

HERITAGE FINANCIAL CORP /WA/  
Form 10-Q  
May 05, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**  
**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended March 31, 2008

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 office)

**98501**  
(ZIP Code)

**(360) 943-1500**

(Registrant's telephone number, including area code)

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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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 9, 2008 there were 6,688,430 common shares outstanding, with no par value, of the registrant.

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**HERITAGE FINANCIAL CORPORATION**

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**Table of Contents****ITEM 1. HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(Dollars in thousands, except for per share data)

(Unaudited)

|  | <b>Three Months<br/>Ended<br/>March 31,</b> |               |
|--|---|---------------|
|  | <b>2008</b>                                 | <b>2007</b>   |
| <b>INTEREST INCOME:</b>                                      |   |               |
| Interest and fees on loans                                   | \$ 14,168                                   | \$ 14,419     |
| Taxable interest on investment securities                    | 392   | 414           |
| Nontaxable interest on investment securities                 | 45  | 44            |
| Interest on federal funds sold and interest bearing deposits | 88  | 44            |
| Dividends on Federal Home Loan Bank stock                    | 8   | 3             |
| <b>Total interest income</b>                                 | <b>14,701</b>                               | <b>14,924</b> |
| <b>INTEREST EXPENSE:</b>                                     |   |               |
| Deposits   | 5,540                                       | 5,614         |
| Other borrowings   | 97  | 413           |
| <b>Total interest expense</b>                                | <b>5,637</b>                                | <b>6,027</b>  |
| <b>Net interest income</b>                                   | <b>9,064</b>                                | <b>8,897</b>  |
| Provision for loan losses                                    | 360   | 180           |
| <b>Net interest income after provision for loan losses</b>   | <b>8,704</b>                                | <b>8,717</b>  |
| <b>NONINTEREST INCOME:</b>                                   |   |               |
| Gains on sales of loans, net                                 | 42  | 2             |
| Brokered mortgage income                                     | 88  | 181           |
| Service charges on deposits                                  | 990   | 853           |
| Rental income  | 83  | 80            |
| Merchant visa income   | 700   | 655           |
| Other income   | 343   | 262           |
| <b>Total noninterest income</b>                              | <b>2,246</b>                                | <b>2,033</b>  |
| <b>NONINTEREST EXPENSE:</b>                                  |   |               |
| Salaries and employee benefits                               | 3,721                                       | 3,836         |
| Occupancy and equipment                                      | 988   | 1,090         |
| Data processing  | 384   | 380           |
| Marketing  | 103   | 89            |
| Office supplies and printing                                 | 95  | 99            |
| Merchant visa  | 562   | 525           |
| Professional services  | 163   | 171           |
| State and local taxes  | 237   | 216           |
| Other expense  | 717   | 779           |
| <b>Total noninterest expense</b>                             | <b>6,970</b>                                | <b>7,185</b>  |
| <b>Income before federal income taxes</b>                    | <b>3,980</b>                                | <b>3,565</b>  |

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|                               |          |          |
|-------------------------------|----------|----------|
| Federal income taxes          | 1,320    | 1,192    |
| Net income                    | \$ 2,660 | \$ 2,373 |
| Earnings per share:           |          |          |
| Basic                         | \$ 0.40  | \$ 0.37  |
| Diluted                       | \$ 0.40  | \$ 0.36  |
| Dividends declared per share: | \$ 0.210 | \$ 0.210 |

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

(Dollars in thousands)

(Unaudited)

|  | March 31,<br>2008 | December 31,<br>2007 |
|--|-------------------|----------------------|
| <b>Assets</b>  |                   |                      |
| Cash on hand and in banks  | \$ 21,949         | \$ 28,401            |
| Interest earning deposits  | 17,942            | 6,062                |
| Investment securities available for sale   | 36,242            | 35,660               |
| Investment securities held to maturity (market value of \$3,402 and \$3,929)   | 3,321             | 3,890                |
| Loans held for sale  | 777               | 447                  |
| Loans receivable   | 776,418           | 779,319              |
| Less: Allowance for loan losses  | (10,690)          | (10,374)             |
| Loans receivable, net  | 765,728           | 768,945              |
| Other real estate owned  | 169               | 169                  |
| Premises and equipment, at cost, net   | 14,726            | 14,819               |
| Federal Home Loan Bank and Federal Reserve stock, at cost  | 3,227             | 3,227                |
| Accrued interest receivable  | 4,071             | 4,401                |
| Prepaid expenses and other assets  | 5,610             | 4,156                |
| Deferred federal income taxes, net   | 2,274             | 2,364                |
| Intangible assets, net   | 483               | 502                  |
| Goodwill   | 13,012            | 13,012               |
| Total assets   | \$ 889,531        | \$ 886,055           |
| <b>Liabilities and Stockholders Equity</b>   |                   |                      |
| Deposits   | \$ 792,983        | \$ 776,280           |
| Advances from Federal Home Loan Bank   | 1,996             | 14,990               |
| Other borrowings   | 1,639             | 1,951                |
| Accrued expenses and other liabilities   | 6,116             | 7,867                |
| Total liabilities  | 802,734           | 801,088              |
| Stockholders' equity:  |                   |                      |
| Common stock, no par value per share, 15,000,000 shares authorized; 6,688,505 and 6,642,972 shares outstanding at March 31, 2008 and December 31, 2007, respectively | 25,368            | 24,985               |
| Unearned compensation - ESOP   | (427)             | (447)                |
| Retained earnings  | 62,040            | 60,780               |
| Accumulated other comprehensive loss, net  | (184)             | (351)                |
| Total stockholders' equity   | 86,797            | 84,967               |
| Total liabilities and stockholders' equity   | \$ 889,531        | \$ 886,055           |

See Notes to Condensed Consolidated Financial Statements.



