014 and no specific allowance for loan losses was recorded as of March 31, 2015. There were no covered loans modified during the previous twelve months ended March 31, 2014 that subsequently defaulted during the three months ended March 31, 2014.

## (g) Purchased Credit Impaired Loans

The Company acquired covered loans which the Bank accounts for under FASB ASC 310-30 as they were identified as PCI loans at the time of acquisition.

The following table reflects the outstanding principal balance and recorded investment at March 31, 2015 and December 31, 2014 of the PCI covered loans:

	March 31, 2015		December 31, 2014	
	Outstanding Principal	Recorded Investment	Outstanding Principal	Recorded Investment
	(In thousands)			
Commercial business:				
Commercial and industrial	\$10,239	\$7,891	\$9,635	\$7,134
Owner-occupied commercial real estate	19,782	17,946	23,071	20,666
Non-owner occupied commercial real estate	17,403	17,878	20,607	20,257
Total commercial business	47,424	43,715	53,313	48,057
One-to-four family residential	3,626	3,287	3,837	3,478
Real estate construction and land development:				
One-to-four family residential	101	1,215	103	1,308
Five or more family residential and commercial properties	1,915	1,617	2,140	1,802
Total real estate construction and land development	2,016	2,832	2,243	3,110
Consumer	2,796	2,584	2,945	2,717
Gross PCI covered loans	\$55,862	\$52,418	\$62,338	\$57,362

The Bank has the option to modify PCI covered loans; however, modifying the loan may terminate the FDIC shared-loss coverage on those loans. At March 31, 2015 and December 31, 2014, the recorded investment balance of PCI covered loans which are no longer covered under the FDIC shared-loss agreements was \$461,000 and \$476,000, respectively. The Bank continues to report these loans in the covered portfolio as they are in a pool and they continue to be accounted for under FASB ASC 310-30. The FDIC indemnification asset has been adjusted to reflect the change in the loan status.

Table of Contents

## (h) Accretable Yield

The following table summarizes the accretable yield on the PCI covered loans resulting from the Cowlitz acquisition and Washington Banking Merger for the three months ended March 31, 2015 and 2014.

	Three Months Ended March 31,	
	2015	2014
	(In thousands)	
Balance at the beginning of the period	\$8,520	\$9,535
Accretion	(898	) (685
Disposal and other	(354	) (43
Change in accretable yield	1,042	256
Balance at the end of the period	\$8,310	\$9,063

## (5) Allowance for Loan Losses

The allowance for loan losses is maintained at a level deemed appropriate by management to provide for probable incurred credit losses in the loan portfolio.

A summary of the changes in the noncovered loans' allowance for loan losses during the three months ended March 31, 2015 and 2014 are as follows:

	Three Months Ended March 31,	
	2015	2014
	(In thousands)	
Balance at the beginning of the period	\$22,153	\$22,657
Charge-offs	(1,435	) (63
Recoveries of loans previously charged-off	314	247
Provision for loan losses	1,285	(21
Balance at the end of the period	\$22,317	\$22,820

A summary of the changes in the covered loans' allowance for loan losses during the three months ended March 31, 2015 and 2014 are as follows:

	Three Months Ended March 31,	
	2015	2014
	(In thousands)	
Balance at the beginning of the period	\$5,576	\$6,167
Charge-offs	—	(79
Provision for loan losses	(77	) 479
Balance at the end of the period	\$5,499	\$6,567

The covered loans acquired in the Cowlitz acquisition and Washington Banking Merger (including Washington Banking's prior acquisitions of City Bank and North County Bank and related covered loans) are subject to the Company's internal credit review. If and when credit deterioration occurs subsequent to the acquisition dates, a provision for loan losses will be charged to earnings for the full amount of the covered loan balance without regard to the FDIC shared-loss agreements. The portion of the estimated loss reimbursable from the FDIC is recorded in noninterest income and increases the FDIC indemnification asset.

Table of Contents

The following tables detail activity in the allowance for loan losses disaggregated on the basis of the Company's impairment method as of and for the three months ended March 31, 2015:

	Balance at Beginning of Period (In thousands)	Charge-offs	Recoveries	Provision for Loan Losses	Balance at End of Period
Three Months Ended March 31, 2015					
Commercial business:					
Commercial and industrial	\$10,553	\$(660)	\$201	\$(236)	\$9,858
Owner-occupied commercial real estate	4,095	—	—	78	4,173
Non-owner occupied commercial real estate	5,538	(188)	—	679	6,029
Total commercial business	20,186	(848)	201	521	20,060
One-to-four family residential	1,200	—	1	41	1,242
Real estate construction and land development:					
One-to-four family residential	1,786	(106)	—	(115)	1,565
Five or more family residential and commercial properties	972	—	—	33	1,005
Total real estate construction and land development	2,758	(106)	—	(82)	2,570
Consumer	2,769	(481)	112	775	3,175
Unallocated	816	—	—	(47)	769
Total	\$27,729	\$(1,435)	\$314	\$1,208	\$27,816

	Noncovered loans individually evaluated for impairment	Noncovered loans collectively evaluated for impairment	Covered loans individually evaluated for impairment	Covered loans collectively evaluated for impairment	PCI noncovered loans	PCI covered loans	March 31, 2015
(In thousands)							
Commercial business:							
Commercial and industrial	\$797	\$6,278	\$—	\$116	\$2,211	\$456	\$9,858
Owner-occupied commercial real estate	629	1,756	302	14	330	1,142	4,173
Non-owner occupied commercial real estate	783	2,772	57	6	363	2,048	6,029
Total commercial business	2,209	10,806	359	136	2,904	3,646	20,060
One-to-four family residential	75	580	—	8	207	372	1,242
Real estate construction and land development:							
One-to-four family residential	152	362	48	—	264	739	1,565
Five or more family residential and commercial properties	204	713	—	—	88	—	1,005
	356	1,075	48	—	352	739	2,570

Total real estate  
construction and land  
development

Consumer	22	2,233	2	4	729	185	3,175
Unallocated	—	769	—	—	—	—	769
Total	\$2,662	\$15,463	\$409	\$148	\$4,192	\$4,942	\$27,816

34

---



Table of Contents

The following table details the recorded investment balance of the loan receivables disaggregated on the basis of the Company's impairment method as of March 31, 2015:

	Noncovered loans individually evaluated for impairment (In thousands)	Noncovered loans collectively evaluated for impairment	Covered loans individually evaluated for impairment	Covered loans collectively evaluated for impairment	PCI noncovered loans	PCI covered loans	March 31, 2015
Commercial business:							
Commercial and industrial	\$8,328	\$533,873	\$2,180	\$9,318	\$17,162	\$7,891	\$578,752
Owner-occupied commercial real estate	2,339	541,411	1,419	36,024	14,448	17,946	613,587
Non-owner occupied commercial real estate	7,101	613,483	413	4,988	11,043	17,878	654,906
Total commercial business	17,768	1,688,767	4,012	50,330	42,653	43,715	1,847,245
One-to-four family residential	244	61,471	—	2,488	2,229	3,287	69,719
Real estate construction and land development:							
One-to-four family residential	3,583	35,594	174	949	3,816	1,215	45,331
Five or more family residential and commercial properties	2,032	53,374	—	1,535	2,492	1,617	61,050
Total real estate construction and land development	5,615	88,968	174	2,484	6,308	2,832	106,381
Consumer	125	250,172	6	5,709	6,680	2,584	265,276
Total	\$23,752	\$2,089,378	\$4,192	\$61,011	\$57,870	\$52,418	\$2,288,621

Table of Contents

The following tables detail activity in the allowance for loan losses disaggregated on the basis of the Company's impairment method for the three months ended March 31, 2014 and as of December 31, 2014.

	Balance at Beginning of Period (In thousands)	Charge-offs	Recoveries	Provision for Loan Losses	Balance at End of Period
Three Months Ended March 31, 2014					
Commercial business:					
Commercial and industrial	\$13,478	\$(79)	\$232	\$(1,354)	\$12,277
Owner-occupied commercial real estate	4,049	—	—	414	4,463
Non-owner occupied commercial real estate	5,326	—	—	(100)	5,226
Total commercial business	22,853	(79)	232	(1,040)	21,966
One-to-four family residential	1,100	—	—	21	1,121
Real estate construction and land development:					
One-to-four family residential	1,720	—	—	259	1,979
Five or more family residential and commercial properties	953	—	—	1,030	1,983
Total real estate construction and land development	2,673	—	—	1,289	3,962
Consumer	1,597	(63)	15	141	1,690
Unallocated	601	—	—	47	648
Total	\$28,824	\$(142)	\$247	\$458	\$29,387

	Noncovered loans individually evaluated for impairment (In thousands)	Noncovered loans collectively evaluated for impairment (In thousands)	Covered loans individually evaluated for impairment (In thousands)	Covered loans collectively evaluated for impairment (In thousands)	PCI noncovered loans	PCI covered loans	December 31, 2014
Commercial business:							
Commercial and industrial	\$1,325	\$6,449	\$9	\$108	\$2,191	\$471	\$10,553
Owner-occupied commercial real estate	684	1,629	295	14	330	1,143	4,095
Non-owner occupied commercial real estate	465	2,541	66	6	353	2,107	5,538
Total commercial business	2,474	10,619	370	128	2,874	3,721	20,186
One-to-four family residential	75	530	—	8	207	380	1,200
Real estate construction and land development:							
One-to-four family residential	396	322	51	—	264	753	1,786
Five or more family residential and commercial properties	234	650	—	—	88	—	972

Total real estate construction and land development	630	972	51	—	352	753	2,758
Consumer	56	1,931	2	12	617	151	2,769
Unallocated	—	816	—	—	—	—	816
Total	\$3,235	\$14,868	\$423	\$148	\$4,050	\$5,005	\$27,729

36

---

Table of Contents

The following table details the recorded investment balance of the loan receivables disaggregated on the basis of the Company's impairment method for the year ended December 31, 2014:

	Noncovered loans individually evaluated for impairment (In thousands)	Noncovered loans collectively evaluated for impairment	Covered loans individually evaluated for impairment	Covered loans collectively evaluated for impairment	PCI noncovered loans	PCI covered loans	December 31, 2014
Commercial business:							
Commercial and industrial	\$9,040	\$524,263	\$2,334	\$9,642	\$18,040	\$7,134	\$570,453
Owner-occupied commercial real estate	2,781	516,753	1,132	37,446	16,208	20,666	594,986
Non-owner occupied commercial real estate	7,305	598,267	424	6,198	11,185	20,257	643,636
Total commercial business	19,126	1,639,283	3,890	53,286	45,433	48,057	1,809,075
One-to-four family residential	245	61,060	—	2,512	2,235	3,478	69,530
Real estate construction and land development:							
One-to-four family residential	4,524	38,002	179	959	4,223	1,308	49,195
Five or more family residential and commercial properties	2,056	56,341	—	1,758	2,963	1,802	64,920
Total real estate construction and land development	6,580	94,343	179	2,717	7,186	3,110	114,115
Consumer	205	243,063	6	6,248	7,055	2,717	259,294
Total	\$26,156	\$2,037,749	\$4,075	\$64,763	\$61,909	\$57,362	\$2,252,014

## (6) FDIC Indemnification Asset

Changes in the FDIC indemnification asset during the three months ended March 31, 2015 and 2014 were as follows:

	Three Months Ended March 31,	
	2015	2014
	(In thousands)	
Balance at the beginning of the period	\$1,116	\$4,382
Cash payments received or receivable from the FDIC	(231	) (376
FDIC share of additional estimated (gains) losses	(69	) 336
Net amortization	(124	) (373
Balance at the end of the period	\$692	\$3,969

Table of Contents

## (7) Other Real Estate Owned

Changes in other real estate owned during the three months ended March 31, 2015 and 2014 were as follows:

	Three Months Ended March 31,	
	2015	2014
	(In thousands)	
Balance at the beginning of the period	\$3,355	\$4,559
Additions	1,728	218
Proceeds from dispositions	(589	) (520
(Loss) gain on sales, net	(70	) 27
Valuation adjustment	(330	) —
Balance at the end of the period	\$4,094	\$4,284

At March 31, 2015 and December 31, 2014, the balance of other real estate owned that was covered by shared-loss agreements was \$2.8 million and \$1.2 million, respectively.

## (8) Goodwill and Other Intangible Assets

## (a) Goodwill

The Company's goodwill represents the excess of the purchase price over the fair value of net assets acquired in the Washington Banking Merger on May 1, 2014, and the acquisitions of Valley on July 15, 2013, Western Washington Bancorp in 2006 and North Pacific Bank in 1998. The Company's goodwill is assigned to the Bank and is evaluated for impairment at the Bank level (reporting unit).

There were no additions to goodwill during the three months ended March 31, 2015 and 2014.

At March 31, 2015, the Company's step-one analysis concluded that the reporting unit's fair value was greater than its carrying value and therefore no goodwill impairment charges were required for the three months ended March 31, 2015. The Company did not record any goodwill impairment charges for the three months ended March 31, 2014.

