

HEARTLAND FINANCIAL USA INC  
Form 10-Q  
May 11, 2009

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

FORM 10-Q

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

For quarterly period ended March 31, 2009

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

For transition period \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-24724

HEARTLAND FINANCIAL USA, INC.  
(Exact name of Registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

42-1405748  
(I.R.S. employer identification number)

1398 Central Avenue, Dubuque, Iowa 52001  
(Address of principal executive offices)(Zip Code)

(563) 589-2100  
(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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 the definitions of "accelerated filer," "large accelerated filer" and "smaller reporting

company” in Rule 12b-2 of the Act.

Large accelerated filer “ Accelerated filer  
p Non-accelerated filer “ Smaller reporting company “  
(Do not check if a smaller reporting company)

Indicate by check mark whether the Registrant is a shell company (as defined by Rule 12b-2 of the Securities Exchange Act of 1934). Yes “ No p

Indicate the number of shares outstanding of each of the classes of Registrant's common stock as of the latest practicable date: As of May 8, 2009, the Registrant had outstanding 16,294,828 shares of common stock, \$1.00 par value per share.

---

HEARTLAND FINANCIAL USA, INC.  
Form 10-Q Quarterly Report

Part I

Item 1.	Financial Statements
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations
Item 3.	Quantitative and Qualitative Disclosures About Market Risk
Item 4.	Controls and Procedures

Part II

Item 1.	Legal Proceedings
Item 1A.	Risk Factors
Item 2.	Unregistered Sales of Issuer Securities and Use of Proceeds
Item 3.	Defaults Upon Senior Securities
Item 4.	Submission of Matters to a Vote of Security Holders
Item 5.	Other Information
Item 6.	Exhibits

Form 10-Q Signature Page

---

## PART I

## ITEM 1. FINANCIAL STATEMENTS

HEARTLAND FINANCIAL USA, INC.  
CONSOLIDATED BALANCE SHEETS  
(Dollars in thousands, except per share data)

	March 31, 2009 (Unaudited)	December 31, 2008
<b>ASSETS</b>		
Cash and due from banks	\$ 86,235	\$ 48,977
Federal funds sold and other short-term investments	1,026	2,326
Cash and cash equivalents	87,261	51,303
Securities:		
Trading, at fair value	1,560	1,694
Available for sale, at fair value (cost of \$972,103 for March 31, 2009, and \$875,143 for December 31, 2008)	974,711	871,686
Held to maturity, at cost (fair value of \$27,828 for March 31, 2009, and \$26,326 for December 31, 2008)	29,901	30,325
Loans held for sale	18,263	19,695
Loans and leases:		
Held to maturity	2,356,391	2,405,001
Allowance for loan and lease losses	(37,277)	(35,651)
Loans and leases, net	2,319,114	2,369,350
Premises, furniture and equipment, net	119,569	120,500
Other real estate, net	29,317	11,750
Goodwill, net	40,207	40,207
Other intangible assets, net	9,606	8,079
Cash surrender value on life insurance	54,581	54,431
Other assets	46,010	51,248
<b>TOTAL ASSETS</b>	<b>\$ 3,730,100</b>	<b>\$ 3,630,268</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>LIABILITIES:</b>		
Deposits:		
Demand	\$ 409,921	\$ 383,061
Savings	1,185,756	1,128,312
Time	1,193,044	1,128,859
Total deposits	2,788,721	2,640,232
Short-term borrowings	117,766	210,184
Other borrowings	477,640	437,833
Accrued expenses and other liabilities	30,496	33,396
<b>TOTAL LIABILITIES</b>	<b>3,414,623</b>	<b>3,321,645</b>
<b>EQUITY:</b>		
Preferred stock (par value \$1 per share; authorized 102,302 shares; none issued or outstanding)	-	-
Series A Junior Participating preferred stock (par value \$1 per share; authorized 16,000 shares; none issued or outstanding)	-	-
	76,279	75,578

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

Series B Fixed Rate Cumulative Perpetual preferred stock (par value \$1 per share; authorized 81,698 shares; issued, 81,698 shares)		
Common stock (par value \$1 per share; authorized 20,000,000 shares; issued 16,611,671 shares)	16,612	16,612
Capital surplus	43,865	43,827
Retained earnings	180,927	177,753
Accumulated other comprehensive income (loss)	1,287	(1,341)
Treasury stock at cost (316,843 shares at March 31, 2009, and 337,181 shares at December 31, 2008, respectively)	(6,454)	(6,826)
TOTAL STOCKHOLDERS' EQUITY	312,516	305,603
Noncontrolling interest	2,961	3,020
TOTAL EQUITY	315,477	308,623
TOTAL LIABILITIES AND EQUITY	\$ 3,730,100	\$ 3,630,268

See accompanying notes to consolidated financial statements.

---

HEARTLAND FINANCIAL USA, INC.  
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)  
(Dollars in thousands, except per share data)

	Three Months Ended	
	March 31, 2009	March 31, 2008
<b>INTEREST INCOME:</b>		
Interest and fees on loans and leases	\$ 39,483	\$ 42,899
Interest on securities and other:		
Taxable	8,421	6,615
Nontaxable	1,883	1,647
Interest on federal funds sold and other short-term investments	1	131
Interest on interest bearing deposits in other financial institutions	1	5
<b>TOTAL INTEREST INCOME</b>	<b>49,789</b>	<b>51,297</b>
<b>INTEREST EXPENSE:</b>		
Interest on deposits	14,122	17,096
Interest on short-term borrowings	212	2,186
Interest on other borrowings	4,378	4,277
<b>TOTAL INTEREST EXPENSE</b>	<b>18,712</b>	<b>23,559</b>
<b>NET INTEREST INCOME</b>	<b>31,077</b>	<b>27,738</b>
Provision for loan and lease losses	6,665	1,761
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES</b>	<b>24,412</b>	<b>25,977</b>
<b>NONINTEREST INCOME:</b>		
Service charges and fees	2,887	2,615
Loan servicing income	2,786	1,296
Trust fees	1,697	2,021
Brokerage and insurance commissions	881	892
Securities gains, net	2,965	362
Loss on trading account securities	(286)	(207)
Impairment loss on securities	-	(86)
Gains on sale of loans	1,808	504
Income on bank owned life insurance	130	463
Other noninterest income	(106)	614
<b>TOTAL NONINTEREST INCOME</b>	<b>12,762</b>	<b>8,474</b>
<b>NONINTEREST EXPENSES</b>		
Salaries and employee benefits	16,433	14,793
Occupancy	2,375	2,344
Furniture and equipment	1,647	1,768
Outside services	3,217	2,510
Advertising	583	795
Intangible assets amortization	235	236
Other noninterest expenses	3,796	3,318
<b>TOTAL NONINTEREST EXPENSES</b>	<b>28,286</b>	<b>25,764</b>
<b>INCOME BEFORE INCOME TAXES</b>	<b>8,888</b>	<b>8,687</b>
Income taxes	2,819	2,420
<b>NET INCOME</b>	<b>\$ 6,069</b>	<b>\$ 6,267</b>
Net income attributable to noncontrolling interest, net of tax	59	-
<b>NET INCOME ATTRIBUTABLE TO HEARTLAND</b>	<b>\$ 6,128</b>	<b>\$ 6,267</b>
Preferred dividends and discount	(1,336)	-
<b>NET INCOME AVAILABLE TO COMMON STOCKHOLDERS</b>	<b>\$ 4,792</b>	<b>\$ 6,267</b>

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

EARNINGS PER COMMON SHARE – BASIC	\$	0.29	\$	0.38
EARNINGS PER COMMON SHARE – DILUTED	\$	0.29	\$	0.38
CASH DIVIDENDS DECLARED PER COMMON SHARE	\$	0.10	\$	0.10

See accompanying notes to consolidated financial statements.

