HERITAGE FINANCIAL CORP /WA/
Form 10-K
March 05, 2007
Table of Contents

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K

x **Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the fiscal year ended December 31, 2006

¨ **Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**
Commission File No. 0-29480

HERITAGE FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Washington	**91-1857900**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**

201 Fifth Avenue SW, Olympia, Washington 98501

(Address of principal executive offices, including zip code)

Registrant s telephone number, including area code: (360) 943-1500

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, no par value per share

(Title of class)

Indicate by check mark if the registrant is a well-seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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 x Non-accelerated filer ¨

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

The aggregate market value of the voting stock held by non-affiliates of the registrant was $138,585,618 and was based upon the last sales price as quoted on the NASDAQ Stock Market for June 30, 2006.

The Registrant had 6,566,755 shares of common stock outstanding as of February 9, 2007.

DOCUMENTS TO BE INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement expected to be dated March 22, 2007 for the 2007 Annual Meeting of Stockholders will be incorporated by reference into Part III of this Form 10-K.

Table of Contents

HERITAGE FINANCIAL CORPORATION

FORM 10-K

December 31, 2006

TABLE OF CONTENTS

2

Table of Contents

PART I

ITEM 1. BUSINESS

General

Heritage Financial Corporation (Company) is a bank holding company 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 (Conversion).

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. Heritage Bank is a Washington state-chartered commercial bank whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) under the Deposit Insurance Fund (DIF). During 2004, Heritage Bank changed its charter from a savings bank to a commercial bank. 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. Central Valley Bank is a Washington state-chartered commercial bank whose deposits are insured by the FDIC under the DIF. During 2005, Central Valley Bank changed its charter from a nationally-chartered commercial bank to a state-chartered commercial bank. Central Valley Bank conducts business from its main office in Toppenish, Washington, and its five branch offices located in Yakima and Kittitas Counties. In June 2006, the Company completed the acquisition of Western Washington Bancorp (WWB) and its wholly owned subsidiary, Washington State Bank, N.A. Washington State Bank, N.A. was mergered into Heritage Bank on the date of acquisition.

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 State. We also make residential construction, income property, and consumer loans.

Market Areas

We offer financial services to meet the needs of the communities we serve through our community-oriented financial institutions. Headquartered in Olympia, Thurston County, Washington, we conduct business through Heritage Bank and Central Valley Bank. Heritage Bank has fourteen full service offices, with seven in Pierce County, five in Thurston County, one in Mason County and one in south King County. Heritage Bank has mortgage origination offices in Thurston County, Mason County and Pierce County, which all operate within banking offices. The mortgage loan operations are performed in one office located in Thurston County. Central Valley Bank operates six full service offices, with five in Yakima County and one in Kittitas County.

Lending Activities

General. Our lending activities are conducted through Heritage Bank and Central Valley Bank. We offer commercial, real estate, income property, agricultural, and consumer loans. Our focus is on commercial lending with commercial loans increasing in the recent year to $440.5 million, or 58.8% of total loans, as of December 31, 2006 from $359.8 million, or 55.2% of total loans, as of December 31, 2005. We continue to provide real estate mortgages, both single and multifamily residential and commercial. Real estate mortgages increased to $231.8 million, or 30.9% of total loans, at December 31, 2006, from $217.9 million, or 33.4% of total loans, at December 31, 2005.

Our overall lending operations are guided by loan policies, which are reviewed and approved annually by our board of directors. These policies outline the basic policies and procedures by which lending operations are conducted. The policies address the types of loans, underwriting and collateral requirements, terms, interest rate and yield considerations, compliance with laws and regulations, and compliance with internal lending limits. We

Table of Contents

supplement our own supervision of the loan underwriting and approval process with periodic loan audits by experienced external loan specialists who review credit quality, loan documentation, and compliance with laws and regulations.

The following table provides information about our loan portfolio by type of loan for the dates indicated. These balances are prior to deduction for the allowance for loan losses.

	At December 31,									
	2006		2005		2004		2003		2002	
	Balance (3)	% of Total	Balance	% of Total	Balance	% of Total	Balance	% of Total	Balance	% of Total
	(Dollars in thousands)									
Commercial	$ 440,450	58.75%	$ 359,808	55.16%	$ 336,227	56.06%	$ 266,252	51.06%	$ 243,872	51.86%
Real Estate Mortgages										
One-four family residential(1)	58,911	7.86	53,098	8.14	58,903	9.82	57,377	11.00	72,846	15.49
Five or more family residential and commercial properties	172,937	23.07	164,788	25.26	152,958	25.50	149,728	28.72	114,750	24.40
Total real estate mortgages	231,848	30.93	217,886	33.40	211,861	35.32	207,105	39.72	187,596	39.89
Real estate construction										
One-four family residential	53,298	7.11	42,245	6.48	23,266	3.88	19,881	3.81	29,201	6.21
Five or more family residential and commercial properties	13,532	1.80	21,355	3.27	17,121	2.85	19,570	3.75	3,169	0.67
Total real estate construction(2)	66,830	8.91	63,600	9.75	40,387	6.73	39,451	7.56	32,370	6.88
Consumer	12,976	1.73	12,855	1.97	13,045	2.18	10,043	1.93	7,616	1.62
Gross loans	752,104	100.32%	654,149	100.28%	601,520	100.29%	522,851	100.27%	471,454	100.25%
Less deferred loan fees and other	(2,403)	(0.32)	(1,852)	(0.28)	(1,759)	(0.29)	(1,438)	(0.27)	(1,190)	(0.25)
Total loans receivable and loans held for sale	$ 749,701	100.00%	$ 652,297	100.00%	$ 599,761	100.00%	$ 521,413	100.00%	$ 470,264	100.00%

(1) Includes loans held for sale of $0, $263, $381, $1,018, and $8,113 as of December 31, 2006, 2005, 2004, 2003, and 2002, respectively.
(2) Balances are net of undisbursed loan proceeds.
(3) The June 2006 acquisition of WWB included $41.5 million in total loans.