Even though there was no goodwill impairment at March 31, 2015, adverse events may impact the recoverability of goodwill and could result in a future impairment charge which could have a material impact on the Company's operating results.

## (b) Other Intangible Assets

The other intangible assets represent the core deposit intangible ("CDI") acquired in business combinations. The useful life of the CDI related to the Washington Banking Merger, the acquisitions of Valley, NCB, Pierce, Cowlitz, and Western Washington Bancorp were estimated to be ten, ten, five, four, nine and eight years, respectively.

The following table presents the change in the other intangible assets for the periods indicated:

	Three Months Ended March 31,	
	2015	2014
	(In thousands)	
Balance at the beginning of the period	\$10,889	\$1,615
Less: Amortization	527	156
Balance at the end of the period	\$10,362	\$1,459

## (9) Junior Subordinated Debentures

As part of the Washington Banking Merger on May 1, 2014, the Company acquired the Washington Banking Master Trust, a statutory business trust ("Master Trust"), which retained its name following the completion of the Washington Banking Merger. The Master Trust was a wholly-owned subsidiary of Washington Banking Company created for the exclusive purposes of issuing and selling capital securities and utilizing sale proceeds to acquire junior subordinated debt issued by Washington Banking Company. During 2007, the Master Trust issued \$25.0 million of trust preferred securities with a 30-year maturity, callable after the fifth year by Washington Banking Company (now callable by Heritage). The trust preferred securities have a quarterly adjustable rate based upon the three-month London Interbank

Offered Rate (“LIBOR”) plus 1.56%. The junior subordinated debentures are the sole assets of the

38

---

Table of Contents

Master Trust, and payments under the junior subordinated debentures are the sole revenues of the Trust. All of the common securities of the Master Trust are owned by the Company. Heritage has fully and unconditionally guaranteed the capital securities along with all obligations of the Master Trust under the trust agreements.

The adjustable rate of the securities at March 31, 2015 was 1.82%. The weighted average rate of the junior subordinated debentures was 5.06% for the three months ended March 31, 2015 and included the accretion of the discount established at the merger date with Washington Banking Company which is amortized over the life of the trust preferred securities.

## (10) Stockholders' Equity

## (a) Earnings Per Common Share

The following table illustrates the reconciliation of weighted average shares used for earnings per common share computations for the three months ended March 31, 2015 and 2014:

	Three Months Ended March 31,	
	2015	2014
	(Dollars in thousands)	
Net income:		
Net income	\$9,779	\$2,543
Less: Dividends and undistributed earnings allocated to participating securities	(95	) (28
Net income allocated to common shareholders	\$9,684	\$2,515
Basic:		
Weighted average common shares outstanding	30,290,200	16,214,735
Less: Restricted stock awards	(261,264	) (197,697
Total basic weighted average common shares outstanding	30,028,936	16,017,038
Diluted:		
Basic weighted average common shares outstanding	30,028,936	16,017,038
Incremental shares from stock options	22,946	9,764
Total diluted weighted average common shares outstanding	30,051,882	16,026,802

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three months ended March 31, 2015 and 2014, anti-dilutive shares outstanding related to options to acquire common stock totaled 7,037 and 131,459, respectively, as the assumed proceeds from exercise price, tax benefits and future compensation was in excess of the market value.

## (b) Dividends

The timing and amount of cash dividends paid on the Company's common stock depends on the Company's earnings, capital requirements, financial condition and other relevant factors. Dividends on common stock from the Company depend substantially upon receipt of dividends from the Bank, which is the Company's predominant source of income. The following table summarizes the dividend activity for the three months ended March 31, 2015 and calendar year 2014.

Declared	Cash Dividend per Share	Record Date	Paid Date
January 29, 2014	\$0.08	February 10, 2014	February 24, 2014
March 27, 2014	\$0.08	April 8, 2014	April 23, 2014
July 24, 2014	\$0.09	August 7, 2014	August 21, 2014
October 23, 2014	\$0.09	November 6, 2014	November 20, 2014
November 11, 2014	\$0.16	December 2, 2014	December 12, 2014
January 28, 2015	\$0.10	February 10, 2015	February 24, 2015

Table of Contents

The FDIC and the Washington State Department of Financial Institutions, Division of Banks have the authority under their supervisory powers to prohibit the payment of dividends by the Bank to the Company. Additionally, current guidance from the Board of Governors of the Federal Reserve System ("Federal Reserve Board") provides, among other things, that dividends per share on the Company's common stock generally should not exceed earnings per share, measured over the previous four fiscal quarters. Current regulations allow the Company and the Bank to pay dividends on their common stock if the Company's or the Bank's regulatory capital would not be reduced below the statutory capital requirements set by the Federal Reserve Board and the FDIC.

(c) Stock Repurchase Program

The Company has had various stock repurchase programs since March 1999. On October 23, 2014, the Company's Board of Directors authorized the repurchase of up to 5% of the Company's outstanding common shares, or approximately 1,513,000 shares, under the eleventh stock repurchase plan. The number, timing and price of shares repurchased will depend on business and market conditions, and other factors, including opportunities to deploy the Company's capital. On August 30, 2012, the Board of Directors approved the Company's tenth stock repurchase plan, authorizing the repurchase of up to 5% of the Company's outstanding shares of common stock, or approximately 757,000 shares. As the eleventh plan superseded the tenth stock repurchase program, the Company did not repurchase the total number of shares available under the tenth plan.

The following table provides total repurchased shares and average share prices under the applicable plans for the periods indicated:

	Three Months Ended March 31,		Plan Total (1)
	2015	2014	
<b>Tenth Plan</b>			
Repurchased shares	—	—	704,975
Stock repurchase average share price	\$—	\$—	\$15.85
<b>Eleventh Plan</b>			
Repurchased shares	137,366	—	137,366
Stock repurchase average share price	\$16.10	\$—	\$16.10

(1) Represents shares repurchased and average share price paid during the duration of the plan.

During the three months ended March 31, 2015 and 2014, the Company also repurchased 9,923 and 9,298 shares at an average price of \$16.31 and \$17.77, respectively, to pay withholding taxes on the vesting of restricted stock that vested during the three months ended March 31, 2015 and 2014, respectively.



Table of Contents(11) Accumulated Other Comprehensive  
Income (Loss)

The changes in accumulated other comprehensive income (loss) ("AOCI") by component, during the three months ended March 31, 2015 and 2014 are as follows:

	Three Months Ended March 31, 2015		
	Changes in fair value of available for sale securities <sup>(1)</sup>	Accretion of other-than- temporary impairment on held to maturity securities <sup>(1)</sup>	Total
	(In thousands)		
Balance of AOCI at the beginning of period	\$3,567	\$(189)	) \$3,378
Other comprehensive income before reclassification	3,152	8	3,160
Amounts reclassified from AOCI for gain on sale of investment securities available for sale included in net income	(354)	) —	(354)
Net current period other comprehensive income	2,798	8	2,806
Balance of AOCI at the end of period	\$6,365	\$(181)	) \$6,184

<sup>(1)</sup> All amounts are net of tax.

	Three Months Ended March 31, 2014		
	Changes in fair value of available for sale securities (1)	Accretion of other-than- temporary impairment on held to maturity securities (1)	Total
	(In thousands)		
Balance of AOCI at the beginning of the period	\$(923)	) \$(239)	) \$(1,162)
Other comprehensive income before reclassification	593	15	608
Amounts reclassified from AOCI for gain on sale of investment securities available for sale included in net income	(117)	) —	(117)
Net current period other comprehensive income	476	15	491
Balance of AOCI at the end of the period	\$(447)	) \$(224)	) \$(671)

<sup>(1)</sup> All amounts are net of tax.

## (12) Stock-Based Compensation

Stock options generally vest ratably over three years and expire five years after they become exercisable or vest ratably over four years and expire ten years from date of grant. Restricted stock awards issued generally have a five-year cliff vesting or four year ratable vesting schedule. The Company issues new shares of common stock to satisfy share option exercises and restricted stock awards.

On July 24, 2014, the Company's shareholders approved the Heritage Financial Corporation 2014 Omnibus Equity Plan (the "Plan") under which 1,500,000 shares of the Company's common stock may be issued in the form of nonqualified stock option awards, restricted stock awards and restricted stock unit awards.

As of March 31, 2015, 1,292,810 shares remain available for future issuances under the Company's stock-based compensation plans.

## (a) Stock Option Awards

For the three months ended March 31, 2015, the Company did not recognize compensation expense or the related tax benefit for the outstanding stock options as all compensation expense had been previously recognized. For the three months ended March 31, 2014, the Company recognized compensation expense related to stock options of \$15,000, with no related tax benefit for the period. The intrinsic value and cash proceeds from options exercised during the three months ended March 31, 2015 was \$163,000 and \$446,000, respectively. The intrinsic value and

Table of Contents

cash proceeds from options exercised during the three months ended March 31, 2014 was \$22,000 and \$57,000, respectively.

The following tables summarize the stock option activity for the three months ended March 31, 2015 and 2014:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding at December 31, 2013	194,482	\$ 15.82		
Granted	—	—		
Exercised	(4,492	) 12.70		
Forfeited or expired	(6,055	) 19.76		
Outstanding at March 31, 2014	183,935	\$ 15.77	3.22	\$503
Outstanding at December 31, 2014	156,407	\$ 13.59		
Granted	—	—		
Exercised	(37,437	) 11.91		
Forfeited or expired	(7,441	) 15.08		
Outstanding at March 31, 2015	111,529	\$ 14.06	3.17	\$353
Vested and expected to vest at March 31, 2015	111,529	\$ 14.06	3.17	\$353
Exercisable at March 31, 2015	111,529	\$ 14.06	3.17	\$353

## (b) Restricted and Unrestricted Stock Awards

For the three months ended March 31, 2015 and 2014, the Company recognized compensation expense related to restricted and unrestricted stock awards of \$348,000 and \$276,000, respectively, and a related tax benefit of \$122,000 and \$97,000, respectively. As of March 31, 2015, the total unrecognized compensation expense related to non-vested restricted and unrestricted stock awards was \$3.5 million and the related weighted average period over which it is expected to be recognized is approximately 2.8 years. The vesting date fair value of restricted stock awards that vested during the three months ended March 31, 2015 and 2014 was \$533,000 and \$536,000, respectively.

The following tables summarize the restricted and unrestricted stock award activity for the three months ended March 31, 2015 and 2014:

	Shares	Weighted-Average Grant Date Fair Value
Nonvested at December 31, 2013	202,939	\$14.29
Granted	6,407	17.17
Vested	(30,176	) 14.55
Forfeited	(811	) 14.67
Nonvested at March 31, 2014	178,359	\$14.35
Nonvested at December 31, 2014	238,669	\$15.20
Granted	90,627	16.28
Vested	(32,699	) 14.66
Forfeited	(2,022	) 15.63
Nonvested at March 31, 2015	294,575	\$15.59

## (13) Fair Value Measurements

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:



## Table of Contents

Level 1: Valuations for assets and liabilities traded in active exchange markets, or interest in open-end mutual funds that allow the Company to sell its ownership interest back to the fund at net asset value on a daily basis. Valuations are obtained from readily available pricing sources for market transactions involving identical assets, liabilities, or funds.

Level 2: Valuations for assets and liabilities traded in less active dealer, or broker markets, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active or valuations using methodologies with observable inputs.

Level 3: Valuations for assets and liabilities that are derived from other valuation methodologies, such as option pricing models, discounted cash flow models and similar techniques using unobservable inputs, and not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

### (a) Recurring and Nonrecurring Basis

The Company used the following methods and significant assumptions to estimate fair value of certain assets on a recurring and nonrecurring basis:

#### Investment Securities Available for Sale and Held to Maturity:

The fair values of all investment securities are based upon the assumptions market participants would use in pricing the security. If available, investment securities are determined by quoted market prices which is generally the case for mutual funds and other equities (Level 1). For investment securities where quoted market prices are not available, fair values are calculated based on market prices on similar securities (Level 2). Level 2 includes U.S. Treasury, U.S. Government and agency debt securities, municipal securities, corporate securities and mortgage-backed securities and collateralized mortgage obligations-residential. For investment securities where quoted prices or market prices of similar securities are not available, fair values are calculated by using observable and unobservable inputs such as discounted cash flows or other market indicators (Level 3). Security valuations are obtained from third party pricing services for comparable assets or liabilities.

#### Impaired Loans:

At the time a loan is considered impaired, its impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, a loan's observable market prices, or fair market value of the collateral if the loan is collateral-dependent. Impaired loans for which impairment is measured using the discounted cash flow approach are not considered to be measured at fair value because the loan's effective interest rate is not a fair value input, and for the purposes of fair value disclosures, the fair value of these loans are measured commensurate with non-impaired loans. Generally, the Company utilizes the fair market value of the collateral, which is commonly based on recent real estate appraisals, to measure impairment. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business (Level 3). Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

#### Other Real Estate Owned:

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers for commercial properties or certified residential appraisers for residential properties whose qualifications and licenses have been reviewed and verified by the Company. Once received, the Company reviews the assumptions and approaches utilized in the appraisal as well as the resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. On a quarterly basis, the Company

Table of Contents

compares the actual selling price of collateral that has been liquidated to the most recent appraised value to determine what additional adjustment should be made to the appraisal value to arrive at fair value.