---

HEARTLAND FINANCIAL USA, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)  
(Dollars in thousands, except per share data)

	Three Months Ended	
	March 31, 2009	March 31, 2008
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 6,069	\$ 6,267
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,292	2,352
Provision for loan and lease losses	6,665	1,761
Net amortization of premium on securities	1,165	(219)
Securities gains, net	(2,965)	(362)
Decrease in trading account securities	134	102
Loss on impairment of securities	-	86
Stock-based compensation	229	288
Loans originated for sale	(291,652)	(78,906)
Proceeds on sales of loans	294,892	80,867
Net gains on sales of loans	(1,808)	(504)
Decrease in accrued interest receivable	715	2,433
Decrease in accrued interest payable	(1,383)	(1,923)
Other, net	(2,243)	(4,820)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>12,110</b>	<b>7,422</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from the sale of securities available for sale	75,687	23,288
Proceeds from the maturity of and principal paydowns on securities available for sale	38,890	29,734
Proceeds from the maturity of and principal paydowns on securities held to maturity	549	9
Purchase of securities available for sale	(209,862)	(93,517)
Net decrease in loans and leases	24,936	7,579
Capital expenditures	(1,140)	(1,227)
Proceeds on sale of OREO and other repossessed assets	982	316
<b>NET CASH USED BY INVESTING ACTIVITIES</b>	<b>(69,958)</b>	<b>(33,818)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in demand deposits and savings accounts	84,304	4,241
Net increase in time deposit accounts	64,185	40,399
Net decrease in short-term borrowings	(92,418)	(128,040)
Proceeds from other borrowings	55,050	124,258
Repayments of other borrowings	(15,243)	(7,386)
Purchase of treasury stock	(31)	(2,412)
Proceeds from issuance of common stock	210	254
Excess tax benefits on exercised stock options	2	8
Common and preferred dividends paid	(2,253)	(1,617)
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b>93,806</b>	<b>29,705</b>
Net increase in cash and cash equivalents	35,958	3,309
Cash and cash equivalents at beginning of year	51,303	46,832



Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$	87,261	\$	50,141
Supplemental disclosures:				
Cash paid for income/franchise taxes	\$	769	\$	1,210
Cash paid for interest	\$	20,095	\$	25,482

See accompanying notes to consolidated financial statements.

---

## HEARTLAND FINANCIAL USA, INC.

## CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY AND COMPREHENSIVE INCOME (Unaudited)

(Dollars in thousands, except per share data)

	Heartland Financial USA, Inc. Stockholders' Equity							
	Accumulated							
	Preferred	Common	Capital	Retained	Other	Treasury	Non-controlling	Total
	Stock	Stock	Surplus	Earnings	Comprehensive	Stock	Interest	Equity
					Income			
					(Loss)			
Balance at January 1, 2008	\$ -	\$ 16,612	\$ 37,269	\$ 173,100	\$ 6,506	\$(3,678)	\$ -	\$ 229,809
Net income				6,267				6,267
Unrealized gain on securities available for sale arising during the period					4,138			4,138
Unrealized gain on derivatives arising during the period					1,450			1,450
Reclassification adjustment for net security gains realized in net income					(276)			(276)
Reclassification adjustment for net derivatives gains realized in net income					(211)			(211)
Income taxes					(1,844)			(1,844)
Comprehensive income								9,524
Cash dividends declared:								
Common, \$0.10 per share				(1,617)				(1,617)
Purchase of 129,069 shares of common stock						(2,412)		(2,412)
Issuance of 14,437 shares of common stock			(77)				338	261
Commitments to issue common			288					288

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

stock									
Balance at March 31, 2008	\$-	-	\$- 16,612	\$ 37,480	\$ 177,750	\$ 9,763	\$(5,752)	\$ -	\$ 235,853
Balance at January 1, 2009	\$ 75,578	\$ 16,612	\$ 43,827	\$ 177,753	\$ (1,341)	\$ (6,826)	\$ 3,020	\$ 308,623	
Net income				6,128			(59)	6,069	
Unrealized gain on securities available for sale arising during the period						9,030		9,030	
Unrealized loss on derivatives arising during the period						(1,932)		(1,932)	
Reclassification adjustment for net security gains realized in net income						(2,965)		(2,965)	
Reclassification adjustment for net derivatives losses realized in net income						23		23	
Income taxes						(1,528)		(1,528)	
Comprehensive income								8,697	
Cumulative preferred dividends accrued and discount accretion	701			(701)				-	
Cash dividends declared:									
Preferred, \$12.50 per share				(635)				(635)	
Common, \$0.10 per share				(1,618)				(1,618)	
Purchase of 1,913 shares of common stock							(31)	(31)	
Issuance of 22,251 shares of common stock			(191)				403	212	
Commitments to issue common stock			229					229	
Balance at March 31, 2009	\$ 76,279	\$16,612	\$ 43,865	\$ 180,927	\$ 1,287	\$(6,454)	\$ 2,961	\$ 315,477	

See accompanying notes to consolidated financial statements.

---

HEARTLAND FINANCIAL USA, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 1: BASIS OF PRESENTATION

The interim unaudited consolidated financial statements contained herein should be read in conjunction with the audited consolidated financial statements and accompanying notes to the consolidated financial statements for the fiscal year ended December 31, 2008, included in Heartland Financial USA, Inc.'s ("Heartland") Form 10-K filed with the Securities and Exchange Commission on March 16, 2009. Accordingly, footnote disclosures, which would substantially duplicate the disclosure contained in the audited consolidated financial statements, have been omitted.

The financial information of Heartland included herein has been prepared in accordance with U.S. generally accepted accounting principles for interim financial reporting and has been prepared pursuant to the rules and regulations for reporting on Form 10-Q and Rule 10-01 of Regulation S-X. Such information reflects all adjustments (consisting of normal recurring adjustments), that are, in the opinion of management, necessary for a fair presentation of the financial position and results of operations for the periods presented. The results of the interim period ended March 31, 2009, are not necessarily indicative of the results expected for the year ending December 31, 2009.