**Table of Contents****HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY FOR THE THREE MONTHS ENDED  
MARCH 31, 2008 AND COMPREHENSIVE INCOME FOR THE THREE MONTHS ENDED****MARCH 31, 2008 AND 2007**

(In Thousands)

(Unaudited)

|   | Number<br>of<br>common<br>shares | Common<br>stock | Unearned<br>Compensation-<br>ESOP | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>loss, net | Total<br>stockholders<br>equity |
|---|----------------------------------|-----------------|-----------------------------------|----------------------|--|---------------------------------|
| Balance at December 31, 2007  | 6,643                            | \$ 24,985       | \$ (447)                          | \$ 60,780            | \$ (351)   | \$ 84,967                       |
| Stock option compensation expense   |                                  | 54              |                                   |                      |  | 54                              |
| Earned ESOP shares  | 2                                | 22              | 20                                |                      |  | 42                              |
| Earned restricted stock shares  |                                  | 76              |                                   |                      |  | 76                              |
| Restricted stock awards granted   | 24                               |                 |                                   |                      |  |                                 |
| Tax benefit on dividends paid on unallocated ESOP<br>shares and restricted stock shares |                                  | 8               |                                   |                      |  | 8                               |
| Exercise of stock options (including tax benefits from<br>nonqualified stock options)   | 20                               | 223             |                                   |                      |  | 223                             |
| Net income  |                                  |                 |                                   | 2,660                |  | 2,660                           |
| Change in fair value of securities available for sale, net<br>of tax                    |                                  |                 |                                   |                      | 167  | 167                             |
| Cash dividends declared   |                                  |                 |                                   | (1,400)              |  | (1,400)                         |
| Balance at March 31, 2008   | 6,689                            | \$ 25,368       | \$ (427)                          | \$ 62,040            | \$ (184)   | \$ 86,797                       |

| Comprehensive Income   | Three months ended<br>March 31, |          |
|--|---------------------------------|----------|
|  | 2008                            | 2007     |
| Net income   | \$ 2,660                        | \$ 2,373 |
| Change in fair value of securities available for sale, net of tax of \$90 and \$45 | 167                             | 84       |
| Comprehensive income   | \$ 2,827                        | \$ 2,457 |

See Notes to Condensed Consolidated Financial Statements.



**Table of Contents****HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****For the three months ended March 31, 2008 and 2007**

(Dollars in thousands)

(Unaudited)

|   | 2008     | 2007     |
|---|----------|----------|
| Cash flows from operating activities:   |          |          |
| Net income  | \$ 2,660 | \$ 2,373 |
| Adjustments to reconcile net income to net cash provided by operating activities:   |          |          |
| Depreciation and amortization   | 313      | 419      |
| Deferred loan fees, net of amortization   | (207)    | 59       |
| Provision for loan losses   | 360      | 180      |
| Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities                                    | (2,850)  | 1,048    |
| Recognition of compensation related to ESOP shares and restricted stock awards  | 118      | 73       |
| Stock option compensation expense   | 54       | 87       |
| Tax benefit realized from stock options exercised, restricted stock awards vested, and dividends on unallocated ESOP shares and restricted stock awards | (20)     | (145)    |
| Amortization of intangible assets   | 19       | 19       |
| Deferred federal income tax   |          | 128      |
| Origination of loans held for sale  | (3,472)  | (393)    |
| Gain on sale of loans   | (42)     |          |
| Proceeds from sale of loans   | 3,184    |          |
| Loss on sale of other real estate owned   |          | 20       |
| Gain on sale of premises and equipment  |          | (1)      |
| Net cash provided by operating activities   | 117      | 3,867    |
| Cash flows from investing activities:   |          |          |
| Loans originated, net of principal payments   | 3,064    | (15,759) |
| Maturities of investment securities available for sale  | 5,996    | 2,584    |
| Maturities of investment securities held to maturity  | 568      | 47       |
| Purchase of investment securities available for sale  | (6,309)  |          |
| Purchase of premises and equipment  | (231)    | (406)    |
| Proceeds from sale of other real estate owned   |          | 205      |
| Proceeds from sale of premises and equipment  |          | 5        |
| Net cash (used in) provided by investing activities   | 3,088    | (13,324) |
| Cash flows from financing activities:   |          |          |
| Net increase in deposits  | 16,703   | 16,911   |
| Net decrease in borrowed funds  | (12,994) | (7,820)  |
| Repayments of long-term debt  | (312)    |          |
| Cash dividends paid   | (1,405)  | (1,390)  |
| Proceeds from exercise of stock options   | 211      | 533      |
| Tax benefit realized from stock options exercised, restricted stock awards vested, and dividends on unallocated ESOP shares and restricted stock awards | 20       | 145      |
| Repurchase of common stock  |          | (375)    |
| Net cash provided by financing activities   | 2,223    | 8,004    |