The following tables summarize the balances of assets measured at fair value on a recurring basis as of March 31, 2015 and December 31, 2014.

	March 31, 2015			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Investment securities available for sale:				
U.S. Treasury and U.S. Government-sponsored agencies	\$22,519	\$—	\$22,519	\$—
Municipal securities	185,831	—	185,831	—
Mortgage backed securities and collateralized mortgage obligations—residential:				
U.S Government-sponsored agencies	530,706	—	530,706	—
Corporate obligations	6,259	—	6,259	—
Mutual funds and other equities	1,984	1,984	—	—
Total	\$747,299	\$1,984	\$745,315	\$—
	December 31, 2014			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Investment securities available for sale:				
U.S. Treasury and U.S. Government-sponsored agencies	\$21,427	\$—	\$21,427	\$—
Municipal securities	173,037	—	173,037	—
Mortgage backed securities and collateralized mortgage obligations—residential:				
U.S Government-sponsored agencies	542,399	—	542,399	—
Corporate obligations	4,010	—	4,010	—
Mutual funds and other equities	1,973	1,973	—	—
Total	\$742,846	\$1,973	\$740,873	\$—

There were no transfers between Level 1 and Level 2 during the three months ended March 31, 2015 and 2014.

The Company may be required to measure certain financial assets and liabilities at fair value on a nonrecurring basis. These adjustments to fair value usually result from application of lower-of-cost-or-market accounting or write-downs of individual assets.

Table of Contents

The tables below represent assets measured at fair value on a nonrecurring basis at March 31, 2015 and December 31, 2014 and the net losses (gains) recorded in earnings during three months ended March 31, 2015 and 2014.

## Fair Value at March 31, 2015

	Basis <sup>(1)</sup>	Total	Level 1	Level 2	Level 3	Net Losses Recorded in Earnings During the Three Months Ended March 31, 2015
(In thousands)						
Impaired noncovered loans:						
Commercial business:						
Commercial and industrial	\$84	\$81	\$—	\$—	\$81	\$—
Total commercial business	84	81	—	—	81	—
Total	84	81	—	—	81	—
Other real estate owned:	\$1,057	\$727	\$—	\$—	\$727	\$330
Total assets measured	\$1,141	\$808	\$—	\$—	\$808	\$330

(1) Basis represents the unpaid principal balance of impaired noncovered loans and carrying value at ownership date of other real estate owned.

## Fair Value at December 31, 2014

	Basis <sup>(1)</sup>	Total	Level 1	Level 2	Level 3	Net Losses (Gains) Recorded in Earnings During the Three Months Ended March 31, 2014
(In thousands)						
Impaired noncovered loans:						
Commercial business:						
Commercial and industrial	\$161	\$138	\$—	\$—	\$138	\$369
Owner-occupied commercial real estate	—	—	—	—	—	(62 )
Non-owner occupied commercial real estate	—	—	—	—	—	(27 )
Total commercial business	161	138	—	—	138	280
Real estate construction and land development:						
One-to-four family residential	2,094	1,725	—	—	1,725	338
Total real estate construction and land development	2,094	1,725	—	—	1,725	338
Consumer	49	45	—	—	45	24
Total	2,304	1,908	—	—	1,908	642
Covered impaired loans:						
Total	—	—	—	—	—	42
Investment securities held to maturity:						



Mortgage back securities and collateralized mortgage obligations – residential:

Private residential collateralized mortgage obligations	36	11	—	11	—	8
Total assets measured	\$2,340	\$1,919	\$—	\$11	\$1,908	\$692

(1) Basis represents the unpaid principal balance of impaired noncovered and impaired covered loans and amortized cost of investment securities held to maturity.

45

---

Table of Contents

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at March 31, 2015 and December 31, 2014.

March 31, 2015				
	Fair Value (Dollars in thousands)	Valuation Technique(s)	Unobservable Input(s)	Range of Inputs; Weighted Average
Impaired noncovered loans	\$81	Market approach	Adjustment for differences between the comparable sales	(50.0%) - 0.0%; (25.0%)
Other real estate owned	\$727	Market approach	Adjustment for differences between the comparable sales	(6.0%) - 3.0%; (5.0%)
December 31, 2014				
	Fair Value (Dollars in thousands)	Valuation Technique(s)	Unobservable Input(s)	Range of Inputs; Weighted Average
Impaired noncovered loans	\$1,908	Market approach	Adjustment for differences between the comparable sales	(47.5%) - 96.2%; 7.0%

## (b) Fair Value of Financial Instruments

Because broadly traded markets do not exist for most of the Company's financial instruments, the fair value calculations attempt to incorporate the effect of current market conditions at a specific time. These determinations are subjective in nature, involve uncertainties and matters of significant judgment and do not include tax ramifications; therefore, the results cannot be determined with precision, substantiated by comparison to independent markets and may not be realized in an actual sale or immediate settlement of the instruments. There may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results. For all of these reasons, the aggregation of the fair value calculations presented herein do not represent, and should not be construed to represent, the underlying value of the Company.

Table of Contents

The tables below present the carrying value amount of the Company's financial instruments and their corresponding estimated fair values at the dates indicated.

	March 31, 2015		Fair Value Measurements Using:		
	Carrying Value	Fair Value	Level 1	Level 2	Level 3
	(In thousands)				
<b>Financial Assets:</b>					
Cash and cash equivalents	\$80,064	\$80,064	\$80,064	\$—	\$—
Other interest earning deposits	9,364	9,396	—	9,396	—
Investment securities available for sale	747,299	747,299	1,984	745,315	—
Investment securities held to maturity	35,425	36,633	—	36,633	—
Federal Home Loan Bank stock	12,022	N/A	N/A	N/A	N/A
Loans held for sale	8,742	8,966	—	8,966	—
Loans receivable, net of allowance for loan losses	2,260,498	2,325,462	—	—	2,325,462
Accrued interest receivable	10,132	10,132	3	3,465	6,664
<b>Financial Liabilities:</b>					
<b>Deposits:</b>					
Noninterest deposits, NOW accounts, money market accounts and savings accounts					
Certificate of deposit accounts	490,245	483,408	—	483,408	—
Total deposits	\$2,912,458	\$2,905,621	\$2,422,213	\$483,408	\$—
Federal Home Loan Bank advances	\$7,420	\$7,420	\$7,420	\$—	\$—
Securities sold under agreement to repurchase	23,177	23,177	23,177	—	—
Junior subordinated debentures	19,205	19,205	—	—	19,205
Accrued interest payable	266	266	58	188	20

Table of Contents

	December 31, 2014		Fair Value Measurements Using:		
	Carrying Value	Fair Value	Level 1	Level 2	Level 3
	(In thousands)				
<b>Financial Assets:</b>					
Cash and cash equivalents	\$ 121,636	\$ 121,636	\$ 121,636	\$—	\$—
Other interest earning deposits	10,126	10,145	—	10,145	—
Investment securities available for sale	742,846	742,846	1,973	740,873	—
Investment securities held to maturity	35,814	36,874	—	36,874	—
Federal Home Loan Bank stock	12,188	N/A	N/A	N/A	N/A
Loans held for sale	5,582	5,710	—	5,710	—
Loans receivable, net of allowance for loan losses	2,223,348	2,279,081	—	—	2,279,081
Accrued interest receivable	9,836	9,836	3	3,009	6,824
<b>Financial Liabilities:</b>					
<b>Deposits:</b>					
<b>Noninterest deposits, NOW accounts, money market accounts and savings accounts</b>					
Certificate of deposit accounts	525,397	525,768	—	525,768	—
Total deposits	\$ 2,906,331	\$ 2,906,702	\$ 2,380,934	\$ 525,768	\$—
<b>Securities sold under agreement to repurchase</b>					
Junior subordinated debentures	19,082	19,082	—	—	19,082
Accrued interest payable	411	411	62	328	21

The methods and assumptions, not previously presented, used to estimate fair value are described as follows:

**Cash and Cash Equivalents:**

The fair value of financial instruments that are short-term or reprice frequently and that have little or no risk are considered to have a fair value equal to carrying value (Level 1).

**Other Interest Earning Deposits:**

These deposits with other banks have maturities greater than three months. The fair value is calculated based upon market prices for similar deposits (Level 2).

**Federal Home Loan Bank Stock:**

Federal Home Loan Bank of Seattle stock is not publicly traded, as such, it is not practicable to determine the fair value of Federal Home Loan Bank stock due to restrictions placed on its transferability.

**Loans Held for Sale:**

The fair value of loans held for sale is estimated based upon binding contracts or quotes from third party investors. (Level 2).

**Loans Receivable:**

Except for impaired loans discussed previously, fair value is based on discounted cash flows using current market rates applied to the estimated life (Level 3). While these methodologies are permitted under U.S. GAAP, they are not based on the exit price concept of the fair value required under ASC 820-10, Fair Value Measurements and Disclosures, and generally produce a higher value.

## Table of Contents

### Accrued Interest Receivable/Payable:

The fair value of accrued interest receivable/payable balances are determined using inputs and fair value measurements commensurate with the asset or liability from which the accrued interest is generated. The carrying amounts of accrued interest approximate fair value (Level 1, Level 2 and Level 3).

### Deposits:

For deposits with no contractual maturity, the fair value is assumed to equal the carrying value (Level 1). The fair value of fixed maturity deposits is based on discounted cash flows using the difference between the deposit rate and the rates offered by the Company for deposits of similar remaining maturities (Level 2).

### Federal Home Loan Bank Advances:

Federal Home Loan Bank advances are used by the Bank in a short-term manner, generally with repayment in one-day. Fair value financial instruments that are short-term in nature and have little risk are considered to have fair value equal to carrying value (Level 1).

### Securities Sold Under Agreement to Repurchase:

Securities sold under agreement to repurchase are short-term in nature and they reprice on a daily basis. Fair value financial instruments that are short-term or reprice frequently and that have little or no risk are considered to have a fair value equal to carrying value (Level 1).

### Junior Subordinated Debentures:

The fair value is estimated using discounted cash flow analysis based on current rates for similar types of debt, which may be unobservable, and considering recent trading activity of similar instruments in markets which can be inactive. At March 31, 2015, the fair value approximated the carrying value based on these valuation techniques (Level 3).

### Off-Balance Sheet Financial Instruments:

The majority of our commitments to extend credit, standby letters of credit and commitments to sell mortgage loans carry current market interest rates if converted to loans. As such, no premium or discount was ascribed to these commitments (Level 1). They are excluded from the preceding tables.

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

The following discussion is intended to assist in understanding the financial condition and results of the Company as of and for the three months ended March 31, 2015. The information contained in this section should be read with the unaudited Condensed Consolidated Financial Statements and the accompanying Notes included herein, and the December 31, 2014 audited Consolidated Financial Statements and the accompanying Notes included in our Annual Report on Form 10-K for the year ended December 31, 2014.

### Overview

Heritage Financial Corporation is a bank holding company, which primarily engages in the business activities of its wholly owned subsidiary, Heritage Bank. We provide financial services to our local communities with an ongoing strategic focus on expanding our commercial lending relationships and market area and a continual focus on asset quality. At March 31, 2015, we had total assets of \$3.46 billion and total stockholders' equity of \$462.5 million. The Company's business activities generally are limited to passive investment activities and oversight of its investment in the Bank. Accordingly, the information set forth in this report relates primarily to the Bank's operations.

Our business consists primarily of commercial lending and deposit relationships with small businesses and their owners in our market areas and attracting deposits from the general public. We also originate real estate construction and land development loans, consumer loans and one-to-four family residential loans collateralized by residential properties located in western and central Washington State and the greater Portland, Oregon area.

Our core profitability depends primarily on our net interest income. Net interest income is the difference between interest income, which is the income that we earn on interest earning assets, comprised primarily of loans and investments, and interest expense, which is the amount we pay on our interest bearing liabilities, including primarily

deposits. Management strives to match the repricing characteristics of the interest earning assets and interest bearing liabilities to protect net interest income from changes in market interest rates and changes in the shape of the yield curve. Like most financial institutions, our net interest income is affected significantly by general and local economic

## Table of Contents

conditions, particularly changes in market interest rates, and by governmental policies and actions of regulatory agencies. Net interest income is additionally affected by changes on the volume and mix of interest earning assets, interest earned on these assets, the volume and mix of interest bearing liabilities and interest paid on interest bearing liabilities.

Our net income is affected by many factors, including the provision for loan losses. The provision for loan losses is dependent on changes in the loan portfolio and management's assessment of the collectability of the loan portfolio as well as prevailing economic and market conditions. The allowance for loan losses reflects the amount that the Company believes is appropriate to provide for known and inherent credit losses in its loan portfolio.