## Earnings Per Share

Basic earnings per share is determined using net income available to common stockholders and weighted average common shares outstanding. Diluted earnings per share is computed by dividing net income available to common stockholders by the weighted average common shares and assumed incremental common shares issued. Amounts used in the determination of basic and diluted earnings per share for the three-month period ended March 31, 2009 and 2008, are shown in the tables below:

(Dollars and numbers in thousands, except per share data)	Three Months Ended	
	March 31, 2009	March 31, 2008
Net income attributable to Heartland	6,128	6,267
Preferred dividends and discount	(1,336)	-
Net income available to common stockholders	\$ 4,792	6,267
Weighted average common shares outstanding for basic earnings per share	16,276	16,378
Assumed incremental common shares issued upon exercise of stock options	21	88
Weighted average common shares for diluted earnings per share	16,297	16,466
Earnings per common share – basic	\$ 0.29	\$ 0.38
Earnings per common share – diluted	\$ 0.29	\$ 0.38

## Stock-Based Compensation

Options are typically granted annually with an expiration date ten years after the date of grant. Vesting is generally over a five-year service period with portions of a grant becoming exercisable at three years, four years and five years after the date of grant. A summary of the status of the stock options as of March 31, 2009 and 2008, and changes during the three months ended March 31, 2009 and 2008, follows:



	2009		2008	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding at January 1	743,363	\$ 19.79	733,012	\$ 18.61
Granted	-	-	164,400	18.60
Exercised	(1,125)	8.80	(3,050)	11.72
Forfeited	(1,000)	24.13	(3,750)	24.99
Outstanding at March 31	741,238	\$ 19.81	890,612	\$ 18.60
Options exercisable at March 31	335,338	\$ 16.01	370,462	\$ 13.04
Weighted-average fair value of options granted during the three-month periods ended March 31	\$ -		\$ 4.81	

At March 31, 2009, the vested options totaled 335,338 shares with a weighted average exercise price of \$16.01 per share and a weighted average remaining contractual life of 4.33 years. The intrinsic value for the vested options as of March 31, 2009, was \$422 thousand. The intrinsic value for the total of all options exercised during the three months ended March 31, 2009, was \$5 thousand, and the total fair value of shares vested during the three months ended March 31, 2009, was \$229 thousand. At March 31, 2009, shares available for issuance under the 2005 Long-Term Incentive Plan totaled 465,810.

No options were granted during the first quarter of 2009. The fair value of the 2008 stock options granted was estimated utilizing the Black Scholes valuation model. The fair value of a share of common stock on the grant date of the 2008 options was \$18.60. Significant assumptions include:

Risk-free interest rate	2008 3.10%
Expected option life	6.4 years
Expected volatility	26.96%
Expected dividends	1.99%

The option term of each award granted was based upon Heartland's historical experience of employees' exercise behavior. Expected volatility was based upon historical volatility levels and future expected volatility of Heartland's common stock. Expected dividend yield was based on a set dividend rate. Risk free interest rate reflects the average of the yields on the 5 year and 7 year zero coupon U.S. Treasury bond. Cash received from options exercised for the three months ended March 31, 2009, was \$10 thousand, with a related tax benefit of \$2 thousand. Cash received from options exercised for the three months ended March 31, 2008, was \$36 thousand, with a related tax benefit of \$8 thousand.

Total compensation costs recorded were \$229 thousand and \$288 thousand for the three months ended March 31, 2009 and 2008, respectively, for stock options, restricted stock awards and shares to be issued under the 2006 Employee Stock Purchase Plan. As of March 31, 2009, there was \$2.2 million of total unrecognized compensation costs related to the 2005 Long-Term Incentive Plan for stock options and restricted stock awards which is expected to be recognized through 2012.

#### Fair Value Measurements

On January 1, 2008, Heartland adopted Statement of Financial Accounting Standards No. 157 ("FAS 157"), Fair Value Measurements. FAS 157 defines fair value, establishes a framework for measuring fair value under U.S. generally accepted accounting principles, and expands disclosures about fair value measurements. FAS 157 applies to reported balances that are required or permitted to be measured at fair value under existing accounting pronouncements; accordingly, the standard does not require any new fair value measurements of reported balances. Fair value is defined as the exchange price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FAS 157 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. FAS 157 requires fair value measurements to be separately disclosed by level within the fair value hierarchy. Under FAS 157, Heartland bases fair values on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. For assets and liabilities recorded at fair value, it is Heartland's policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy in FAS 157.

Fair value measurements for assets and liabilities where there exists limited or no observable market data, and therefore, are based primarily upon estimates, are often calculated based upon current pricing policy, the economic and competitive environment, the characteristics of the asset or liability and other such factors. Therefore, the results cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset or liability. Additionally, 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 of current or future values. Additional information regarding disclosures of fair value is presented in Note 4.

Heartland now applies the fair value measurement and disclosure provisions of FAS 157 effective January 1, 2009, to nonfinancial assets and nonfinancial liabilities measured on a nonrecurring basis. Heartland measures the fair value of the following on a nonrecurring basis: (1) long-lived assets, (2) foreclosed assets, (3) goodwill and other intangibles and (4) indefinite-lived assets.

#### Effect of New Financial Accounting Standards

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (Revised 2007) Business Combinations ("FAS 141R"), which requires significant changes in the accounting and reporting for business acquisitions. Among many changes under FAS 141R, an acquirer will record 100% of all assets and liabilities at fair value at the acquisition date with changes possibly recognized in earnings, and acquisition related costs will be expensed rather than capitalized. FAS 141R applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009. The adoption of FAS 141R by Heartland on January 1, 2009, had no effect on Heartland's accompanying consolidated financial statements and its subsequent effect will depend upon the extent and magnitude of future acquisitions.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 ("FAS 160"), which establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary. Key changes under FAS 160 are that noncontrolling interests in a subsidiary are to be reported as part of equity, losses allocated to a noncontrolling interest can result in a deficit balance, and changes in ownership interests that do not result in a change of control are accounted for as equity transactions and upon a loss of control, the resultant gain or loss is recognized and the remaining interest is remeasured at fair value on the date control is lost. Effective January 1, 2009, FAS 160 requires retroactive adoption of the presentation and disclosure requirements for existing consolidated minority interests and prospective application for any new minority interests. The presentation and disclosure requirements of FAS 160 have been applied for the current period and retrospectively for prior periods on Heartland's accompanying consolidated



financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161 (“FAS 161”), Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133, which changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flows. FAS 161 is effective for all financial statements issued for fiscal years and interim periods beginning after November 15, 2008. For further detail on Heartland’s derivative instruments and hedging activities, see Note 3.