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|  |           |           |
|--|-----------|-----------|
| Net increase (decrease) in cash and cash equivalents | 5,428     | (1,453)   |
| Cash and cash equivalents at beginning of period     | 34,463    | 26,431    |
| Cash and cash equivalents at end of period           | \$ 39,891 | \$ 24,978 |
| Supplemental disclosures of cash flow information:   |           |           |
| Cash payments for:                                   |           |           |
| Interest expense                                     | \$ 6,303  | \$ 6,346  |
| Federal income taxes                                 |           |           |
| Supplemental disclosures of cash flow information:   |           |           |
| Loans transferred to other real estate owned         |           | (80)      |

See Notes to Condensed Consolidated Financial Statements.

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**HERITAGE FINANCIAL CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Three Months Ended March 31, 2008 and 2007**

(Unaudited)

**NOTE 1. Description of Business and Basis of Presentation**

*(a.) Description of Business*

Heritage Financial Corporation (Company) is a bank holding company that was incorporated in the State of Washington in August 1997. We were organized for the purpose of acquiring all of the capital stock of Heritage Savings Bank upon our reorganization from a mutual holding company form of organization to a stock holding company form of organization. Effective September 1, 2004, Heritage Savings Bank switched its charter from a State Chartered Savings Bank to a State Chartered Commercial Bank and changed its legal name from Heritage Savings Bank to Heritage Bank. Effective September 1, 2005, Central Valley Bank (acquired by the Company in March 1999) changed its charter from a Nationally Chartered Commercial Bank to a State Chartered Commercial Bank.

We are primarily engaged in the business of planning, directing, and coordinating the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. The deposits of Heritage Bank and Central Valley Bank are insured by the Federal Deposit Insurance Corporation (FDIC) under the Deposit Insurance Fund (DIF). Heritage Bank conducts business from its main office in Olympia, Washington and its thirteen branch offices located in Thurston, Pierce, Mason and south King Counties of Washington State. Central Valley Bank conducts business from its main office in Toppenish, Washington and its five branch offices located in Yakima and Kittitas Counties of Washington State.

Our business consists primarily of lending and deposit relationships with small businesses including agribusiness and their owners in our market area, attracting deposits from the general public and originating for sale or investment purposes first mortgage loans on residential properties located in western and central Washington. We also make residential construction loans, income property loans, and consumer loans.

*(b.) Basis of Presentation*

The accompanying condensed consolidated financial statements have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. These condensed consolidated financial statements should be read with our December 31, 2007 audited consolidated financial statements and its accompanying notes included in our Annual Report on Form 10-K. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2008 are not necessarily indicative of the results that may be expected for the year ended December 31, 2008. In preparing the consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates.

Certain amounts in the consolidated financial statements for the prior year have been reclassified to conform to the current consolidated financial statement presentation. These amounts include the segregation of brokered mortgage income from other income in the Consolidated Statements of Income and the reclassification of specific loans between loan categories. These reclassifications had no effect on net income.

**NOTE 2. Stockholders Equity**

*(a.) Earnings per Share*

The following table illustrates the reconciliation of weighted average shares used for earnings per share for the noted periods.

**Three months ended  
March 31,**

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|  | 2008      | 2007      |
|--|-----------|-----------|
| <b>Basic:</b>  |           |           |
| Weighted average shares outstanding  | 6,662,115 | 6,567,677 |
| Less: Weighted average unvested restricted stock awards                                | (74,564)  | (63,128)  |
| Basic weighted average shares outstanding  | 6,587,551 | 6,504,549 |
| <b>Diluted:</b>  |           |           |
| Basic weighted average shares outstanding  | 6,587,551 | 6,504,549 |
| Incremental shares from unexercised stock options and unvested restricted stock awards | 52,503    | 174,011   |
| Weighted average shares outstanding  | 6,640,054 | 6,678,560 |

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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, 2008 and 2007, anti-dilutive shares outstanding related to options to acquire common stock totaled 440,987 and 105,600, respectively, as the exercise price was in excess of the market value.

*(b.) Cash Dividend Declared*

On March 25, 2008, we announced a quarterly cash dividend of 21.0 cents per share payable on April 30, 2008 to stockholders of record on April 15, 2008.

**NOTE 3. Share Based Payment**

The Company maintains a number of stock-based incentive programs, which are discussed in more detail in Note 4. Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R ( SFAS No. 123R ) Share-based Payment. SFAS No. 123R requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award on the grant date. This statement was adopted using the modified prospective method of application, which requires the Company to recognize compensation expense on a prospective basis. Therefore, prior period financial statements have not been restated. Under this method, in addition to reflecting compensation expense for new share-based awards, expense is also recognized to reflect the remaining service period of awards that had been included in pro forma disclosures in prior periods.

Total stock-based compensation expense (excluding ESOP expense) for the three months ended March 31, 2008 and 2007 were as follows:

|                                 | 2008                   | 2007   |
|---------------------------------|------------------------|--------|
|                                 | (Dollars in thousands) |        |
| Compensation expense recognized | \$ 130                 | \$ 103 |
| Related tax benefit recognized  | 31                     | 10     |

As of March 31, 2008, the total unrecognized compensation expense related to non-vested stock awards was \$1,029,000 and the related weighted average period over which it is expected to be recognized is approximately 3.1 years.