Net income is also affected by noninterest income and noninterest expense. Noninterest income primarily consists of service charges and other fees, gain on sale of loans (net), merchant Visa income (net), change in FDIC indemnification asset and other income. Noninterest expense consists primarily of compensation and employee benefits, occupancy and equipment, data processing, professional services and other expenses. Compensation and employee benefits consist primarily of the salaries and wages paid to our employees, payroll taxes, expenses for retirement and other employee benefits. Occupancy and equipment expenses, which are the fixed and variable costs of buildings and equipment, consist primarily of lease payments, taxes, depreciation charges, maintenance and costs of utilities.

Results of operations may also be affected significantly by general and local economic and competitive conditions, governmental policies and actions of regulatory authorities. Other income and other expenses are also impacted by growth of operations and growth in the number of loan and deposit accounts through acquisitions and core banking business growth. Growth in operations affects other expenses primarily as a result of additional employees, branch facilities and marketing expense. Growth in the number of loan and deposit accounts affects other income, including service charges as well as other expenses such as data processing services, supplies, postage, telecommunications and other miscellaneous expenses.

### Recent Developments

We completed the Washington Banking Merger on May 1, 2014. Legacy Washington Banking results since May 1, 2014 are included in the results of operations herein; therefore, the results included in this Quarterly Report on Form 10-Q for the three months ended March 31, 2015 include three months of operations of legacy Washington Banking. The results included in this Quarterly Report on Form 10-Q for the three months ended March 31, 2014 do not contain the operating results of legacy Washington Banking as the merger was subsequent to the first quarter of 2014.

The Washington Banking Merger is consistent with our strategy of expanding our footprint along the I-5 corridor. We believe the Washington Banking Merger creates a more efficient organization by combining two culturally similar commercial banks. We anticipate the Washington Banking Merger will provide additional lending opportunities, increase our ability to gather and maintain low cost core deposits, generate substantial cost savings and create revenue enhancing opportunities.

As of March 31, 2015 the Company had 66 branching locations. We intend to continue executing our lending practices across our newly expanded market area. We will focus on commercial and consumer lending, including increased small business lending. As a result of the Washington Banking Merger, we have a greater, more diversified non-interest income stream through increased mortgage banking operations and Small Business Administration ("SBA") lending operations.

### Earnings Summary

Net income was \$0.32 per diluted common share for the three months ended March 31, 2015 compared to \$0.16 per diluted common share for the three months ended March 31, 2014. Net income for the three months ended March 31, 2015 was \$9.8 million compared to net income of \$2.5 million for the same period in 2014. The \$7.2 million, or 284.5% increase in net income for the three months ended March 31, 2015 was primarily the result of the Washington Banking Merger.

The efficiency ratio consists of noninterest expense divided by the sum of net interest income before provision for loan losses plus noninterest income. The Company's efficiency ratio decreased to 63.5% for the three months ended March 31, 2015 from 77.6% for the three months ended March 31, 2014. The decrease is due primarily to the \$15.9 million increase in net interest income, partially offset by the \$11.3 million increase in noninterest expense, primarily as a result of the Washington Banking Merger. The decrease in the efficiency ratio is also attributed to the \$6.0 million increase in noninterest income to \$8.3 million for the three months ended March 31, 2015 compared \$2.3



Table of Contents

million for the same period in 2014 due primarily to increases in other income and service charges and other fees as a result of the Washington Banking Merger. The efficiency ratio for the three months ended March 31, 2015 and 2014 was additionally affected by a continued decline in the net interest margin.

## Net Interest Income

One of the Company's key sources of earnings is net interest income. There are several factors that affect net interest income including, but not limited to, the volume, pricing, mix and maturity of interest-earning assets and interest-bearing liabilities; the volume of noninterest-bearing deposits and other liabilities and shareholders' equity; the volume of noninterest-earning assets; market interest rate fluctuations; and asset quality.

Net interest income increased \$15.9 million, or 95.2%, to \$32.7 million for the three months ended March 31, 2015, compared to \$16.7 million for the same period in 2014. The following table provides relevant net interest income information for the dates indicated. The average loan balances presented in the table are net of allowances for loan losses. Nonaccrual loans have been included in the tables as loans carrying a zero yield. Yields on tax-exempt securities and loans have not been stated on a tax-equivalent basis.

	Three Months Ended March 31, 2015			2014				
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate <sup>(1)</sup>	Average Balance	Interest Earned/ Paid	Average Yield/ Rate <sup>(1)</sup>		
(Dollars in thousands)								
<b>Interest Earning Assets:</b>								
Loans, net	\$2,239,662	\$30,481	5.52	% \$1,205,416	\$16,451	5.53	%	
Taxable securities	568,887	2,684	1.91	127,863	639	2.03		
Nontaxable securities	201,199	1,033	2.08	73,096	436	2.42		
Other interest earning assets	66,100	51	0.31	109,826	87	0.32		
Total interest earning assets	3,075,848	34,249	4.52	% 1,516,201	17,613	4.71	%	
Noninterest earning assets	364,120			136,693				
Total assets	\$3,439,968			\$1,652,894				
<b>Interest Bearing Liabilities:</b>								
Certificates of deposit	\$509,141	647	0.52	% \$301,017	\$553	0.75	%	
Savings accounts	364,857	99	0.11	165,911	40	0.10		
Interest bearing demand and money market accounts	1,322,733	572	0.18	582,300	261	0.18		
Total interest bearing deposits	2,196,731	1,318	0.24	1,049,228	854	0.33		
FHLB advances and other borrowings	271	—	0.23	1	—	0.70		
Securities sold under agreement to repurchase	28,223	18	0.26	27,649	18	0.26		
Junior subordinated debentures	19,146	239	5.06	—	—	—		
Total interest bearing liabilities	2,244,371	1,575	0.28	% 1,076,878	872	0.33	%	
Demand and other noninterest bearing deposits	696,299			343,826				
Other noninterest bearing liabilities	38,486			14,469				
Stockholders' equity	460,812			217,721				
Total liabilities and stockholders' equity	\$3,439,968			\$1,652,894				
Net interest income		\$32,674			\$16,741			
Net interest spread			4.24	%		4.38	%	
Net interest margin			4.31	%		4.48	%	

Average interest earning assets to average interest bearing liabilities (1) Annualized	137.05 %	140.80 %
----------------------------------------------------------------------------------------------	----------	----------

The \$15.9 million increase in net interest income for the three months ended March 31, 2015 compared to the same period in 2014 was primarily the result of an increase in the interest and fees on loans as a result of the

51

---

Table of Contents

Washington Banking Merger. The average loans receivable for the three months ended March 31, 2015 was \$2.24 billion compared to \$1.21 billion for the three months ended March 31, 2014. A decrease in the contractual loan note rates caused the yield to slightly decrease to 5.52% for the three months ended March 31, 2015 as compared to 5.53% for the same period in 2014, which partially offset the increase in incremental accretion income as a result of the Washington Banking merger, resulting in an effect on loan yields of 0.60% and 0.31%, respectively. The increase in taxable securities and nontaxable securities' average balances to \$770.1 million for the three months ended March 31, 2015 compared to \$201.0 million for the three months ended March 31, 2014 is attributable to the Washington Banking Merger as well as investment purchases, which also caused an increase in interest income earned on the securities. The increase in interest income from securities was partially offset by a decrease in yield on taxable securities to 1.91% for the three months ended March 31, 2015 from 2.03% for the same period in 2014 and the yield decrease on nontaxable securities to 2.08% for the three months ended March 31, 2015 from 2.42% for the same period in 2014. Although the average balance of interest bearing deposits increased \$1.15 billion, or 109.4%, to \$2.20 billion for the three months ended March 31, 2015 from \$1.05 billion for the three months ended March 31, 2014, a decrease in the average rates to 0.24% from 0.33%, respectively, resulted in an increase of only \$464,000, or 54.3%, in interest expense on deposits for the three months ended March 31, 2015 compared to the same period in 2014. In connection with the Washington Banking Merger, the Company acquired junior subordinated debentures of Washington Banking. The average rate of these debentures for the three months ended March 31, 2015 was 5.06%, including the effects of accretion of the discount established as of the date of the merger. Net interest income as a percentage of average interest earning assets (net interest margin) for the three months ended March 31, 2015, decreased 17 basis points to 4.31% from 4.48% for the same period in 2014. The net interest spread for the three months ended March 31, 2015 decreased 14 basis points to 4.24% from 4.38% for the same period in 2014.

The following table presents the net interest margins and effects of the incremental accretion on purchased loans for the three months ended March 31, 2015 and 2014:

	Three Months Ended		
	March 31,		
	2015	2014	
Net interest margin, excluding incremental accretion on purchased loans <sup>(1)</sup>	3.87	% 4.23	%
Impact on net interest margin from incremental accretion on purchased loans <sup>(1)</sup>	0.44	0.25	
Net interest margin	4.31	% 4.48	%

The incremental accretion income represents the amount of income recorded on the purchased loans above the <sup>(1)</sup> contractual stated interest rate in the individual loan notes. This income results from the discount established at the time these loan portfolios were acquired and modified as a result of quarterly cash flow re-estimation.

The impact on net interest margin from incremental accretion on purchased loans increased 19 basis points to 0.44% for the three months ended March 31, 2015 from 0.25% for the same period in 2014. The dollar amount of incremental income increased to \$3.3 million for the three months ended March 31, 2015 compared to \$935,000 for the three months ended March 31, 2014 primarily as a result of the Washington Banking Merger and to a lesser extent the volume of contractual payments, including significant unanticipated prepayments.

Total interest income increased \$16.6 million, or 94.5%, to \$34.2 million for the three months ended March 31, 2015, from \$17.6 million for the three months ended March 31, 2014. The increase in interest income for the three months ended March 31, 2015 from the same period in 2014 was primarily due to the increase in interest and fees on loans as a result of the Washington Banking Merger. This increase was partially offset by a decrease in the loan yields as a result of lower contractual note rates as a result of the continuing low interest rate environment.

The balance of average interest earning assets (including nonaccrual loans) increased \$1.56 billion, or 102.9%, to \$3.08 billion for the three months ended March 31, 2015, from \$1.52 billion for the three months ended March 31, 2014. The increase in average interest earning assets for the three months ended March 31, 2015 from the same period in 2014 is primarily due to the Washington Banking Merger. The Company acquired \$1.00 billion of fair value in loans, excluding loans held for sale, and \$458.3 million of fair value in investment securities in the Washington

Banking Merger. The average loans receivable, net increased \$1.03 billion, or 85.8%, during the three months ended March 31, 2015 as compared to the same period in 2014.

The yield on total interest earning assets decreased 19 basis points to 4.52% for the three months ended March 31, 2015 from 4.71% for the three months ended March 31, 2014. The decrease in the yield on interest earning assets for the three months ended March 31, 2015 reflects the decrease in loan and securities yields as a result of lower contractual rates from the low interest rate environment.

Table of Contents

Total interest expense increased by \$703,000, or 80.6%, to \$1.6 million for the three months ended March 31, 2015 from \$872,000 for the three months ended March 31, 2014. The increase in interest expense was attributable to the combination of higher average interest bearing deposits balances, primarily as a result of the Washington Banking Merger, partially offset by lower average rates paid on interest bearing certificates of deposit. The increase in interest expense during the three months ended March 31, 2015 compared to the same period in 2014 is also the result of interest expense on the junior subordinated debentures of \$239,000 which were acquired in the Washington Banking Merger.

The average cost of interest bearing liabilities decreased five basis points to 0.28% for the three months ended March 31, 2015 from 0.33% for the three months ended March 31, 2014. Total average interest bearing liabilities increased by \$1.17 billion, or 108.4%, to \$2.24 billion for the three months ended March 31, 2015 from \$1.08 billion for the three months ended March 31, 2014. The increase in average interest bearing liabilities for the three months ended March 31, 2015 was due primarily to the Washington Banking Merger which had approximately \$1.43 billion in fair value of assumed deposits (including noninterest bearing deposits) and \$18.9 million in fair value of assumed junior subordinated debentures.

Deposit interest expense increased \$464,000, or 54.3%, to \$1.3 million for the three months ended March 31, 2015 compared to \$854,000 for the same quarter in 2014. The increase in deposit interest expense for the three months ended March 31, 2015 is primarily a result of the increase in the average deposit balance as a result of the Washington Banking Merger, offset partially by a decrease in the deposit average rate to 0.24% for the three months ended March 31, 2015 from 0.33% for the same period in 2014.

Due to the current low interest rate environment, together with the projected principal reduction in higher yielding purchased loans, the Company expects the net interest margin will continue a downward pressure in future periods.

#### Provision for Loan Losses

The provision for loan losses is dependent on the Company's ability to manage asset quality and control the level of net charge-offs through prudent underwriting standards. In addition, a decline in general economic conditions could increase future provisions for loan losses and have a material effect on the Company's net income.