In April 2009, the FASB issued Staff Position FAS 107-1 (“FAS 107-1”), Interim Disclosures About Fair Value of Financial Instruments, which extends the disclosure requirements of Statement of Financial Accounting Standards No. 107, Disclosures About Fair Value of Financial Instruments, to interim financial statements of publicly traded companies. FAS 107-1 is effective for interim periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. Heartland will adopt FAS 107-1 for the period ending June 30, 2009, and does not anticipate that the adoption will have a material impact on its consolidated financial statement disclosures.

In April 2009, the FASB issued Staff Position FAS 115-2 (“FAS 115-2”), Recognition and Presentation of Other-Than-Temporary Impairments, which revises the guidance for determining whether an impairment is other than temporary for debt securities, requires bifurcation of any other than temporary impairment between the amount representing credit loss and the amount related to all other factors and requires additional disclosures on other than temporary impairment of debt and equity securities. FAS 115-2 is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. Heartland will adopt FAS 115-2 for the period ending June 30, 2009, and does not anticipate that the adoption will have a material impact on its consolidated financial statements.

In April 2009, the FASB issued Staff Position FAS 157-4 (“FAS 157-4”), Determining Fair Value When the Volume and Level of Activity for the Asset or Liability have Significantly Decreased and Identifying Transactions that are not Orderly, which provides additional guidance on estimating fair value when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity for the asset or liability, provides guidance on circumstances that may indicate that a transaction is not orderly and requires additional disclosures about fair value measurements in annual and interim reporting periods. FAS 157-4 is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. Heartland will adopt FAS 157-4 for the period ending June 30, 2009, and does not anticipate that the adoption will have a material impact on its consolidated financial statements.

## NOTE 2: CORE DEPOSIT PREMIUM AND OTHER INTANGIBLE ASSETS

The gross carrying amount of intangible assets and the associated accumulated amortization at March 31, 2009, and December 31, 2008, are presented in the table below, in thousands:

	March 31, 2009		December 31, 2008	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:				
Core deposit intangibles	\$ 9,757	\$ 7,301	\$ 9,757	\$ 7,092
Mortgage servicing rights	9,321	2,994	7,799	3,233
Customer relationship intangible	1,177	354	1,177	329

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

Total	\$ 20,255	\$ 10,649	\$ 18,733	\$ 10,654
Unamortized intangible assets		\$ 9,606		\$ 8,079

Projections of amortization expense for mortgage servicing rights are based on existing asset balances and the existing interest rate environment as of March 31, 2009. Heartland's actual experience may be significantly different depending upon changes in mortgage interest rates and market conditions. There was no valuation allowance on mortgage servicing rights at March 31, 2009, or December 31, 2008. The fair value of Heartland's mortgage servicing rights was estimated at \$8.6 million and \$6.2 million at March 31, 2009, and December 31, 2008, respectively.

The following table shows the estimated future amortization expense for amortized intangible assets, in thousands:

	Core Deposit Intangibles	Mortgage Servicing Rights	Customer Relationship Intangible	Total
Nine months ending December 31, 2009	\$ 544	\$ 4,812	\$ 76	\$ 5,432
Year ending December 31,				
2010	466	433	101	1,000
2011	450	361	99	910
2012	422	289	55	766
2013	405	216	45	666
2014	169	144	43	356
Thereafter	-	72	404	476

### NOTE 3: DERIVATIVE FINANCIAL INSTRUMENTS

On occasion, Heartland uses derivative financial instruments as part of its interest rate risk management, including interest rate swaps, caps, floors and collars. Heartland's objectives in using derivatives are to add stability to its net interest margin and to manage its exposure to movements in interest rates.

To reduce the potentially negative impact a downward movement in interest rates would have on its interest income, Heartland entered into the following two transactions. On April 4, 2006, Heartland entered into a three-year interest rate collar transaction with a notional amount of \$50.0 million. The collar was effective on April 4, 2006, and matured on April 4, 2009. Heartland was the payer on prime at a cap strike rate of 8.95% and the counterparty was the payer on prime at a floor strike rate of 7.00%. As of March 31, 2009, and December 31, 2008, the fair market value of this collar transaction was recorded as an asset of \$185 thousand and \$636 thousand, respectively.

On September 19, 2005, Heartland entered into a five-year interest rate collar transaction on a notional amount of \$50.0 million. The collar has an effective date of September 21, 2005, and a maturity date of September 21, 2010. Heartland is the payer on prime at a cap strike rate of 9.00% and the counterparty is the payer on prime at a floor strike rate of 6.00%. As of March 31, 2009, and December 31, 2008, the fair market value of this collar transaction was recorded as an asset of \$1.9 million and \$2.1 million, respectively.

For accounting purposes, the two collar transactions above are designated as cash flow hedges of the overall changes in the cash flows above and below the collar strike rates associated with interest payments on certain of Heartland's prime-based loans that reset whenever prime changes. The hedged transactions for the two hedging relationships are designated as the first prime-based interest payments received by Heartland each calendar month during the term of the collar that, in aggregate for each period, are interest payments on principal from specified portfolios equal to the notional amount of the collar.

Prepayments in the hedged loan portfolios are treated in a manner consistent with the guidance in SFAS 133 Implementation Issue No. G25, Cash Flow Hedges: Using the First-Payments-Received Technique in Hedging the Variable Interest Payments on a Group of Non-Benchmark-Rate-Based Loans, which allows the designated forecasted transactions to be the variable, prime-rate-based interest payments on a rolling portfolio of prepayable interest-bearing loans using the first-payments-received technique, thereby allowing interest payments from loans that prepay to be replaced with interest payments from new loan originations. Based on Heartland's assessments, both at inception and throughout the life of the hedging relationship, it is probable that sufficient prime-based interest receipts will exist through the maturity dates of the collars.

To reduce the potentially negative impact an upward movement in interest rates would have on its net interest income, Heartland entered into the following four cap transactions. For accounting purposes, these four cap transactions are designated as cash flow hedges of the changes in cash flows attributable to changes in LIBOR, the benchmark interest rate being hedged, above the cap strike rate associated with the interest payments made on \$65.0 million of Heartland's subordinated debentures (issued in connection with the trust preferred securities of Heartland Financial Statutory Trust IV, V and VII) that reset quarterly on a specified reset date. At inception, Heartland asserted that the underlying principal balance will remain outstanding throughout the hedge transaction making it probable that sufficient LIBOR-based interest payments will exist through the maturity date of the caps.

The first transaction executed was a twenty-three month interest rate cap transaction on a notional amount of \$20.0 million. The cap had an effective date of February 1, 2007, and matured on January 7, 2009. Should 3-month LIBOR have exceeded 5.5% on a reset date, the counterparty would have paid Heartland the amount of interest that exceeded the amount owed on the debt at the cap LIBOR rate of 5.5%. The floating-rate subordinated debentures contain an interest deferral feature that was mirrored in the cap transaction. As of December 31, 2008, this cap transaction had no fair value.