The fair value of options granted during the three months ended March 31, 2008 is estimated on the date of grant using the Black-Scholes option pricing model based on the assumptions noted in the following table (there were no options granted during the three months ended March 31, 2007). The expected term of share options is derived from historical data and represents the period of time that share options granted are expected to be outstanding. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on historical volatility of Company shares. Expected dividend yield is based on dividends expected to be paid during the expected term of the share options.

| Grant period ended | Weighted<br>Average<br>Risk Free<br>Interest Rate | Expected<br>Term in<br>years | Expected<br>Volatility | Expected<br>Dividend<br>Yield | Weighted<br>Average Fair<br>Value |
|--------------------|---|------------------------------|------------------------|-------------------------------|-----------------------------------|
| March 31, 2008     | 2.38%   | 4.50                         | 21%                    | 4.30%                         | \$ 2.38                           |

**NOTE 4. Stock Option and Award Plans**

On September 24, 1996, Heritage Bank's stockholders approved the adoption of the 1997 stock option plan. On October 15, 1998, the Company's stockholders approved the adoption of the 1998 stock option plan, which is similar to the 1997 plan. The 1998 plan does not affect any options granted under the 1997 plan. On April 25, 2002, the Company's stockholders approved the adoption of the 2002 Incentive Stock Option Plan, the 2002 Director Nonqualified Stock Option Plan and the 2002 Restricted Stock Plan, which are generally similar to the 1997 and 1998 stock plans. On April 27, 2006, the Company's stockholders approved the adoption of the 2006 Incentive Stock Option Plan, the 2006 Director Nonqualified Stock Option Plan and the 2006 Restricted Stock Plan, which are generally similar to the 1997, 1998 and 2002 stock plans.

Under these stock option plans, on the date of grant, the exercise price of the option must at least equal the market value per share of the Company's common stock. The 1997 plan provides for the granting of options and stock awards up to 270,333 common



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shares. The 1998 plan provides for the grant of stock options for up to 414,750 shares and stock awards for up to 69,431 shares. The 2002 and 2006 Incentive Stock Option plans provide for the grant of stock options for up to 451,500 and 400,000 shares, respectively. The 2002 and 2006 Director Nonqualified Stock Option Plans provide for the grant of stock options for up to 73,500 and 75,000 shares, respectively. The 2002 and 2006 Restricted Stock Plans provide for the grant of stock awards for up to 52,500 and 25,000 shares, respectively.

Stock options generally vest ratably over three years and expire five years after they become exercisable which amounts to an average term of seven years. Restricted Stock awards issued have a five-year cliff vesting. The Company issues new shares to satisfy share option exercises and restricted stock awards.

The following table summarizes stock option activity for the three months ended March 31, 2008.

|                                  | Shares   | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value (in thousands) |
|----------------------------------|----------|---------------------------------|---|--|
| Outstanding at December 31, 2007 | 518,658  | \$ 20.15                        |   |  |
| Granted                          | 17,550   | 19.99                           |   |  |
| Exercised                        | (19,542) | 10.79                           |   |  |
| Forfeited or expired             | (520)    | 13.60                           |   |  |
| Outstanding at March 31, 2008    | 516,146  | \$ 20.50                        | 3.4   | \$ 328                                   |
| Exercisable at March 31, 2008    | 415,740  | \$ 19.57                        | 2.8   | \$ 328                                   |

The total intrinsic value of options exercised during the three months ended March 31, 2008 and 2007, was \$162,000 and \$478,000, respectively. The total fair value of shares vested during the three months ended March 31, 2008 and 2007 was \$110,000 and \$998,000 respectively.

The following table summarizes restricted stock award activity for the three months ended March 31, 2008.

|                                  | Shares | Weighted-Average Grant Date Fair Value |
|----------------------------------|--------|--|
| Outstanding at December 31, 2007 | 65,945 | \$ 22.62                               |
| Granted                          | 23,995 | 19.99                                  |
| Vested                           |        |  |
| Forfeited                        | (320)  | 23.40                                  |
| Outstanding at March 31, 2008    | 89,620 | \$ 21.91                               |

**Table of Contents****NOTE 5. Fair Value Accounting**

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157 ( SFAS No. 157 ) Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under Generally Accepted Accounting Principles ( GAAP ), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements.

In accordance with SFAS No. 157, we group our financial assets and financial liabilities measured 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 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 (NAV) 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 or quoted prices in markets that are not active. Level 2 includes U.S. Treasury, U.S. government and agency debt securities, and mortgage-backed securities. Valuations are usually obtained from third party pricing services for identical or comparable assets or liabilities.

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, 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.