The provision for loan losses for noncovered loans increased \$1.3 million, or 6,219.0%, to \$1.3 million for the three months ended March 31, 2015 from \$(21,000) for the three months ended March 31, 2014. The amount of the provision was calculated in accordance with the Company's methodology for determining the allowance for loan losses as discussed below. The increase in provision for loan losses was primarily the result of an increase in charge-offs during the three months ended March 31, 2015 as compared to the same period in 2014. The Bank had net charge-offs on noncovered loans of \$1.1 million for the three months ended March 31, 2015 compared to net recoveries of \$184,000 for the three months ended March 31, 2014.

Based on the change in mix and volume of the noncovered loan portfolio at March 31, 2015 compared to December 31, 2014, as well as the decrease in certain historical loss factors and improvements in certain environmental factors, the Company determined that the provision for loan losses on noncovered loans of \$1.3 million for the three months ended March 31, 2015 was appropriate. The ratio of net charge-offs (recoveries) to average noncovered loans outstanding was 0.21% for the three months ended March 31, 2015 compared to (0.06)% for the three months ended March 31, 2014.

The Bank has established a comprehensive methodology for determining the allowance for loan losses on noncovered loans, excluding PCI noncovered loans. On a quarterly basis, the Bank performs an analysis taking into consideration pertinent factors underlying the credit quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, historical loss experience for various loan classes, changes in economic conditions, delinquency rates, a detailed analysis of individual loans on nonaccrual status, and other factors to determine the level of the allowance for loan losses.

For the PCI noncovered loans, the acquisition date fair value incorporated our estimate of future expected cash flows until the ultimate resolution of these credits. To the extent actual or projected cash flows are less than previously estimated, additional provisions for loan losses on the PCI noncovered loan portfolio will be recognized immediately

into earnings. To the extent actual or projected cash flows are more than previously estimated, the increase in cash flows is recognized immediately as a recapture of provision for loan losses up to the previously recognized provision for that pool of loans, if any, and then prospectively recognized in interest income as a yield adjustment.

The allowance for loan losses on noncovered loans, including PCI noncovered loans, decreased by \$164,000, or 0.7%, to \$22.3 million at March 31, 2015 from \$22.2 million at December 31, 2014. As of March 31, 2015, the Bank

Table of Contents

identified \$23.8 million of impaired noncovered loans, which included \$16.7 million of performing troubled debt restructured noncovered loans. Of those impaired noncovered loans, \$7.2 million have no allowances for credit losses as their estimated collateral value or discounted estimated cash flow is equal to or exceeds their carrying costs. The remaining \$16.6 million have related allowances for credit losses totaling \$2.7 million.

Based on the established comprehensive methodology, management deemed the allowance for loan losses on noncovered loans of \$22.3 million at March 31, 2015 (1.03% of total noncovered loans and 299.48% of nonperforming noncovered loans) appropriate to provide for probable incurred losses based on an evaluation of known and inherent risks in the loan portfolio at that date. This compares to an allowance for loan losses on noncovered loans at December 31, 2014 of \$22.2 million (1.04% of total noncovered loans and 294.98% of nonperforming noncovered loans). At applicable merger dates, no allowance for loan losses was established on purchased noncovered loans as the loans were accounted for at their fair value and a discount was established for the loans. At March 31, 2015 and December 31, 2014, the remaining fair value discount for the purchased noncovered loans was \$21.5 million and \$24.0 million, respectively.

The following table outlines the allowance for loan losses on noncovered loans and related noncovered loan balances at March 31, 2015 and December 31, 2014:

	March 31, 2015	December 31, 2014	
	(Dollars in thousands)		
General Valuation Allowance:			
Allowance for loan losses on noncovered loans	\$ 19,655	\$ 18,918	
Gross noncovered loans, excluding impaired noncovered loans	2,147,248	2,099,658	
Percentage	0.92	% 0.90	%
Specific Valuation Allowance:			
Allowance for loan losses on noncovered loans	\$ 2,662	\$ 3,235	
Gross impaired noncovered loans	23,752	26,156	
Percentage	11.21	% 12.37	%
Total Allowance for Loan Losses:			
Allowance for loan losses on noncovered loans	\$ 22,317	\$ 22,153	
Gross noncovered loans	2,171,000	2,125,814	
Percentage	1.03	% 1.04	%

The provision for loan losses on covered loans are calculated in the same manner as the noncovered loans described above. The related provision for loan losses on the covered loans is recorded at the gross amount regardless of the portion of the estimated losses covered by the FDIC shared-loss agreements. The offset to this potential loss is included in the change in the FDIC indemnification asset. For the three months ended March 31, 2015, the provision for loan losses on covered loans totaled \$(77,000), a decrease of \$556,000, or 116.1%, compared to \$479,000 for the three months ended March 31, 2014. The FDIC indemnification asset was decreased through a reduction of noninterest income totaling \$193,000 for the three months ended March 31, 2015 as a result of the change in estimated losses.

While the Bank believes it has established its existing allowances for loan losses in accordance with GAAP, there can be no assurance that bank regulators, in reviewing the Bank's loan portfolio, will not request the Bank to increase significantly its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is appropriate or that increased provisions will not be necessary should the credit quality of the loans deteriorate. Any material increase in the allowance for loan losses would adversely affect the Company's financial condition and results of operations.





Table of Contents

## Noninterest Income

Total noninterest income increased \$6.0 million, or 261.7%, to \$8.3 million for the three months ended March 31, 2015 compared to \$2.3 million for the same period in 2014. The following table presents the change in the key components of noninterest income for the periods noted.

	Three Months Ended March 31,				Percentage Change
	2015	2014	Change		
	(Dollars in thousands)				
Service charges and other fees	\$3,295	\$1,398	\$1,897	135.7	%
Merchant Visa income, net	198	245	(47)	(19.2)	)
Change in FDIC indemnification asset	(193)	(37)	(156)	(421.6)	)
Gain on sale of investment securities, net	544	180	364	202.2	
Gain on sale of loans, net	1,135	—	1,135	100.0	
Other income	3,366	521	2,845	546.1	
Total noninterest income	\$8,345	\$2,307	\$6,038	261.7	%

Service charges and other fees increased \$1.9 million, or 135.7%, for the three months ended March 31, 2015 compared to the same period in 2014 primarily as a result of the Washington Banking Merger. The increase in service charges are primarily the result of customer balance increases in loan and deposit accounts. As of March 31, 2015, total loans receivable, net balance was \$2.26 billion compared to \$1.21 billion as of March 31, 2014 and total deposits were \$2.91 billion as of March 31, 2015 compared to \$1.40 billion as of March 31, 2014. On the effective date of the Washington Banking Merger, the Bank acquired fair value of \$1.00 billion in loans, excluding loans held for sale, and assumed fair value of \$1.43 billion of deposits.

Gain on sale of investment securities, net was \$544,000 for the three months ended March 31, 2015 compared to \$180,000 gain on sale of investment securities, net for the same period in 2014. During the three months ended March 31, 2015 and 2014, the Company received approximately \$23.9 million and \$40.3 million, respectively, in proceeds from the sale of investment securities available for sale which were sold in order to continue restructuring the investment securities portfolio.

Gain on sale of loans, net was \$1.1 million for the three months ended March 31, 2015, and includes net gains on sale of one-to-four family residential loans as well as net gains on the sale of the government guaranteed portion of certain SBA loans. There were no gains on sale of loans during the three months ended March 31, 2014 as the Company had discontinued its mortgage banking operations in the second quarter of 2013. Mortgage banking operations were resumed with the consummation of the Washington Banking Merger on May 1, 2014 as were the sales of government guaranteed portions of certain SBA loans.

Other income increased \$2.8 million, or 546.1%, to \$3.4 million for the three months ended March 31, 2015 from \$521,000 for the three months ended March 31, 2014. The increase was primarily the result of the Company's sale of its merchant Visa portfolio, generating a gain of \$1.7 million during the three months ended March 31, 2015. The effects of this sale will result in lower merchant Visa income. As indicated in the table above, the merchant Visa income, net decreased \$47,000, or 19.2%, to \$198,000 for the three months ended March 31, 2015 from \$245,000 for the three months ended March 31, 2014 primarily due to the sale. The increase in other income was also partially a result of loan loss recoveries primarily of Washington Banking loans which were charged-off prior to consummation of the Washington Banking Merger. These off-balance sheet loan deficiencies had a zero fair value estimate at the May 1, 2014 effective date of the Washington Banking Merger. Other income also included \$170,000 of bank owned life insurance valuation increases for the three months ended March 31, 2015. The Company did not have bank owned life insurance during the three months ended March 31, 2014.

The change in FDIC indemnification asset caption includes amortization of the FDIC indemnification asset and changes to the FDIC indemnification asset as a result of changes in projected remaining cash flows of the purchased covered loans. The Bank recorded \$124,000 and \$373,000 of amortization of the FDIC indemnification asset during the three months ended March 31, 2015 and 2014, respectively. The \$156,000 decrease in the change in FDIC

indemnification asset during the three months ended March 31, 2015 was also due to a \$69,000 reduction of the asset through the FDIC share of additional estimated gains as a result of the improvements in estimated cash flows in the related loan pool. The improvements were primarily due to prepayments of nonperforming loans. The Bank had a symmetrical decrease in the provision for loan losses on covered loans during the three months ended March 31, 2015.

Table of Contents

## Noninterest Expense

Noninterest expense increased \$11.3 million, or 76.2%, to \$26.0 million during the three months ended March 31, 2015 compared to \$14.8 million for the three months ended March 31, 2014. The following table presents the change in the key components of noninterest expense for the periods noted.

	Three Months Ended March 31,		Change	Percentage Change	
	2015	2014			
	(Dollars in thousands)				
Compensation and employee benefits	\$ 14,225	\$ 8,011	\$ 6,214	77.6	%
Occupancy and equipment	3,691	2,617	1,074	41.0	
Data processing	1,627	996	631	63.4	
Marketing	633	505	128	25.3	
Professional services	805	830	(25)	(3.0)	)
State and local taxes	620	249	371	149.0	
Impairment loss on investment securities, net	—	8	(8)	(100.0)	)
Federal deposit insurance premium	516	252	264	104.8	
Other real estate owned, net	658	52	606	(1,165.4)	)
Amortization of intangible assets	527	156	371	237.8	
Other expense	2,736	1,103	1,633	148.1	
Total noninterest expense	\$ 26,038	\$ 14,779	\$ 11,259	76.2	%

The increase in total noninterest expense for the three months ended March 31, 2015 compared to the three months ended March 31, 2014 was due primarily to increased expenses related to Washington Banking Merger.

Compensation and employee benefits increased \$6.2 million, or 77.6%, to \$14.2 million during the three months ended March 31, 2015 compared to \$8.0 million during the three months ended March 31, 2014. The increase in the three months ended March 31, 2015 compared to the same period in 2014 is primarily the result of the increase in the number of full-time equivalent employees attributable to the Washington Banking Merger, which increased to 730 full-time equivalent employees at March 31, 2015, or 103.9%, from 358 full-time equivalent employees at March 31, 2014. Occupancy and equipment increased \$1.1 million, or 41.0%, to \$3.7 million for the three months ended March 31, 2015 compared to \$2.6 million for the same period in 2014. The increase was primarily the result of lease expenses associated with the acquired Whidbey branches. Data processing increased \$631,000, or 63.4%, to \$1.6 million for the three months ended March 31, 2015 from \$996,000 for the same period in 2014. The data processing expense for the three months ended March 31, 2015 reflects primarily costs associated with the core system processing, which increased from the prior period because of the Washington Banking Merger and a resulting increase in the number of accounts and users in the Bank. Professional services decreased \$25,000, or 3.0%, to \$805,000 for the three months ended March 31, 2015 from \$830,000 for the three months ended March 31, 2014. The decrease in professional services was related to expenses incurred during the three months ended March 31, 2014 for attorney, accountant and financial advisor fees in conjunction primarily with the Washington Banking Merger.

Other real estate owned, net expense increased \$606,000, or 1,165.4%, to \$658,000 during the three months ended March 31, 2015 compared to \$52,000 during the three months ended March 31, 2014. The increase in the expense during the three months ended March 31, 2015 was primarily the result of \$330,000 in valuation adjustments recorded during the period. Additionally, due to the increase in the number and balance of other real estate owned, primarily as a result of additions from the Washington Banking Merger, the cost of maintenance on the properties has increased to \$260,000 during the three months ended March 31, 2015 compared to \$84,000 for the same period in 2014.

Other expense increased \$1.6 million, or 148.1%, to \$2.7 million for the three months ended March 31, 2015 from \$1.1 million for the same period in 2014. The increase for the three months ended March 31, 2015 compared to the same period in 2014 is primarily the result of the increases in employee-related expenses such as courier services,

travel expenses, telephone and Visa card expenses given the increase in employees and market area as a result of the Washington Banking Merger. Other expenses during the three months ended March 31, 2015 decreased to a

56

---

Table of Contents

lesser extent as a result of a loss on sale of an other asset in the amount of \$187,000 during the three months ended March 31, 2014.