The second transaction executed on February 1, 2007, was a twenty-five month interest rate cap transaction on a notional amount of \$25.0 million to reduce the potentially negative impact an upward movement in interest rates would have on its net interest income. The cap had an effective date of February 1, 2007, and matured on March 17, 2009. Should 3-month LIBOR have exceeded 5.5% on a reset date, the counterparty would have paid Heartland the amount of interest that exceeded the amount owed on the debt at the cap LIBOR rate of 5.5%. The floating-rate subordinated debentures contain an interest rate deferral feature that was mirrored in the cap transaction. As of December 31, 2008, this cap transaction had no fair value.

The third transaction executed on January 15, 2008, was a fifty-five month interest rate cap transaction on a notional amount of \$20.0 million to reduce the potentially negative impact an upward movement in interest rates would have on its net interest income. The cap has an effective date of January 15, 2008, and a maturity date of September 1, 2012. Should 3-month LIBOR exceed 5.12% on a reset date, the counterparty will pay Heartland the amount of interest that exceeds the amount owed on the debt at the cap LIBOR rate of 5.12%. The floating-rate subordinated debentures contain an interest rate deferral feature that is mirrored in the cap transaction. As of March 31, 2009, and December 31, 2008, the fair market value of this cap transaction was recorded as an asset of \$36 thousand and \$46 thousand, respectively.

The fourth transaction executed on March 27, 2008, was a twenty-eight month interest rate cap transaction on a notional amount of \$20.0 million to reduce the potentially negative impact an upward movement in interest rates would have on its net interest income. The cap has an effective date of January 7, 2009, and a maturity date of April 7, 2011. Should 3-month LIBOR exceed 5.5% on a reset date, the counterparty will pay Heartland the amount of interest that exceeds the amount owed on the debt at the cap LIBOR rate of 5.5%. The floating-rate subordinated debentures contain an interest rate deferral feature that is mirrored in the cap transaction. As of March 31, 2009, and December 31, 2008, the fair market value of this cap transaction was recorded as an asset of \$4 thousand and \$8 thousand, respectively.

In addition to the four cap transactions, Heartland entered into the following three forward-starting interest rate swap transactions to effectively convert \$65.0 million of its variable interest rate subordinated debentures (issued in connection with the trust preferred securities of Heartland Financial Statutory Trust IV, V and VII) to fixed interest rate debt. For accounting purposes, these three swap transactions are designated as cash flow hedges of the changes in cash flows attributable to changes in LIBOR, the benchmark interest rate being hedged, associated with the interest payments made on \$65.0 million of Heartland's subordinated debentures (issued in connection with the trust preferred securities of Heartland Financial Statutory Trust IV, V and VII) that reset quarterly on a specified reset date. At inception, Heartland asserted that the underlying principal balance will remain outstanding throughout the hedge transaction making it probable that sufficient LIBOR-based interest payments will exist through the maturity date of the swaps.

The first swap transaction was executed on January 28, 2009, on a notional amount of \$25.0 million with an effective date of March 17, 2010, and an expiration date of March 17, 2014. Under this interest rate swap contract, Heartland will pay a fixed interest rate of 2.58% and receive a variable interest rate equal to 3-month LIBOR. As of March 31, 2009, the fair value of this swap transaction was recorded as a liability of \$149 thousand.

The second swap transaction was executed on February 4, 2009, on a notional amount of \$20.0 million with an effective date of January 7, 2010, and an expiration date of January 7, 2020. Under this interest rate swap contract, Heartland will pay a fixed interest rate of 3.35% and receive a variable interest rate equal to 3-month LIBOR. As of March 31, 2009, the fair value of this swap transaction was recorded as a liability of \$615 thousand.

The third swap transaction was executed on February 4, 2009, on a notional amount of \$20.0 million with an effective date of March 1, 2010, and an expiration date of March 1, 2017. Under this interest rate swap contract, Heartland will pay a fixed interest rate of 3.22% and receive a variable interest rate equal to 3-month LIBOR. As of March 31, 2009, the fair value of this swap transaction was recorded as a liability of \$530 thousand.

For the collar, cap and swap transactions described above, the effective portion of changes in the fair values of the derivatives is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified to earnings (interest income on loans or interest expense on borrowings) when the hedged transactions affect earnings. Ineffectiveness resulting from the hedging relationship, if any, is recorded as a gain or loss in earnings as part of noninterest income. Heartland uses the "Hypothetical Derivative Method" described in SFAS 133 Implementation Issue No. G20, Cash Flow Hedges: Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge, for its quarterly prospective and retrospective assessments of hedge effectiveness, as well as for measurements of hedge ineffectiveness. All components of the derivative instruments' change in fair value were included in the assessment of hedge effectiveness. No ineffectiveness was recognized for the cash flow hedge transactions for the three months ended March 31, 2008 and 2009.

The April 4, 2006 collar transaction did not meet the retrospective hedge effectiveness test at March 31, 2009. The failure was on the full \$50.0 million notional amount that was designated as a cash flow hedge of the overall changes in the cash flows above and below the collar strike rates associated with interest payments on certain of Heartland's prime-based loans. The failure of this hedge relationship was caused by paydowns, which reduced the designated loan pool from \$50.0 million to \$38.7 million. This hedge failure resulted in the recognition of a loss of \$282 thousand during the first quarter of 2009, which consists of the mark to market loss on the collar transaction of \$463 thousand and a reclass of unrealized gains out of other comprehensive income to earnings of \$181 thousand.

A portion of the September 19, 2005 collar transaction did not meet the retrospective hedge effectiveness test at March 31, 2008. The failure was on a portion of the \$50.0 million notional amount. That portion, \$14.3 million, was designated as a cash flow hedge of the overall changes in the cash flows above and below the collar strike rates associated with interest payments on certain of Dubuque Bank and Trust Company's prime-based loans. The failure of this hedge relationship was caused by paydowns, which reduced the designated loan pool from \$14.3 million to \$9.6 million. This hedge failure resulted in the recognition of a gain of \$198 thousand during the quarter ended March 31,

2008, which consists of the mark to market gain on the collar transaction of \$212 thousand and a reclass of unrealized losses out of other comprehensive income to earnings of \$14 thousand. During the first quarter of 2009, the mark to market adjustment on this collar transaction was recorded as a loss of \$49 thousand.