The following table summarizes the balances of assets and liabilities measured at fair value on a recurring basis for the three months ended March 31, 2008.

|  | Total                  | Level 1   | Level 2   | Level 3 |
|--|------------------------|-----------|-----------|---------|
|  | (Dollars in thousands) |           |           |         |
| Investment securities available for sale | \$ 36,242              | \$ 10,550 | \$ 25,692 | \$      |

**ITEM 2. 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. The information contained in this section should be read with the unaudited condensed consolidated financial statements and its accompanying notes, and the December 31, 2007 audited consolidated financial statements and its accompanying notes included in our recent Annual Report on Form 10-K.*

*Statements concerning future performance, developments or events, expectations for growth and market forecasts, and any other guidance on future periods, constitute forward-looking statements and are subject to a number of risks and uncertainties, which might cause actual results to differ materially from stated expectations. Specific factors include, but are not limited to, the effect of interest rate changes, risks associated with acquisition of other banks and opening new branches, the ability to control costs and expenses, and general economic conditions. Additional information on these and other factors, which could affect our financial results, are included in our filings with the Securities and Exchange Commission.*

**Overview**

Heritage Financial Corporation is a bank holding company, which primarily engages in the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. We provide financial services to our local communities with an ongoing strategic focus in expanding our commercial lending relationships, market expansion and a continual focus on asset quality. Effective January 8, 1998, our common stock began to trade on the NASDAQ National Market under the symbol HFWA .



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The following table provides relevant net interest income information for selected time periods. 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.

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|   | For the Three Months Ended March 31, |                           |              |                   |                           |              |
|---|--------------------------------------|---------------------------|--------------|-------------------|---------------------------|--------------|
|   | Average Balance                      | 2008 Interest Earned/Paid | Average Rate | Average Balance   | 2007 Interest Earned/Paid | Average Rate |
| <b>Interest Earning Assets:</b>   |                                      |                           |              |                   |                           |              |
| Loans   | \$ 765,350                           | \$ 14,168                 | 7.45%        | \$ 737,640        | \$ 14,419                 | 7.84%        |
| Taxable securities  | 34,636                               | 392                       | 4.56         | 36,526            | 414                       | 4.44         |
| Nontaxable securities   | 4,918                                | 45                        | 3.67         | 4,765             | 44                        | 3.64         |
| Interest earning deposits   | 12,252                               | 88                        | 2.89         | 3,342             | 44                        | 5.17         |
| Federal Home Loan Bank stock  | 3,227                                | 8                         | 1.01         | 3,227             | 3                         | .40          |
| <b>Total interest earning assets</b>                                    | <b>\$ 820,383</b>                    | <b>\$ 14,701</b>          | <b>7.21%</b> | <b>\$ 785,500</b> | <b>\$ 14,924</b>          | <b>7.59%</b> |
| Noninterest earning assets  | 57,009                               |                           |              | 58,897            |                           |              |
| <b>Total assets</b>   | <b>\$ 877,392</b>                    |                           |              | <b>\$ 844,397</b> |                           |              |
| <b>Interest Bearing Liabilities:</b>                                    |                                      |                           |              |                   |                           |              |
| Certificates of deposit   | \$ 358,777                           | \$ 3,941                  | 4.42%        | \$ 338,020        | \$ 4,004                  | 4.69%        |
| Savings accounts  | 81,752                               | 351                       | 1.73         | 89,803            | 437                       | 1.95         |
| Interest bearing demand and money market accounts                       | 230,956                              | 1,248                     | 2.17         | 199,006           | 1,173                     | 2.25         |
| <b>Total interest bearing deposits</b>                                  | <b>671,485</b>                       | <b>5,540</b>              | <b>3.32</b>  | <b>626,829</b>    | <b>5,614</b>              | <b>3.49</b>  |
| FHLB advances and other borrowings                                      | 7,640                                | 97                        | 5.10         | 28,900            | 413                       | 5.88         |
| <b>Total interest bearing liabilities</b>                               | <b>\$ 679,125</b>                    | <b>\$ 5,637</b>           | <b>3.34%</b> | <b>\$ 655,729</b> | <b>\$ 6,027</b>           | <b>3.53%</b> |
| Demand and other noninterest bearing deposits                           | 104,022                              |                           |              | 100,890           |                           |              |
| Other noninterest bearing liabilities                                   | 7,003                                |                           |              | 7,070             |                           |              |
| Stockholders equity   | 87,242                               |                           |              | 80,708            |                           |              |
| <b>Total liabilities and stockholders equity</b>                        | <b>\$ 877,392</b>                    |                           |              | <b>\$ 844,397</b> |                           |              |
| <b>Net interest income</b>  |                                      | <b>\$ 9,064</b>           |              |                   | <b>\$ 8,897</b>           |              |
| Net interest spread   |                                      |                           | 3.87%        |                   |                           | 3.98%        |
| Net interest margin   |                                      |                           | 4.44%        |                   |                           | 4.59%        |
| Average interest earning assets to average interest bearing liabilities |                                      |                           | 120.80%      |                   |                           | 119.79%      |

**Financial Condition Data**

Total assets increased \$3.5 million (0.4%) to \$889.5 million as of March 31, 2008 from the December 31, 2007 balance of \$886.1 million. Deposits increased \$16.7 million (2.2%) to \$793.0 million as of March 31, 2008 from the December 31, 2007 balance of \$776.3 million. For the same period, net loans, which exclude loans held for sale but are net of the allowance for loan losses, decreased \$3.2 million (0.4%) to \$765.7 million as of March 31, 2008 from the December 31, 2007 balance of \$768.9 million. Commercial loans continue to be the largest segment of loans at 54.2% and 54.0% as a percentage of total loans as of March 31, 2008 and December 31, 2007, respectively.