**Income Tax Expense**

Income tax expense increased by \$2.7 million, or 215.0%, to \$4.0 million for the three months ended March 31, 2015 from \$1.3 million for the three months ended March 31, 2014. The Company's effective tax rate was 29.0% for the three months ended March 31, 2015 compared to 33.3% for the same period in 2014. The increase in the income tax expense was primarily due to the increase in pre-tax income. The decrease in the Company's effective tax rate for the three months ended March 31, 2015 compared to the same period in 2014 is due primarily to the tax credits as a result of investment in a new markets tax credit partnership and investment in a low income housing tax credit partnership as well as an increase in interest from nontaxable securities. The non-deductible acquisition expenses related to the Washington Banking Merger incurred during the three months ended March 31, 2014 also created an increase in the effective tax rate during that period.

**Financial Condition Overview**

Total assets remained relatively consistent at \$3.459 billion as of March 31, 2015 as compared to \$3.458 billion as of December 31, 2014. The total loans receivable, net increased \$37.2 million, or 1.7%, to \$2.26 billion at March 31, 2015 compared to \$2.22 billion at December 31, 2014. To fund the increase in loans, cash and cash equivalents decreased \$41.6 million, or 34.2%, to \$80.1 million at March 31, 2015 from \$121.6 million at December 31, 2014. Investment securities available for sale and held to maturity increased \$4.1 million, or 0.52%, to \$782.7 million at March 31, 2015 from \$778.7 million at December 31, 2014.

Deposits increased by \$6.13 million, or 0.2%, to \$2.912 billion as of March 31, 2015 compared to \$2.906 billion as of December 31, 2014. Total non-maturity deposits increased to 83.2% of total deposits at March 31, 2015 from 81.9% at December 31, 2014 and certificates of deposits decreased to 16.8% of total deposits at March 31, 2015 from 18.1% at December 31, 2014.

Securities sold under agreement to repurchase decreased \$9.0 million, or 28.0%, to \$23.2 million as of March 31, 2015 from \$32.2 million as of December 31, 2014 primarily due to changes in customer deposit balances.

The Company had \$7.4 million of FHLB advances at March 31, 2015 compared to no similar borrowings at December 31, 2014. These funds were needed on a temporary basis and were repaid one day after the borrowing date. The Company will continue to utilize borrowings on an as-needed basis.

Accrued expenses and other liabilities decreased \$11.1 million, or 24.3%, to \$34.6 million at March 31, 2015 from \$45.7 million at December 31, 2014 primarily as a result of federal income tax payments made during the first quarter of 2015. The decrease during the three months ended March 31, 2015 is also related to payments of employee compensation plans and customer-related balances, such as cashier's checks.

Total stockholders' equity increased by \$8.0 million, or 1.8%, to \$462.5 million as of March 31, 2015 from \$454.5 million at December 31, 2014. The increase during the three months ended March 31, 2015 was due primarily to net income of \$9.8 million and other comprehensive income of \$2.8 million, partially offset by cash dividends paid of \$3.0 million and common stock repurchases totaling \$2.4 million. The Company's equity position continues to remain strong at 13.4% of total assets as of March 31, 2015 compared to 13.1% as of December 31, 2014.

The table below provides a comparison of the changes in the Company's financial condition from December 31, 2014 to March 31, 2015.

Table of Contents

	March 31, 2015	December 31, 2014	Change between March 31, 2015 and December 31, 2014
<b>Assets</b>			
Cash and cash equivalents	\$80,064	\$121,636	\$(41,572)
Other interest earning deposits	9,364	10,126	(762)
Investment securities	782,724	778,660	4,064
Loans held for sale	8,742	5,582	3,160
Noncovered loans receivable, net of allowance for loan losses	2,148,376	2,102,724	45,652
Covered loans receivable, net of allowance for loan losses	112,122	120,624	(8,502)
FDIC indemnification asset	692	1,116	(424)
Other real estate owned	4,094	3,355	739
Premises and equipment, net	64,547	64,938	(391)
Federal Home Loan Bank stock, at cost	12,022	12,188	(166)
Bank owned life insurance	35,346	35,176	170
Accrued interest receivable	10,132	9,836	296
Prepaid expenses and other assets	61,733	61,871	(138)
Other intangible assets, net	10,362	10,889	(527)
Goodwill	119,029	119,029	—
<b>Total assets</b>	<b>\$3,459,349</b>	<b>\$3,457,750</b>	<b>\$1,599</b>
<b>Liabilities</b>			
Deposits	\$2,912,458	\$2,906,331	\$6,127
Federal Home Loan Bank advances	7,420	—	7,420
Junior subordinated debentures	19,205	19,082	123
Securities sold under agreement to repurchase	23,177	32,181	(9,004)
Accrued expenses and other liabilities	34,563	45,650	(11,087)
<b>Total liabilities</b>	<b>2,996,823</b>	<b>3,003,244</b>	<b>(6,421)</b>
<b>Stockholders' equity</b>			
Common stock	363,202	364,741	(1,539)
Retained earnings	93,140	86,387	6,753
Accumulated other comprehensive income, net	6,184	3,378	2,806
<b>Total stockholders' equity</b>	<b>462,526</b>	<b>454,506</b>	<b>8,020</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$3,459,349</b>	<b>\$3,457,750</b>	<b>\$1,599</b>

**Lending Activities**

As indicated in the table below, total loans receivable, net of net deferred loan fees increased \$37.2 million, or 1.7%, to \$2.29 billion at March 31, 2015 from \$2.25 billion at December 31, 2014. Noncovered loans receivable, net of deferred loan fees increased \$45.8 million, or 2.2%, to \$2.17 billion at March 31, 2015 from \$2.12 billion at December 31, 2014. Covered loans receivable decreased by \$8.6 million, or 6.8%, to \$117.6 million at March 31, 2015 from \$126.2 million at December 31, 2014. The increases in the noncovered loan receivable balances for the three months ended March 31, 2015 was primarily in the non-owner and owner-occupied commercial real estate loans.

Table of Contents

	March 31, 2015	% of Total Noncovered	December 31, 2014	% of Total Noncovered	
(Dollars in thousands)					
Noncovered loans receivable					
Commercial business:					
Commercial and industrial	\$559,363	25.8	% \$551,343	26.0	%
Owner-occupied commercial real estate	558,198	25.7	535,742	25.2	
Non-owner occupied commercial real estate	631,627	29.1	616,757	29.0	
Total commercial business	1,749,188	80.6	1,703,842	80.2	
One-to-four family residential	63,944	3.0	63,540	3.0	
Real estate construction and land development:					
One-to-four family residential	42,993	2.0	46,749	2.2	
Five or more family residential and commercial properties	57,898	2.7	61,360	2.9	
Total real estate construction and land development	100,891	4.7	108,109	5.1	
Consumer	256,977	11.8	250,323	11.8	
Gross noncovered loans	2,171,000	100.1	2,125,814	100.1	
Net deferred loan fees	(307	) (0.1	) (937	) (0.1	)
Noncovered loans receivable, net	2,170,693	100.0	% 2,124,877	100.0	%
Covered loans receivable	117,621		126,200		
Total loans receivable, net of net deferred loan fees	\$2,288,314		\$2,251,077		

Table of Contents

## Nonperforming Noncovered Assets

The following table describes our nonperforming noncovered assets at the dates indicated:

	March 31, 2015	December 31, 2014	
	(Dollars in thousands)		
Nonaccrual noncovered loans:			
Commercial business	\$4,918	\$4,719	
Real estate construction and land development	2,513	2,652	
Consumer	21	139	
Total nonaccrual noncovered loans (1)(2)	7,452	7,510	
Other real estate owned, noncovered	1,322	2,178	
Total nonperforming noncovered assets	\$8,774	\$9,688	
Performing TDR noncovered loans:			
Commercial business	\$13,168	\$14,408	
One-to-four family residential	244	245	
Real estate construction and land development	3,102	3,927	
Consumer	222	184	
Total performing TDR noncovered loans (3)	\$16,736	\$18,764	
Accruing noncovered loans past due 90 days or more (4)	\$—	\$—	
Noncovered potential problem loans (5)	100,411	117,250	
Allowance for loan losses on noncovered loans	22,317	22,153	
Allowance for loan losses on noncovered loans to total noncovered loans, net	1.03	%	1.04 %
Allowance for loan losses on noncovered loans to nonperforming noncovered loans	299.48	%	294.98 %
Nonperforming noncovered loans to total noncovered loans	0.34	%	0.35 %
Nonperforming noncovered assets to total noncovered assets	0.26	%	0.29 %

(1) At March 31, 2015 and December 31, 2014, \$5.3 million and \$4.1 million of nonperforming noncovered loans, respectively, were considered troubled debt restructurings.

(2) At March 31, 2015 and December 31, 2014, \$1.7 million and \$1.6 million of nonperforming noncovered loans, respectively, were guaranteed by government agencies.

(3) At March 31, 2015 and December 31, 2014, \$517,000 and \$751,000 of performing TDR noncovered loans, respectively, were guaranteed by government agencies.

(4) There were no accruing noncovered loans past due 90 days or more that were guaranteed by government agencies at March 31, 2015 or December 31, 2014.

(5) At March 31, 2015 and December 31, 2014, \$576,000 and \$2.0 million of noncovered potential problem loans, respectively, were guaranteed by government agencies.

Nonperforming noncovered assets decreased \$914,000 to \$8.8 million, or 0.26% of total noncovered assets, at March 31, 2015 from \$9.7 million, or 0.29% of total noncovered assets at December 31, 2014 due primarily to a decrease of \$856,000 in noncovered other real estate owned. For the three months ended March 31, 2015, the slight decrease in nonperforming noncovered loans was due to \$618,000 in net principal reductions, \$249,000 in charge-offs and \$149,000 of transfers to accrual status, offset partially by \$958,000 of additions of nonperforming noncovered loans. The noncovered other real estate owned balance decreased to \$1.3 million at March 31, 2015 from \$2.2 million at December 31, 2014 as a result of sale of two noncovered properties with net proceeds of \$457,000 and losses of \$70,000 along with a \$330,000 valuation adjustment to record six properties at their estimated proceeds value based on recent purchase and sales agreements.

Performing TDR noncovered loans were \$16.7 million and \$18.8 million as of March 31, 2015 and December 31, 2014, respectively. The \$2.0 million, or 10.8%, decrease in the performing TDR noncovered loans for the three



months ended March 31, 2015 was primarily the result of net principal payments of \$1.6 million and \$957,000 of loans transferred to nonaccrual status, partially offset by \$571,000 of additions due to loans restructured during the period. At March 31, 2015 and December 31, 2014, the Company had recorded \$2.0 million and \$1.9 million, respectively, in allowance for loan losses on the performing TDR noncovered loans.

## Table of Contents

Noncovered potential problem loans as of March 31, 2015 and December 31, 2014 were \$100.4 million and \$117.3 million, respectively. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which we are monitoring because the financial information of the borrower causes us concerns as to their ability to comply with their loan repayment terms. Loans that are past due 90 days or more and still accruing interest are both well secured and in the process of collection. The \$16.8 million, or 14.4%, decrease in the noncovered potential problem loans was primarily the result of \$15.1 million in loan grade improvements, loan principal payments (net) of \$7.1 million and net transfers to nonaccrual status of \$331,000, partially offset by the addition of \$5.9 million of loans graded as potential problem loans during the three months ended March 31, 2015.

### Analysis of Allowance for Loan Losses

Management maintains an allowance for loan losses (“ALL”) to provide for estimated probable incurred credit losses inherent in the loan portfolio. The adequacy of the ALL is monitored through our ongoing quarterly loan quality assessments.

We assess the estimated probable incurred credit losses inherent in our loan portfolio by considering a number of elements including:

- Historical loss experience in a number of homogeneous classes of the loan portfolio;
- The impact of environmental factors, including:
  - Levels of and trends in delinquencies and impaired loans;
  - Levels and trends in charge-offs and recoveries;
  - Effects of changes in risk selection and underwriting standards, and other changes in lending policies, procedures and practices;
- Experience, ability, and depth of lending management and other relevant staff;
- National and local economic trends and conditions;
- External factors such as competition, legal, and regulatory requirements; and
- Effects of changes in credit concentrations.

We calculate an appropriate ALL for the non-classified and classified performing loans in our loan portfolio, except PCI loans, by applying historical loss factors for homogeneous classes of the portfolio, adjusted for changes to the above-noted environmental factors. We may record specific provisions for impaired loans, including loans on nonaccrual status and TDRs, after a careful analysis of each loan’s credit and collateral factors. Our analysis of an appropriate ALL combines the provisions made for our non-classified loans, classified loans, and the specific provisions made for each impaired loan.

For the PCI loans, the acquisition date fair value incorporated our estimate of future expected cash flows until the ultimate resolution of these credits. To the extent actual or projected cash flows are less than previously estimated, additional provisions for loan losses on the PCI loan portfolio will be recognized immediately into earnings. To the extent actual or projected cash flows are more than previously estimated, the increase in cash flows is recognized immediately as a recapture of provision for loan losses up to the previously recognized provision for that pool of loans, if any, and then prospectively recognized in interest income as a yield adjustment.