A portion of the September 19, 2005 collar transaction also did not meet the retrospective hedge effectiveness test at June 30, 2007. The failure was on a portion of the \$50.0 million notional amount. That portion, \$14.3 million, was designated as a cash flow hedge of the overall changes in the cash flows above and below the collar strike rates associated with interest payments on certain of Rocky Mountain Bank's prime-based loans. The failure of this hedge relationship was caused by the sale of its Broadus branch, which reduced the designated loan pool from \$14.3 million to \$7.5 million. This hedge failure resulted in the recognition of a loss of \$51 thousand during the quarter ended June 30, 2007, which consists of the mark to market loss on the collar transaction of \$36 thousand and a reclass of unrealized losses out of other comprehensive income to earnings of \$15 thousand. On August 17, 2007, the \$14.3 million portion of the September 19, 2005, collar transaction was redesignated and met the requirements for hedge accounting treatment. Since the fair value of the collar transaction was zero on the redesignation date, a mark to market gain of \$36 thousand was recorded as other noninterest income during the period from June 30, 2007, to August 17, 2007. The redesignated collar transaction did not meet the retrospective hedge effectiveness test at December 31, 2008. The failure of the redesignated hedge was caused by paydowns, which reduced the redesignated loan pool from \$14.3 million to \$10.4 million. The hedge failure resulted in the recognition of a gain of \$347 thousand, during the quarter ended December 31, 2008, which consisted of mark to market gain on the collar transaction of \$348 thousand and reclassification of unrealized loss out of other comprehensive income to earnings of \$1 thousand. During the first quarter of 2009, the mark to market adjustment on this collar transaction was recorded as a loss of \$64 thousand.

An additional portion of the September 19, 2005 collar transaction did not meet the retrospective hedge effectiveness test at March 31, 2009. The failure was on a portion of the \$50.0 million notional amount. That portion, \$14.3 million, was designated as a cash flow hedge of the overall changes in the cash flows above and below the collar strike rates associated with interest payments on certain of New Mexico Bank & Trust's prime-based loans. The failure of this hedge relationship was caused by paydowns, which reduced the designated loan pool from \$14.3 million to \$11.6 million. This hedge failure resulted in the recognition of a gain of \$68 thousand during the first quarter of 2009, which consists of the mark to market loss on the collar transaction of \$64 thousand and a reclass of unrealized gains out of other comprehensive income to earnings of \$132 thousand.

For the three months ended March 31, 2009, the change in net unrealized gains of \$1.9 million for derivatives designated as cash flow hedges is separately disclosed in the statement of changes in stockholders' equity, before income taxes of \$720 thousand. For the three months ended March 31, 2008, the change in net unrealized gains of \$1.5 million for derivatives designated as cash flow hedges is separately disclosed in the statement of changes in shareholders' equity, before income taxes of \$541 thousand.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest income or expense as interest payments are received or made on Heartland's variable-rate assets and liabilities. For the three months ended March 31, 2009, the change in net unrealized gains on cash flow hedges reflects a reclassification of \$23 thousand of net unrealized losses from accumulated other comprehensive income to interest income or interest expense. For the next twelve months, Heartland estimates that an additional \$92 thousand will be reclassified from accumulated other comprehensive income to interest income.

By using derivatives, Heartland is exposed to credit risk if counterparties to derivative instruments do not perform as expected. Heartland minimizes this risk by entering into derivative contracts with large, stable financial institutions and Heartland has not experienced any losses from counterparty nonperformance on derivative instruments. Furthermore, Heartland also periodically monitors counterparty credit risk in accordance with the provisions of SFAS 133.

#### NOTE 4: FAIR VALUE

Heartland utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale, trading securities and derivatives are recorded at fair value on a recurring basis. Additionally, from time to time, Heartland may be required to record at fair value other assets on a non-recurring basis such as loans held for sale, loans held to maturity and certain other assets including, but not limited to, mortgage servicing rights. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

##### Fair Value Hierarchy

Under FAS 157, assets and liabilities are grouped at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 - Valuation is based upon quoted prices for identical instruments in active markets.

Level 2 - Valuation is based upon quoted prices for similar instruments in active markets, or similar instruments in markets that are not active, and model-based valuation techniques for all significant assumptions are observable in the market.

Level 3 - Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

The following is a description of valuation methodologies used for assets recorded at fair value and for estimation of fair value for financial instruments not recorded at fair value.

##### Assets

###### Securities Available for Sale

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, as well as U.S. Treasury and other U.S. government and agency securities that are traded by dealers or brokers in active over-the-counter markets. Level 2 securities include agency mortgage-backed securities and private collateralized mortgage obligations, municipal bonds and corporate debt securities. The Level 3 securities of \$120 thousand are related to an investment in a partnership.

###### Trading Assets

Trading assets are recorded at fair value and consist of securities held for trading purposes. The valuation method for trading securities is the same as the methodology used for securities classified as available for sale.

###### Loans Held for Sale

Loans held for sale are carried at the lower of cost or fair value. The fair value of loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, Heartland classifies loans

held for sale subjected to nonrecurring fair value adjustments as Level 2.

#### Loans Held to Maturity

Heartland does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Under Heartland's credit policies, all nonaccrual loans are defined as impaired loans. Once a loan is identified as individually impaired, management measures impairment in accordance with FAS 114, Accounting by Creditors for Impairment of a Loan. Loan impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, except where more practical, at the observable market price of the loan or the fair value of the collateral if the loan is collateral dependent. Heartland's allowance methodology requires specific reserves for all impaired loans. At March 31, 2009, substantially all of the total impaired loans were based on the fair value of the collateral. In accordance with FAS 157, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, Heartland records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, Heartland records the impaired loan as nonrecurring Level 3.

#### Derivative Financial Instruments

Currently, Heartland uses interest rate caps, floors and collars to manage its interest rate risk. The valuation of these instruments is determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The fair values of interest rate options are determined using the market standard methodology of discounting the future expected cash receipts that would occur if variable interest rates fell below (rise above) the strike rate of the floors (caps). The variable interest rates used in the calculation of projected receipts on the floor (cap) are based on an expectation of future interest rates derived from observable market interest rate curves and volatilities. To comply with the provisions of FAS No. 157, Heartland incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, Heartland has considered the impact of netting any applicable credit enhancements, such as collateral postings, thresholds, mutual puts, and guarantees.

Although Heartland has determined that the majority of the inputs used to value its derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by itself and its counterparties. However, as of March 31, 2009, Heartland has assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and has determined that the credit valuation adjustments are not significant to the overall valuation of its derivatives. As a result, Heartland has determined that its derivative valuations in their entirety are classified in Level 2 of the fair value hierarchy.

#### Mortgage Servicing Rights

Mortgage servicing rights are subject to impairment testing. The carrying values of these rights are reviewed quarterly for impairment based upon the calculation of fair value as performed by an outside third party. For purposes of measuring impairment, the rights are stratified into certain risk characteristics including note type, note rate, prepayment trends and external market factors. If the valuation model reflects a value less than the carrying value, mortgage servicing rights are adjusted to fair value through a valuation allowance. As such, Heartland classifies

mortgage servicing rights subjected to nonrecurring fair value adjustments as Level 2.