**Earnings Summary**

Net income was \$0.40 per diluted share for the three months ended March 31, 2008 compared to \$0.36 per diluted share for the three months ended March 31, 2007, an increase of 11.1%. Actual earnings for the three months ended March 31, 2008 were \$2,660,000 compared to \$2,373,000 for the same period in 2007, an increase of 12.1%.

Return on average equity for the quarter ended March 31, 2008 was 12.26% compared to 11.92% for the same period last year. Average equity increased by \$6.5 million to \$87.2 million for the three months ended March 31, 2008 versus \$80.7 million for the same period last year while net income increased by \$287,000. The Company's capital position remains strong at 9.76% of total assets as of March 31, 2008, up from 9.27% at March 31, 2007.

**Net Interest Income**

Net interest income before provision for loan losses for the three months ended March 31, 2008 increased 1.9% to \$9,064,000 from \$8,897,000 for the same quarter in 2007. The net interest margin (net interest income divided by average interest earning assets) decreased to 4.44% for the current quarter from 4.59% for the same quarter last year. The lower net interest margin compared to the prior year have been largely due to a 300 basis point rate decrease in the federal funds target rate and a very competitive business environment.

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Interest income decreased \$223,000 or 1.5%, for the three months ended March 31, 2008 as compared to the first quarter last year and interest expense decreased \$390,000 or 6.5%, during this same period. Loans averaged \$765.4 million with an average yield of 7.45% for the three months ended March 31, 2008 compared to average loans of \$737.6 million with an average yield of 7.84% for the same period in 2007. Certificates of deposit averaged \$358.8 million with an average cost of 4.42% for the three months ended March 31, 2008 compared to \$338.0 million with an average cost of 4.69% for the same period in 2007.

### **Provision for Loan Losses**

The provision for loan losses was \$360,000 for the three months ended March 31, 2008, an increase of \$180,000 over the provision for loan losses during the 1st quarter of 2007. The increase in the loss loan reserves was due to management's assessment of the increased risk in the loan portfolio due to the current economic environment as well as increases in potential problem loans.

### **Noninterest Income**

Noninterest income increased 10.5% to \$2,246,000 for the three months ended March 31, 2008 compared with \$2,033,000 for the same quarter in 2007. This increase was primarily due to a \$177,000 pre-tax gain recognized on the redemption of Class B common stock received from the Visa, Inc. IPO completed on March 18, 2008. In addition, there was an increase of \$137,000, or 16.1%, in service charges on deposits primarily due to increased volume.

### **Noninterest Expense**

Noninterest expense decreased 3.0% to \$6,970,000 during the three months ended March 31, 2008 compared to \$7,185,000 for the same period during 2007. This decrease was primarily due to decreases in salaries and benefits expense, occupancy and equipment expense, and other miscellaneous expenses.

The efficiency ratio for the quarter ended March 31, 2008 was 61.63% compared to 65.74% for the comparable quarter in 2007. The efficiency ratio improvement is primarily a result of decreased noninterest expense and increased noninterest income due to the factors listed above. The efficiency ratio consists of noninterest expense divided by the sum of net interest income before provision for loan losses plus noninterest income.

**Table of Contents****Lending Activities**

As indicated in the table below, total loans (including loans held for sale) decreased to \$777.2 million at March 31, 2008 from \$779.8 million at December 31, 2007.

|   | At<br>March 31,<br>2008 | % of<br>Total<br>(Dollars in thousands) | At<br>December 31,<br>2007 | % of<br>Total |
|---|-------------------------|---|----------------------------|---------------|
| Commercial  | \$ 421,514              | 54.2%                                   | \$ 421,405                 | 54.0%         |
| Real estate mortgages                                     |                         |   |                            |               |
| One-to-four family residential                            | 57,163                  | 7.4                                     | 57,579                     | 7.4           |
| Five or more family residential and commercial properties | 161,143                 | 20.7                                    | 163,715                    | 21.0          |
| <b>Total real estate mortgages</b>                        | <b>218,306</b>          | <b>28.1</b>                             | <b>221,294</b>             | <b>28.4</b>   |
| Real estate construction                                  |                         |   |                            |               |
| One-to-four family residential                            | 75,222                  | 9.7                                     | 82,165                     | 10.6          |
| Five or more family residential and commercial properties | 46,991                  | 6.0                                     | 40,342                     | 5.2           |
| <b>Total real estate construction</b>                     | <b>122,213</b>          | <b>15.7</b>                             | <b>122,507</b>             | <b>15.8</b>   |
| Consumer  | 17,036                  | 2.2                                     | 16,641                     | 2.1           |
| <b>Gross loans</b>  | <b>779,069</b>          | <b>100.2</b>                            | <b>781,847</b>             | <b>100.3</b>  |
| Less: deferred loan fees                                  | (1,874)                 | (0.2)                                   | (2,081)                    | (0.3)         |
| <b>Total loans</b>  | <b>\$ 777,195</b>       | <b>100.0%</b>                           | <b>\$ 779,766</b>          | <b>100.0%</b> |

**Nonperforming Assets**

The following table describes our nonperforming assets for the dates indicated.