While we believe we use the best information available to determine the allowance for loan losses under both methods, results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. A further decline in local and national economic conditions, or other factors, could result in a material increase in the allowance for loan losses and may adversely affect the Company’s financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators, as part of their routine examination process, which may result in the establishment of additional allowance allocations based upon their judgment of information available to them at the time of their examination.

Table of Contents

The following table provides information regarding changes in our allowance for loan losses on noncovered loans as of and for the three months ended March 31, 2015 and 2014:

	Three Months Ended March 31,	
	2015	2014
	(Dollars in thousands)	
Noncovered loans receivable, net at the end of the period	\$2,170,693	\$1,175,563
Average noncovered loans receivable during the period	\$2,123,289	\$1,149,169
Allowance for loan losses on noncovered loans at the beginning of the period	\$22,153	\$22,657
Provision for loan losses on noncovered loans	1,285	(21 )
Charge-offs:		
Commercial business	(848 )	—
One-to-four family residential	—	—
Real estate construction and land development	(106 )	—
Consumer	(481 )	(63 )
Total charge-offs	(1,435 )	(63 )
Recoveries:		
Commercial business	201	232
One-to-four family residential	1	—
Real estate construction and land development	—	—
Consumer	112	15
Total recoveries	314	247
Net (charge-offs) recoveries	(1,121 )	184
Allowance for loan losses on noncovered loans at end of period	\$22,317	\$22,820
Allowance for loan losses on noncovered loans to total noncovered loans receivable, net	1.03	% 1.94 %
Ratio of net charge-offs (recoveries) during period to average noncovered loans receivable (annualized)	0.21	% (0.06 )%

The allowance for loan losses on noncovered loans decreased \$503,000, or 2.2%, to \$22.3 million at March 31, 2015 from \$22.8 million at March 31, 2014. The allowance for loan losses on noncovered loans decreased during the period because of the change in mix and volume of loan types as well as the impact of the Washington Banking Merger.

Purchased loans are recorded at fair value, and the Company does not record allowance for loan losses on the purchased loans at the merger date. Due to this accounting, the allowance for loan losses on noncovered loans receivable to total noncovered loans receivable, net ratio decreased to 1.03% at March 31, 2015 from 1.94% at March 31, 2014. This decrease is a function of the increase in the denominator of the ratio, total noncovered loans receivable, net, without having the increase in the numerator, allowance for loan losses, due to the accounting treatment of purchased loans.

The allowance for loan losses on noncovered loans decreased \$164,000, or 0.7%, to \$22.3 million at March 31, 2015 from \$22.2 million as of December 31, 2014. The nonperforming noncovered loans decreased \$58,000 to \$7.45 million at March 31, 2015 from \$7.51 million at December 31, 2014. Nonperforming noncovered loans to total noncovered loans was 0.34% at March 31, 2015 compared to 0.35% December 31, 2014, and the allowance for loan losses on noncovered loans to nonperforming noncovered loans was 299.48% at March 31, 2015 and 294.98% at December 31, 2014.

Based on management's assessment of loan quality and current economic conditions, the Company believes that its allowance for loan losses was appropriate to absorb the probable incurred losses and inherent risks of loss in the loan portfolio at March 31, 2015.



Table of Contents

## Deposits and Other Borrowings

As indicated in the table below, total deposits increased \$6.1 million, or 0.21%, to \$2.91 billion at March 31, 2015 from \$2.91 billion at December 31, 2014.

	March 31, 2015	% of Total	December 31, 2014	% of Total	
	(Dollars in thousands)				
Non-interest bearing demand deposits	\$698,231	24.0	% \$709,673	24.4	%
NOW accounts	836,786	28.7	793,362	27.3	
Money market accounts	518,388	17.8	520,065	17.9	
Savings accounts	368,808	12.7	357,834	12.3	
Total non-maturity deposits	2,422,213	83.2	2,380,934	81.9	
Certificates of deposit	490,245	16.8	525,397	18.1	
Total deposits	\$2,912,458	100.0	% \$2,906,331	100.0	%

The increase in the deposits was the result of customer activities. Non-maturity deposits (total deposits less certificates of deposit) have increased \$41.3 million, or 1.7%, to \$2.42 billion at March 31, 2015 from \$2.38 billion at December 31, 2014 and certificate of deposit accounts have decreased \$35.2 million, or 6.7%, to \$490.2 million at March 31, 2015 from \$525.4 million at December 31, 2014. Based on the change in the mix and volume of deposits, the percentage of certificates of deposit to total deposits decreased to 16.8% at March 31, 2015 from 18.1% at December 31, 2014.

Borrowings may also be used on a short-term basis to compensate for reductions in other sources of funds (such as deposit inflows at less than projected levels). Borrowings may also be used on a longer-term basis to support expanded lending activities and match the maturity of repricing intervals of assets. The Bank is utilizing securities sold under agreement to repurchase as a supplement to its funding sources. Our repurchase agreements are secured by available for sale investment securities. At March 31, 2015, the Bank had securities sold under agreement to repurchase totaling \$23.2 million, a decrease of \$9.0 million, or 28.0%, from \$32.2 million at December 31, 2014. The decrease is the result of customer activity during the period.

The Bank had FHLB advances of \$7.4 million at March 31, 2015 which were paid one day after the borrowing date. There was no similar short-term borrowing at December 31, 2014. Advances from the FHLB are secured by investment securities and loans secured by real estate. The FHLB advances had a coupon rate of 0.26% at March 31, 2015.

As part of the Washington Banking Merger, the Company acquired junior subordinated debentures with fair value of \$18.9 million. The debentures have a par value of \$25.0 million, and pay quarterly interest based on three-month LIBOR plus 1.56%. The debentures mature in 2037. The balance of the junior subordinated debentures at March 31, 2015 is \$19.2 million.

We are required to maintain an adequate level of liquidity to ensure the availability of sufficient funds to fund loan originations and deposit withdrawals, satisfy other financial commitments, and fund operations. We generally maintain sufficient cash and short-term investments to meet short-term liquidity needs. At March 31, 2015, cash and cash equivalents totaled \$80.1 million, or 2.3% of total assets. In addition, \$7.7 million of the \$9.4 million of other interest earning deposits are scheduled to mature within one year of March 31, 2015. The fair value of investment securities available for sale totaled \$747.3 million at March 31, 2015 of which \$188.3 million were pledged to secure public deposits or borrowing arrangements. The fair value of investment securities available for sale that were not pledged to secure public deposits or borrowing arrangements totaled \$559.0 million, or 16.2%, of total assets at March 31, 2015. The fair value of investment securities available for sale with maturities of one year or less amounted to \$5.1 million, or 0.15% of total assets.

At March 31, 2015, the Bank maintained credit facilities with the FHLB for \$296.4 million and credit facilities with the Federal Reserve Bank of San Francisco for \$80.5 million, of which there were \$7.4 million of FHLB borrowings outstanding at March 31, 2015. The Bank also maintains lines of credit with four correspondent banks to purchase federal funds totaling \$55.0 million as of March 31, 2015. There were no federal funds purchased as of March 31,

2015.

63

---

## Table of Contents

### Liquidity and Cash Flows

Our primary sources of funds are customer deposits, loan principal and interest payments and interest earned on and proceeds from sales and maturities of investment securities. These funds, together with retained earnings, equity and other borrowed funds (as necessary), are used to make loans, acquire investment securities and other assets, and fund continuing operations. While maturities and scheduled amortization of loans are predictable sources of funds, deposit flows and prepayments are greatly influenced by the level of interest rates, economic conditions, and competition. In addition to customer deposits, management may utilize the use of brokered deposits on an as-needed basis.

**Heritage Bank:** The principal objective of the Bank's liquidity management program is to maintain the ability to meet day-to-day cash flow requirements of its customers who either wish to withdraw funds or to draw upon credit facilities to meet their cash needs. The Bank monitors the sources and uses of funds on a daily basis to maintain an acceptable liquidity position. In addition to liquidity from core deposits and the repayment and maturities of loans, the Bank can utilize established credit facilities and lines with correspondent banks or sale of investment securities.

**Heritage Financial Corporation:** The Company is a separate legal entity from the Bank and must provide for its own liquidity. Substantially all of the Company's revenues are obtained from dividends declared and paid by the Bank. There are statutory and regulatory provisions that could limit the ability of the Bank to pay dividends to the Company. However, management believes that such restrictions will not have an adverse impact on the ability of the Company to meet its ongoing cash obligations.

**Consolidated Cash Flows:** As disclosed in the Condensed Consolidated Statements of Cash Flows, net cash provided by operating activities was \$161,000 for the three months ended March 31, 2015, and primarily consisted of proceeds from sale of loans held for sale of \$27.1 million, net income of \$9.8 million and depreciation and amortization of \$3.4 million, partially offset by originations for loans held for sale of \$29.2 million and net change in other assets and liabilities of \$10.9 million. During the three months ended March 31, 2015, net cash used in investing activities was \$41.4 million, which consisted primarily of purchases of investment securities available for sale of \$55.7 million and net loan originations of \$39.5 million, offset partially by maturities of investment securities available for sale of \$28.9 million and proceeds from sales of investment securities available for sale of \$23.9 million. Net cash used in financing activities was \$370,000 for the three months ended March 31, 2015, and primarily consisted of a net increase in Federal Home Loan Bank advances of \$7.4 million and a net increase in deposits of \$6.1 million, offset partially by a \$9.0 million decrease in the securities sold under agreement to repurchase, \$3.0 million payment of cash dividends on common stock and \$2.4 million of repurchases of common stock.

### Capital and Capital Requirements

Stockholders' equity at March 31, 2015 was \$462.5 million compared with \$454.5 million at December 31, 2014. During the three months ended March 31, 2015, the Company realized net income of \$9.8 million, declared and paid cash dividends of \$3.0 million, recorded \$2.8 million in other comprehensive income, recorded stock-based compensation expense totaling \$374,000, recorded \$461,000 related to the exercise of stock options, net of tax effect, and repurchased common stock for \$2.4 million.

The Company is a bank holding company under the supervision of the Federal Reserve Bank of San Francisco. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve Board under the Bank Holding Company Act of 1956, as amended, and the regulations of the Federal Reserve Board. Heritage Bank is a federally insured institution and thereby is subject to the capital requirements established by the FDIC. The Federal Reserve Board capital requirements generally parallel the FDIC requirements. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's Condensed Consolidated Financial Statements and operations. Management believes the Company and the Bank meet all capital adequacy requirements to which they are subject. Pursuant to minimum capital requirements of the FDIC effective on January 1, 2015, all FDIC-insured financial institutions, including Heritage Bank, are required to maintain a minimum common equity Tier 1 risk-based capital to risk-weighted assets ratio of 4.5%, a minimum Tier 1 leverage ratio to average assets of 4.0% and minimum risk-based capital ratios of Tier 1 capital to risk-weighted assets and total capital to risk-weighted assets of 6.0% and

8.0%, respectively.

As of March 31, 2015 and December 31, 2014, the most recent regulatory notifications categorized Heritage Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's categories.

64

---



Table of Contents

	Minimum Requirements		Well-Capitalized Requirements		Actual			
	\$	%	\$	%	\$	%		
(Dollars in thousands)								
As of March 31, 2015:								
The Company consolidated								
Common equity Tier 1 capital to risk-weighted assets	\$ 117,424	4.5	% N/A	N/A	\$ 330,520	12.7	%	
Tier 1 leverage capital to average assets	132,289	4.0	N/A	N/A	349,545	10.6		
Tier 1 capital to risk-weighted assets	156,565	6.0	N/A	N/A	349,545	13.4		
Total capital to risk-weighted assets	208,753	8.0	N/A	N/A	377,541	14.5		
Heritage Bank								
Common equity Tier 1 capital to risk-weighted assets	117,360	4.5	169,520	6.5	342,682	13.1		
Tier 1 leverage capital to average assets	132,247	4.0	165,309	5.0	342,682	10.4		
Tier 1 capital to risk-weighted assets	156,480	6.0	208,640	8.0	342,682	13.1		
Total capital to risk-weighted assets	208,640	8.0	260,800	10.0	370,648	14.2		
As of December 31, 2014:								
The Company consolidated								
Tier 1 leverage capital to average assets	\$ 132,881	4.0	% N/A	N/A	\$ 340,292	10.2	%	
Tier 1 capital to risk-weighted assets	97,620	4.0	N/A	N/A	340,292	13.9		
Total capital to risk-weighted assets	195,240	8.0	N/A	N/A	368,198	15.1		
Heritage Bank								
Tier 1 leverage capital to average assets	132,853	4.0	166,066	5.0	332,147	10.0		
Tier 1 capital to risk-weighted assets	97,585	4.0	146,378	6.0	332,147	13.6		
Total capital to risk-weighted assets	195,171	8.0	243,964	10.0	360,053	14.8		

In July 2013, the Federal banking regulators approved a final rule to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and to address relevant provisions of the Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The final rule strengthens the definition of regulatory capital, increases risk-based capital requirements, makes selected changes to the calculation of risk-weighted assets, and adjusts the prompt corrective action thresholds. Although new capital requirements were effective on January 1, 2015, certain provisions of the new rule will be phased in over the period of 2015 through 2019, including, among others, a new capital conservation buffer requirement, which requires banking organizations to maintain a common equity capital ratio more than 2.5% above the minimum common equity Tier 1 capital, Tier 1 capital and total risk-based capital ratios in order to avoid limitations on capital distributions, including dividend payments, and certain discretionary bonus payments. The capital conservation buffer requirement will be phased in beginning on January 1, 2016 at 0.625% and will be fully phased in at 2.50% by January 1, 2019.