#### Other Real Estate Owned

Other real estate represents property acquired through foreclosures and settlements of loans. Property acquired is carried at the lower of the principal amount of the loan outstanding at the time of acquisition, plus any acquisition costs, or the estimated fair value of the property, less disposal costs. Heartland considers third party appraisals as well as independent fair value assessments from realtors or persons involved in selling OREO in determining the fair value of particular properties. Accordingly, the valuation of OREO is subject to significant external and internal judgment. Heartland also periodically reviews OREO to determine whether the property continues to be carried at the lower of its recorded book value or fair value of the property, less disposal costs.

---



Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

The table below presents, in thousands, Heartland's assets and liabilities that are measured at fair value on a recurring basis as of March 31, 2009, aggregated by the level in the fair value hierarchy within which those measurements fall:

	Total Fair Value March 31, 2009	Level 1	Level 2	Level 3
Trading securities	\$ 1,560	\$ 1,560	\$ -	\$ -
Available-for-sale securities	974,711	253,901	720,690	120
Derivative assets	2,073	-	2,073	-
Total assets at fair value	\$ 978,344	\$ 255,461	\$ 722,763	\$ 120
Derivative liabilities	1,253	-	1,253	-
Total liabilities at fair value	\$ 1,253	\$ -	\$ 1,253	\$ -

The changes in Level 3 assets that are measured at fair value on a recurring basis are summarized in the following table, in thousands:

	Fair Value
Balance at January 1, 2009	\$ 120
Purchases	-
Redemptions	-
Balance at March 31, 2009	\$ 120

The table below presents Heartland's assets measured at fair value on a nonrecurring basis, in thousands:

	Carrying Value at March 31, 2009				Quarter Ended March 31, 2009 Total Losses
	Total	Level 1	Level 2	Level 3	
Impaired loans	\$ 31,765	\$ -	\$ -	\$ 31,765	\$ 807
OREO	29,317	-	-	29,317	12

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### SAFE HARBOR STATEMENT

This document (including information incorporated by reference) contains, and future oral and written statements of Heartland and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of Heartland. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of Heartland's management and on information currently available to management, are generally identifiable by the use of words such as "believe", "expect", "anticipate", "plan", "intend", "estimate", "may", "will", "would", "could", "should" or other similar expressions. Additionally, all statements in this document, including forward-looking statements, speak only as of the date they are made, and Heartland undertakes no obligation to update any statement in light of new information or future events.

Heartland's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. The factors which could have a material adverse effect on the operations and future prospects of Heartland and its subsidiaries are detailed in the "Risk Factors" section included under Item 1A. of Part I of Heartland's 2008 Form 10-K filed with the Securities and Exchange Commission on March 16, 2009. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

### CRITICAL ACCOUNTING POLICIES

The process utilized by Heartland to estimate the adequacy of the allowance for loan and lease losses is considered a critical accounting policy for Heartland. The allowance for loan and lease losses represents management's estimate of identified and unidentified probable losses in the existing loan portfolio. Thus, the accuracy of this estimate could have a material impact on Heartland's earnings. The adequacy of the allowance for loan and lease losses is determined using factors that include the overall composition of the loan portfolio, general economic conditions, types of loans, loan collateral values, past loss experience, loan delinquencies, and potential losses from identified substandard and doubtful credits. Nonperforming loans and large non-homogeneous loans are specifically reviewed for impairment and the allowance is allocated on a loan-by-loan basis as deemed necessary. Homogeneous loans and loans not specifically evaluated are grouped into pools to which a loss percentage, based on historical experience, is allocated. The adequacy of the allowance for loan and lease losses is monitored on an ongoing basis by the loan review staff, senior management and the banks' boards of directors. Specific factors considered by management in establishing the allowance included the following:

- \* Heartland has experienced an increase in net charge-offs and nonperforming loans during the most recent quarters.
- \* Heartland has continued to experience growth in more complex commercial loans as compared to relatively lower-risk residential real estate loans.
- \* During the last several years, Heartland has entered new geographical markets in which it had little or no previous lending experience.

There can be no assurances that the allowance for loan and lease losses will be adequate to cover all loan losses, but management believes that the allowance for loan and lease losses was adequate at March 31, 2009. While management uses available information to provide for loan and lease losses, the ultimate collectibility of a substantial portion of the loan portfolio and the need for future additions to the allowance will be based on changes in economic conditions. Should the economic climate continue to deteriorate, borrowers may experience difficulty, and the level of nonperforming loans, charge-offs, and delinquencies could rise and require further increases in the provision for loan

and lease losses. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the allowance for loan and lease losses carried by the Heartland subsidiaries. Such agencies may require Heartland to make additional provisions to the allowance based upon their judgment about information available to them at the time of their examinations.

## GENERAL

Heartland's results of operations depend primarily on net interest income, which is the difference between interest income from interest earning assets and interest expense on interest bearing liabilities. Noninterest income, which includes service charges and fees, trust income, brokerage and insurance commissions and gains on sale of loans, also affects Heartland's results of operations. Heartland's principal operating expenses, aside from interest expense, consist of compensation and employee benefits, occupancy and equipment costs and provision for loan and lease losses.

Net income was \$6.1 million for the quarter ended March 31, 2009, compared to \$6.3 million earned during the first quarter of 2008. Net income available to common stockholders was \$4.8 million, or \$0.29 per diluted common share, for the quarter ended March 31, 2009, compared to \$6.3 million, or \$0.38 per diluted common share, earned during the first quarter of 2008. Return on average common equity was 8.26 percent and return on average assets was 0.53 percent for the first quarter of 2009, compared to 10.72 percent and 0.77 percent, respectively, for the same quarter in 2008.

Earnings for the first quarter of 2009 were positively affected by increased net interest income, loan servicing income, securities gains and gains on sale of loans. The growth in these areas was partially offset by an increase in the loan loss provision, which was \$6.7 million during the first quarter of 2009 compared to \$1.8 million during the first quarter of 2008. Net interest margin, expressed as a percentage of average earning assets, was 3.94 percent during the first quarter of 2009 compared to 3.88 percent for the first quarter of 2008 and 3.79 percent for the fourth quarter of 2008.

During the first quarter of 2009, net interest income on a tax-equivalent basis increased \$3.4 million or 12 percent compared to the same quarter in 2008. Average earning assets increased \$335.3 million or 11 percent during the comparable quarterly periods. Noninterest income was \$12.8 million during the first quarter of 2009 compared to \$8.5 million during the first quarter of 2008, an increase of \$4.3 million or 51 percent. Contributing to this increase was a \$1.5 million increase in loan servicing income, \$1.3 million increase in gains on sale of loans and \$2.6 million increase in securities gains. For the first quarter of 2009, noninterest expense totaled \$28.3 million, an increase of \$2.5 million or 10 percent from the \$25.8 million recorded during the same quarter in 2008. The largest component of noninterest expense, salaries and employee benefits, increased \$1.6 million or 11 percent during the first quarter of 2009 compared to the first quarter of 2008, primarily due to the opening of Minnesota Bank & Trust and additional staffing at Summit Bank & Trust and at Heartland's operations center. The other noninterest expense category to experience a significant increase during the quarters under comparison was outside services, primarily as a result of higher FDIC assessments.