|  | At<br>March 31,<br>2008 | At<br>December 31,<br>2007 |
|--|-------------------------|----------------------------|
|  | (Dollars in thousands)  |                            |
| Nonaccrual loans                                 | \$ 784                  | \$ 1,021                   |
| Other real estate owned                          | 169                     | 169                        |
| <b>Total nonperforming assets</b>                | <b>\$ 953</b>           | <b>\$ 1,190</b>            |
| Accruing loans past due 90 days or more          | \$ 337                  | \$ 2,084                   |
| Potential problem loans                          | 26,769                  | 22,023                     |
| Allowance for loan losses                        | 10,690                  | 10,374                     |
| Nonperforming loans to loans                     | 0.10%                   | 0.13%                      |
| Allowance for loan losses to loans               | 1.38%                   | 1.33%                      |
| Allowance for loan losses to nonperforming loans | 1,363.52%               | 1,016.06%                  |
| Nonperforming assets to total assets             | 0.11%                   | 0.13%                      |

Nonperforming assets decreased to \$953,000, or 0.11% of total assets at March 31, 2008 from \$1,190,000, or 0.13% of total assets at December 31, 2007 due substantially to pay-downs of nonperforming loans. We believe that we are adequately reserved for losses in the portfolio as of March 31, 2008. Potential problem loans are those loans that are currently accruing interest, but which are considered possible credit problems because financial information of the borrowers causes us concerns as to their ability to comply with the present repayment

program and could result in placing the loan on nonaccrual.

**Analysis of Allowance for Loan Losses**

Management maintains an allowance for loan losses to absorb estimated credit losses associated with the loan portfolio, including all binding commitments to lend. We determine an adequate allowance through our ongoing quarterly loan quality assessments.

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We assess the estimated credit losses inherent in our non-classified and classified loan portfolio by considering a number of elements including:

Historical loss experience in the portfolio;

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; and

Effects of changes in credit concentrations.

We calculate an adequate allowance for the non-classified and classified portion of our loan portfolio based on an appropriate percentage loss factor that is calculated based on the above-noted elements and trends. We may add specific provisions for each impaired loan after a careful analysis of that loan's credit and collateral factors. Our analysis of an adequate allowance combines the provisions made for both our non-classified loans, classified loans, and the specific provisions made for each impaired loan.

While we believe we use the best information available to determine the allowance for loan losses, net income could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance, unforeseen market conditions arise or if we are directed to make adjustments to the allowance for loan losses by our regulators.

The following table summarizes the changes in our allowance for loan losses:

|  | <b>Three Months Ended March 31,</b> |             |
|--|-------------------------------------|-------------|
|  | <b>2008</b>                         | <b>2007</b> |
|  | <b>(Dollars in thousands)</b>       |             |
| Total loans outstanding at end of period(1)      | \$ 777,195                          | \$ 765,510  |
| Average total loans outstanding during period(1) | 775,838                             | 747,667     |
| Allowance balance at beginning of period         | 10,374                              | 10,105      |
| Provision for loan losses                        | 360                                 | 180         |
| Charge offs:                                     |                                     |             |
| Real estate                                      |                                     |             |
| Commercial                                       |                                     | (180)       |
| Agriculture                                      | (26)                                |             |
| Consumer   | (25)                                | (27)        |
| Total charge offs                                | (51)                                | (207)       |

|   |           |           |
|---|-----------|-----------|
| Recoveries:   |           |           |
| Real estate   |           |           |
| Commercial  |           | 1         |
| Agriculture   |           |           |
| Consumer  | 7         | 7         |
| Total recoveries  | 7         | 8         |
| Net charge offs   | (44)      | (199)     |
| Allowance balance at end of period                                  | \$ 10,690 | \$ 10,086 |
| Allowance for loan losses to loans                                  | 1.38%     | 1.32%     |
| Ratio of net charge offs during period to average loans outstanding | (0.01)%   | (0.03)%   |

(1) Includes loans held for sale

While pursuing our growth strategy, we continue to employ prudent underwriting and sound monitoring procedures to maintain asset quality. The allowance for loan losses at March 31, 2008 increased by \$316,000 to \$10.7 million from \$10.4 million at December 31, 2007. Based on management's assessment of loan quality, the Company believes that its allowance for loan losses is at an appropriate level under current economic conditions.



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### **Liquidity and Sources of Funds**

Our primary sources of funds are customer and local government deposits, loan repayments, loan sales, interest earned on and proceeds from investment securities, and advances from the Federal Home Loan Bank (FHLB) of Seattle. These funds, together with retained earnings, equity, and other borrowed funds, are used to make loans, acquire investment securities and other assets, and fund continuing operations. While maturities and scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by the level of interest rates, economic conditions, and competition.

We must 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, 2008, cash and cash equivalents totaled \$39.9 million, and investment securities classified as either available for sale or held to maturity with maturities of one year or less amounted to \$3.4 million, or 0.4% of total assets. At March 31, 2008, our banks maintained a credit facility with the FHLB of Seattle for \$89.7 million, with \$2.0 million in FHLB borrowings as of March 31, 2008.

### **Capital**

Stockholders' equity at March 31, 2008 was \$86.8 million compared with \$85.0 million at December 31, 2007. During the three months ended March 31, 2008, we declared dividends of \$1.4 million, realized income of \$2.7 million, recorded \$167,000 in unrealized gains on securities available for sale, net of tax, and realized the effects of exercising stock options, stock option compensation and earned ESOP and restricted stock shares totaling \$400,000.