Quarterly, the Company reviews the potential payment of cash dividends to its common shareholders. The timing and amount of cash dividends paid on our common stock depends on the Company's earnings, capital requirements, financial condition and other relevant factors. Dividends on common stock from the Company depend substantially upon receipt of dividends from the Bank, which is the Company's predominant source of income. On April 22, 2015, the Company's Board of Directors declared a dividend of \$0.11 per common share payable on May 21, 2015 to

shareholders of record on May 7, 2015.

65

---

Table of Contents

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our results of operations are highly dependent upon our ability to manage interest rate risk. We consider interest rate risk to be a significant market risk that could have a material effect on our financial condition and results of operations. Interest rate risk is measured and assessed on a quarterly basis. In our opinion, there has not been a material change in our interest rate risk exposure since the information disclosed in our annual report on Form 10-K for the year-ended at December 31, 2014.

We do not maintain a trading account for any class of financial instrument nor do we engage in hedging activities or purchase high-risk derivative instruments. Moreover, we have no material foreign currency exchange rate risk or commodity price risk.

**ITEM 4. CONTROLS AND PROCEDURES**

**(a) Evaluation of Disclosure Controls and Procedures**

An evaluation of the Company's disclosure controls and procedure (as defined in Section 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934 (the "Act")) was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and the Company's Disclosure Committee as of the end of the period covered by this quarterly report. In designing and evaluating the Company's disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Based on their evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures as of March 31, 2015 are effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

**(b) Changes in Internal Control Over Financial Reporting**

There have been no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Act) that occurred during the three months ended March 31, 2015, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. The Company does not expect that its internal control over financial reporting will prevent all error and all fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

Heritage and Heritage Bank are not a party to any material pending legal proceedings other than ordinary routine litigation incidental to the business of the Bank, other than the matter described below.

On April 4, 2014, Washington Banking, its directors and Heritage entered into and documented an agreement in principle among Washington Banking, its directors, Heritage and the plaintiffs for the settlement of the putative shareholder class action lawsuit captioned In Re Washington Banking Company Shareholder Litigation, Lead Case No. 13-2-38689-5 SEA, pending before the Superior Court of the State of Washington in and for King County (the

Table of Contents

“Action”). The Action alleged that Washington Banking’s directors breached their fiduciary duties to Washington Banking and its shareholders in connection with the transactions contemplated by the Agreement and Plan of Merger, dated October 23, 2013 (the “Merger Agreement”), under which Washington Banking and Heritage combined their organizations in a strategic combination, with Washington Banking merging with and into Heritage. The Action also alleged, among other things, that Heritage aided and abetted the alleged breaches of fiduciary duties by Washington Banking's directors and that the public disclosures concerning the Washington Banking Merger are misleading in various respects.

On December 15, 2014, the Court entered an order preliminarily approving the settlement of the consolidated litigation and ordering WBCO to provide notice of the proposed settlement to those persons who held Washington Banking shares during the purported class period.

On February 27, 2015, the Court held a hearing to consider whether the settlement was fair and reasonable to the class members and, if so, to approve the settlement and to consider plaintiffs’ counsel’s application for an award of attorneys’ fees and costs from Washington Banking. At the hearing, the Court approved the settlement and entered a Final Judgment and Order of Dismissal With Prejudice awarding plaintiffs’ counsel fees and expenses totaling \$450,000 and terminating the litigation.

The settlement of the Action did not affect the Washington Banking Merger consideration paid to Washington Banking’s shareholders in connection with the completion of the Washington Banking Merger on May 1, 2014. Washington Banking, its directors and Heritage took the position that the Action was without merit and denied any wrongdoing of any kind. Washington Banking, its directors and Heritage entered into the settlement solely to eliminate the costs, risks, burden, distraction and expense of further litigation and to put the claims that were or could have been asserted to rest. Nothing in the stipulation of settlement or any public filing, including this Quarterly Report on Form 10-Q, shall be deemed an admission of the legal necessity of filing or the materiality under applicable laws of any of the additional information contained herein or in any public filing associated with the settlement of the Action.

**ITEM 1A. RISK FACTORS**

There have been no material changes to the risk factors set forth in Part I. Item 1A of the Company’s Annual Report on Form 10-K for the year ended December 31, 2014.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The Company has had various stock repurchase programs since March 1999. On October 23, 2014, the Company's Board of Directors authorized the repurchase of up to 5% of the Company's outstanding common shares, or approximately 1,513,000 shares, under the eleventh stock repurchase plan. The number, timing and price of shares repurchased will depend on business and market conditions, and other factors, including opportunities to deploy the Company's capital. The Company will not repurchase the remaining 52,025 shares available under the tenth plan described below as the eleventh plan supersedes the tenth stock repurchase program. On August 30, 2012, the Board of Directors approved the Company’s tenth stock repurchase plan, authorizing the repurchase of up to 5% of the Company’s outstanding shares of common stock, or approximately 757,000 shares.

The following table provides total repurchased shares and average share prices under the applicable plans for the periods indicated:

	Three Months Ended		Plan Total (1)
	2015	2014	
Tenth Plan			
Repurchased shares	—	—	704,975
Stock repurchase average share price	\$—	\$—	\$15.85

Eleventh Plan

Repurchased shares	137,366	—	137,366
Stock repurchase average share price	\$16.10	\$—	\$16.10

<sup>(1)</sup> Represents shares repurchased and average share price paid during the duration of the plan.

67

---

Table of Contents

During the three months ended March 31, 2015 and 2014, the Company also repurchased 9,923 and 9,298 shares at an average price of \$16.31 and \$17.77, respectively, to pay withholding taxes on the vesting of restricted stock that vested during the three months ended March 31, 2015 and 2014, respectively.

The following table sets forth information about the Company's purchases of its outstanding common stock during the quarter ended March 31, 2015.

Period	Total Number of Shares Purchased(1)	Average Price Paid Per Share(1)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
January 1, 2015— January 31, 2015	164	\$ 16.08	7,313,423	1,513,000
February 1, 2015— February 28, 2015	33,954	16.09	7,340,308	1,486,115
March 1, 2015—March 31, 2015	113,171	16.13	7,450,789	1,375,634
Total	147,289	\$ 16.12	7,450,789	1,375,634

(1) Common shares repurchased by the Company between January 1, 2015 and March 31, 2015 included the cancellation of 9,923 shares of restricted stock to pay withholding taxes at an average price per share of \$16.31.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

## ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

## ITEM 5. OTHER INFORMATION

None

## ITEM 6. EXHIBITS

Exhibit No.	Description of Exhibit
2.1	Purchase and Assumption Agreement for Cowlitz Acquisition (1)
2.2	Purchase and Assumption Agreement for Pierce Acquisition (2)
2.3	Definitive Agreement for Valley Acquisition (3)
2.4	Agreement and Plan of Merger with Washington Banking Company (4)
3.1	Articles of Incorporation (5)
3.2	Amended and Restated Bylaws of the Company (6)
10.1	1998 Stock Option and Restricted Stock Award Plan (7)
10.2	1997 Stock Option and Restricted Stock Award Plan (8)
10.3	2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (9)

- 10.4 2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (10)
- 10.5 Annual Incentive Compensation Plan (11)
- 10.6 2010 Omnibus Equity Plan (12)
- 10.7 2014 Omnibus Equity Plan (13)



Table of Contents

10.8	Form of Nonqualified Stock Option Award Agreement under the Heritage Financial Corporation 2014 Omnibus Equity Plan (14)
10.9	Form of Restricted Stock Award Agreement under the Heritage Financial Corporation 2014 Omnibus Equity Plan (14)
10.10	Form of Restricted Stock Unit Award Agreement under the Heritage Financial Corporation 2014 Omnibus Equity Plan (14)
10.11	Deferred Compensation Plan and Participation Agreements by and between Heritage and each of Brian L. Vance, Jeffrey J. Deuel and Donald J. Hinson (15)
10.12	Employment Agreements by and between Heritage and each of Brian L. Vance, Jeffrey J. Deuel and Donald J. Hinson (15)
10.13	Employment Agreement and Deferred Compensation Participation Agreement by and between Heritage and David A. Spurling (16)
10.14	Employment Agreement by and between Heritage and Bryan McDonald (17)
10.15	Employment Agreements by and between Heritage and Edward Eng (17)
10.16	Deferred Compensation Plan and Participation Agreement by and between Heritage and Bryan D. McDonald (18)
11	Statement regarding computation of earnings per share (19)
14.0	Code of Ethics and Conduct Policy (20)
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following materials from Heritage Financial Corporation’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2015, formatted in Extensible Business Reporting Language (“XBRL”): (i) Unaudited Condensed Consolidated Statements of Financial Condition, (ii) Unaudited Condensed Consolidated Statements of Income; (iii) Unaudited Condensed Consolidated Statements of Comprehensive Income, (iv) Unaudited Condensed Consolidated Statements of Stockholders' Equity; (v) Unaudited Condensed Consolidated Statements of Cash Flows, and (vi) Unaudited Notes to Condensed Consolidated Financial Statements (21)

(1) Incorporated by reference to the Current Report on Form 8-K dated July 30, 2010.

- (2) Incorporated by reference to the Current Report on Form 8-K dated November 5, 2010.
- (3) Incorporated by reference to the Current Report on Form 8-K dated March 11, 2013.
- (4) Incorporated by reference to the Current Report on Form 8-K dated October 23, 2013.  
Incorporated by reference to the Registration Statement on Form S-1 (Reg. No. 333-35573) declared effective on November 12, 1997; as amended, said Amendment being incorporated by reference to the Amendment to the
- (5) Articles of Incorporation of Heritage Financial Corporation filed with the Current Report on Form 8-K dated November 25, 2008.
- (6) Incorporated by reference to the Current Report on Form 8-K dated April 30, 2014.
- (7) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-71415).
- (8) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-57513).
- (9) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-88980; 333-88982; 333-88976).
- (10) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-134473; 333-134474; 333-134475).
- (11) Incorporated by reference to the Annual Report on Form 10-K dated March 2, 2010.
- (12) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 33-167146).
- (13) Incorporated by reference to Heritage Financial Corporation's definitive proxy statement dated June 11, 2014.
- (14) Incorporated by reference to the Current Report on Form 10-Q dated August 6, 2014.

Table of Contents

- (15) Incorporated by reference to the Current Report on Form 8-K dated September 7, 2012.
- (16) Incorporated by reference to the Current Report on Form 8-K dated January 6, 2014.
- (17) Incorporated by reference to the Registration Statement on Form S-4 (Reg. No. 333-192985).
- (18) Incorporated by reference to the Annual Report on Form 10-K dated March 10, 2015.
- (19) Reference is made to Note 10—Stockholders' Equity in the Notes to Condensed Consolidated Financial Statements under Part 1. Item 1. herein.
- (20) Registrant elects to satisfy Regulation S-K §229.406(c) by posting its Code of Ethics on its website at [www.HF-WA.com](http://www.HF-WA.com) in the section titled Investor Information: Corporate Governance.  
Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise not subject to liability under those sections.
- (21) statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise not subject to liability under those sections.
- .

SIGNATURES

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

HERITAGE FINANCIAL CORPORATION

Date:  
May 6, 2015

/S/ BRIAN L. VANCE  
Brian L. Vance  
President and Chief Executive Officer  
(Duly Authorized Officer)

Date:  
May 6, 2015

/S/ DONALD J. HINSON  
Donald J. Hinson  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)

Table of Contents

EXHIBIT INDEX

Exhibit No. Description of Exhibit

31.1	Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following financial information from Heritage Financial Corporation's Quarterly Report on Form 10-Q for the quarter ended March 31, 2015 is formatted in XBRL: (i) the Unaudited Condensed Consolidated Statements of Financial Condition, (ii) the Unaudited Condensed Consolidated Statements of Income, (iii) the Unaudited Condensed Consolidated Statements Comprehensive Income, (iv) the Unaudited Condensed Consolidated Statements of Stockholders' Equity, (v) the Unaudited Condensed Consolidated Statements of Cash Flows, and (vi) the Unaudited Notes to Condensed Consolidated Financial Statements.

71