At March 31, 2009, total assets had increased \$99.8 million or 11 percent annualized since year-end 2008. Total loans and leases were \$2.36 billion at March 31, 2009, compared to \$2.41 billion at year-end 2008, a decrease of \$48.6 million or 8 percent annualized. In order to provide the investing community with a perspective on how the growth in both loans and deposits during the first three months of the year equates to performance on an annualized basis, the growth rates on these two categories have been reflected as an annualized percentage throughout this report. These annualized numbers were calculated by multiplying the growth percentage for the first three months of the year by four. The only loan category to experience growth during the first quarter of 2009 was the agricultural and agricultural real estate loans.

Total deposits grew to \$2.79 billion at March 31, 2009, an increase of \$148.5 million or 22 percent annualized since year-end 2008. This growth was weighted more heavily in Heartland's Midwestern markets, which were responsible

for nearly 58 percent of the growth. Demand deposits increased \$26.9 million or 28 percent annualized since year-end 2008. Savings deposit balances experienced an increase of \$57.4 million or 20 percent annualized since year-end 2008 and time deposits, exclusive of brokered deposits, experienced an increase of \$71.0 million or 26 percent annualized since year-end 2008.

#### NET INTEREST INCOME

Net interest margin, expressed as a percentage of average earning assets, was 3.94 percent during the first quarter of 2009 compared to 3.88 percent for the first quarter of 2008 and 3.79 percent for the fourth quarter of 2008. Success at growing net interest margin during the quarter was a direct result of disciplined pricing. Management is committed to maintaining margin near the 4 percent level and will not compete for loans or deposits strictly for the sake of growth.

Net interest income on a tax-equivalent basis totaled \$32.1 million during the first quarter of 2009, an increase of \$3.4 million or 12 percent from the \$28.7 million recorded during the first quarter of 2008. Contributing to this increase was the \$335.3 million or 11 percent growth in average earning assets over the comparable quarterly period.

On a tax-equivalent basis, interest income in the first quarter of 2009 totaled \$50.8 million compared to \$52.2 million in the first quarter of 2008, a decrease of \$1.4 million or 3 percent. Nearly half of Heartland's commercial and agricultural loan portfolios consist of floating rate loans that reprice immediately upon a change in the national prime interest rate, thus changes in the national prime rate impact interest income more quickly than if there were more fixed rate loans. The national prime interest rate was 3.25 percent for the first three months of 2009. During the first three months of 2008, the national prime interest rate decreased from 7.25 percent on January 1, 2008, to 5.25 percent at March 31, 2008. A large portion of Heartland's floating rate loans that reprice immediately with a change in national prime have interest rate floors that are currently in effect. Additionally, Heartland has two \$50.0 million derivative transactions on the loan portfolio that are at their floor interest rates. One of these derivative transactions matured on April 4, 2009.

Interest expense for the first quarter of 2009 was \$18.7 million compared to \$23.6 million in the first quarter of 2008, a decrease of \$4.9 million or 21 percent, as higher rate certificates of deposit rolled over at lower rates. Approximately 47 percent of Heartland's certificate of deposit accounts will mature within the next six months at a weighted average rate of 2.81 percent.

Heartland attempts to manage its balance sheet to minimize the effect that a change in interest rates has on its net interest margin. Heartland plans to continue to work toward improving both its earning asset and funding mix through targeted organic growth strategies, which management believes will result in additional net interest income. Heartland's net interest income simulations reflect a well-balanced and manageable interest rate posture. Management supports a pricing discipline in which the focus is less on price and more on the unique value provided to business and retail clients. Item 3 of this Form 10-Q contains additional information about the results of Heartland's most recent net interest income simulations. Note 3 to the quarterly financial statements contains a detailed discussion of the derivative instruments Heartland has utilized to manage its interest rate risk.

The table below sets forth certain information relating to Heartland's average consolidated balance sheets and reflects the yield on average earning assets and the cost of average interest bearing liabilities for the periods indicated. Dividing income or expense by the average balance of assets or liabilities derives such yields and costs. Average balances are derived from daily balances. Nonaccrual loans and loans held for sale are included in each respective loan category.

#### ANALYSIS OF AVERAGE BALANCES, TAX EQUIVALENT YIELDS AND RATES<sup>1</sup>

For the quarters ended March 31, 2009 and 2008

(Dollars in thousands)

2009

2008

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

	Average Balance	Interest	Rate	Average Balance	Interest	Rate
<b>EARNING ASSETS</b>						
Securities:						
Taxable	\$ 759,985	\$ 8,421	4.49%	\$ 556,859	\$ 6,615	4.78%
Nontaxable	160,147	2,720	6.89	145,942	2,421	6.67
Total securities	920,132	11,141	4.91	702,801	9,036	5.17
Interest bearing deposits	634	1	0.64	432	5	4.66
Federal funds sold	785	1	0.52	19,006	131	2.77
Loans and leases:						
Commercial and commercial real estate	1,693,796	26,142	6.26	1,623,511	28,597	7.08
Residential mortgage	236,878	3,449	5.90	224,902	3,701	6.62
Agricultural and agricultural real estate	256,059	4,092	6.48	228,964	4,324	7.60
Consumer	231,328	4,973	8.72	198,469	4,931	9.99
Direct financing leases, net	5,544	68	4.97	8,788	133	6.09
Fees on loans	-	966	-	-	1,382	-
Less: allowance for loan and lease losses	(35,600)	-	-	(32,658)	-	-
Net loans and leases	2,388,005	39,690	6.74	2,251,976	43,068	7.69
Total earning assets	3,309,556	\$ 50,833	6.23%	2,974,215	\$ 52,240	7.06%
NON-EARNING ASSETS	349,648			295,319		
<b>TOTAL ASSETS</b>	<b>\$ 3,659,204</b>			<b>\$ 3,269,534</b>		
<b>INTEREST BEARING LIABILITIES</b>						
Interest bearing deposits						
Savings	\$ 1,116,314	\$ 4,524	1.64%	\$ 827,988	\$ 4,035	1.96%
Time, \$100,000 and over	394,948	3,238	3.32	308,760	3,547	4.62
Other time deposits	769,443	6,360	3.35	845,308	9,514	4.53
Short-term borrowings	170,826	212	0.50	301,616	2,186	2.91
Other borrowings	467,232	4,378	3.80	354,290	4,277	4.86
Total interest bearing liabilities	2,918,763	18,712	2.60%	2,637,962	23,559	3.59%
<b>NONINTEREST BEARING LIABILITIES</b>						
Noninterest bearing deposits	393,615			356,578		
Accrued interest and other liabilities	32,858			39,850		
Total noninterest bearing liabilities	426,473			396,428		
<b>STOCKHOLDERS' EQUITY</b>	<b>313,968</b>			<b>235,144</b>		