Banking regulations require bank holding companies and banks to maintain a minimum leverage ratio of core capital to adjusted quarterly average total assets of at least 3%. Our leverage ratio was 8.5% at March 31, 2008 compared to 8.2% at December 31, 2007. In addition, banking regulators have adopted risk-based capital guidelines, under which risk percentages are assigned to various categories of assets and off-balance sheet items to calculate a risk-adjusted capital ratio. Tier I capital generally consists of common shareholders' equity, while Tier II capital includes the allowance for loan losses, subject to certain limitations. Regulatory minimum risk-based capital guidelines require Tier I capital of 4% of risk-adjusted assets and total capital (combined Tier I and Tier II) of 8%. Our Tier I and total risk based capital ratios were 9.6% and 10.9%, respectively, at March 31, 2008 compared with 9.5% and 10.7%, respectively, at December 31, 2007.

During 1992, the FDIC published the qualifications necessary to be classified as a well-capitalized bank, primarily for assignment of FDIC insurance premium rates beginning in 1993. To qualify as well-capitalized, banks must have a Tier I risk based capital ratio of at least 6%, a total risk based capital ratio of at least 10%, and a leverage ratio of at least 5%. Heritage Bank and Central Valley Bank qualified as well-capitalized at March 31, 2008.

### **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 our most recent year-end at December 31, 2007.

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 risk with foreign currency exchange rate risk or commodity price risk.

### **ITEM 4. Controls and Procedures**

(a) Evaluation of disclosure controls and procedures. We maintain controls and procedures designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 are recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those controls and procedures, the Chief Executive and Chief Financial officers of the Company concluded that the Company's disclosure controls and procedures were adequate as of March 31, 2008.

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(b) Changes in internal control over financial reporting. We made no changes in our internal controls over financial reporting that occurred during the Company's quarter ended March 31, 2008, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

None

**Item 1A. Risk Factors**

There have been no material changes from the risk factors as previously disclosed in Item 1A to Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The Company has had various stock repurchase programs since March 1999. In August 2005, the Board of Directors approved a new stock repurchase plan, allowing the Company to repurchase up to 5% of the then outstanding shares, or approximately 295,000 shares over a period of eighteen months. This marked the Company's eighth stock repurchase plan. On January 25, 2006, the Board of Directors authorized an eighteen month extension to this program. On July 25, 2007, the Board of Directors authorized an additional eighteen month extension to this program. During the quarter ended March 31, 2008, the Company did not repurchase additional shares. In total, the Company has repurchased 169,650 shares at an average price of \$22.09 under this plan.

The following table sets forth information about the Company's purchases of its outstanding common stock during the quarter ended March 31, 2008.

| Period                               | Total Number of Shares Purchased | Average Price Paid Per Share | 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, 2008 - January 31, 2008   |                                  | \$                           | 6,017,616  | 140,100  |
| February 1, 2008 - February 29, 2008 |                                  | \$                           | 6,017,616  | 140,100  |
| March 1, 2008 - March 31, 2008       |                                  | \$                           | 6,017,616  | 140,100  |
| Total                                |                                  | \$                           | 6,017,616  | 140,100  |

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

**Exhibit  
No.**

- 3.1 Articles of Incorporation of the Company (1)
- 3.2 Bylaws of the Company (9)
- 10.1 1998 Stock Option and Restricted Stock Award Plan (2)
- 10.6 1997 Stock Option and Restricted Stock Award Plan (3)
- 10.10 2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (4)
- 10.12 2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (6)
- 10.13 Employment Agreement between the Company and Brian L. Vance, effective October 1, 2006 as amended and restated in February 2007 (7)

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- 10.14 Employment Agreement between Central Valley Bank and D. Michael Broadhead, effective April 1, 2007 (7)
  - 10.15 Severance Agreement between Heritage Bank and Edward Cameron, effective April 1, 2007 (7)
  - 10.16 Severance Agreement between Heritage Bank and Gregory D. Patjens, effective April 1, 2007 (7)
  - 10.17 Severance Agreement between Heritage Bank and Donald J. Hinson, effective August 1, 2007 (8)
  - 14.0 Code of Ethics (5)
  - 31.0 Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
  - 32.0 Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 
- (1) Incorporated by reference to the Registration Statement on Form S-1 (Reg. No. 333-35573) declared effective on November 12, 1997.
  - (2) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-71415).
  - (3) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-57513).
  - (4) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-88980; 333-88982; 333-88976).
  - (5) Incorporated by reference to the Annual Report on Form 10-K dated March 8, 2004.
  - (6) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-134473; 333-134474; 333-134475).
  - (7) Incorporated by reference to the Quarterly Report on Form 10-Q dated May 1, 2007.
  - (8) Incorporated by reference to the Quarterly Report on Form 10-Q dated November 2, 2007.
  - (9) Incorporated by reference to the Current Report on Form 8-K dated November 29, 2007.

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**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.

Date: May 5, 2008

HERITAGE FINANCIAL CORPORATION

/s/ Brian L. Vance  
Brian L. Vance  
President and Chief Executive Officer

(Duly Authorized Officer)

/s/ Donald J. Hinson  
Donald J. Hinson  
Senior Vice President and Chief Financial Officer

(Principal Financial and Accounting Officer)