The following table presents at December 31, 2006 (i) the aggregate maturities of loans in the named categories of our loan portfolio and (ii) the aggregate amounts of fixed rate and variable or adjustable rate loans in the named categories that mature after one year.

	Maturing			
	Within 1 year	1-5 years	After 5 years	Total
	(Dollars in thousands)			
Commercial	$ 164,517	$ 119,533	$ 156,400	$ 440,450
Real estate construction	55,111	10,250	1,469	66,830
Total	$ 219,628	$ 129,783	$ 157,869	$ 507,280
Fixed rate loans		$ 60,539	$ 48,114	$ 108,653
Variable or adjustable rate loans		69,244	109,754	178,998
Total		$ 129,783	$ 157,868	$ 287,651

4

Real Estate Lending

Single-Family Residential Real Estate Lending. The majority of our one to four family residential loans are secured by single-family residences located in our primary market areas. Our underwriting standards require that single-family portfolio loans generally are owner-occupied and do not exceed 80% (90% with private mortgage insurance) of the appraised value at origination or cost, whichever is lower, of the underlying collateral. Terms typically range from 15 to 30 years. We offer both fixed rate mortgages and adjustable rate mortgages (ARMs) with repricing based on a Treasury Bill or other index. However, our ability to generate volume in ARMs is largely a function of consumer preference and the interest rate environment. Under our current policy we do not originate ARMs with discounted initial interest rates (*i.e.*, teasers). We generally sell all government guaranteed mortgages, both fixed rate and adjustable rate. Management determines to what extent we will retain or sell other ARMs and other fixed rate mortgages in their strategy to control our interest rate sensitivity position. See Management s Discussion and Analysis of Financial Condition and Results of Operations Asset/Liability Management .

Multifamily and Commercial Real Estate Lending. We originate, on a selective basis, multifamily and commercial real estate loans in our primary market areas. Commercial real estate loans are made for small shopping centers, warehouses, and professional offices. Cash flow coverage to debt servicing requirements is generally 1.2 times or more. Our underwriting standards generally require that the loan-to-value ratio for multifamily and commercial real estate loans not exceed 80% of appraised value at origination or cost, whichever is lower.

Multifamily and commercial real estate mortgage lending affords our banks an opportunity to receive interest at rates higher than those generally available from single-family residential lending. However, loans secured by such properties usually are greater in amount, more difficult to evaluate and monitor and, therefore, involve a greater degree of risk than single-family residential mortgage loans. Because payments on loans secured by multifamily and commercial real estate properties are often dependent on the successful operation and management of the properties, repayment of these loans may be affected by adverse conditions in the real estate market or the economy. We seek to minimize these risks by strictly scrutinizing the financial condition of the borrower, the quality of the collateral, and the management of the property securing the loan. We also generally obtain personal guarantees from financially capable borrowers based on a review of personal financial statements.

Construction Loans. We originate single-family residential construction loans for the construction of custom homes (where the home buyer is the borrower) and provide financing to builders for the construction of pre-sold homes and speculative residential construction (i.e. built before a buyer is identified). We lend to builders who have demonstrated a favorable record of performance and profitable operations and who are building in markets that management understands and is comfortable with existing economic conditions. We further endeavor to limit our construction lending risk through adherence to strict underwriting procedures. Loans to one builder are generally limited on a case-by-case basis with unsold home limits based on builder strengths. Our underwriting standards require that the loan-to-value ratio for pre-sold homes and speculative residential construction generally not exceed 80% of appraised value or builder s cost, whichever is less. Speculative construction and land development loans are short term in nature and priced with a variable rate of interest using the prime rate as the index. We generally require builders to have some tangible form of equity in each construction project. Also, we require prompt and thorough documentation of all draw requests and we inspect the project prior to paying any draw requests from builders.

Construction lending affords us the opportunity to achieve higher interest rates and fees with shorter terms to maturity than does our single-family permanent mortgage lending. However, construction lending is considered to involve a higher degree of risk than single-family permanent mortgage lending because of the inherent difficulty in estimating both a property s value at completion of the project and the estimated costs of the project. As a result, these loans are generally more difficult to evaluate and monitor. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, we may be confronted with a project whose value is insufficient to ensure full repayment. Projects may also be jeopardized by disagreements between buyers and builders, and the failure of builders to pay subcontractors. Loans to builders to construct homes for which no purchaser has been identified carry more risk because the liquidation of the loan depends on the builder s ability to sell the property.

Commercial Business Lending

We offer commercial loans to sole proprietorships, partnerships, and corporations with an emphasis on real estate related industries and businesses in agricultural, health care, legal, and other professions. The types of commercial loans offered are business lines of credit secured primarily by real estate, accounts receivable and inventory financing, business term loans secured by real estate for either working capital or lot acquisition, Small Business Administration (SBA) loans, and unsecured business loans.

Commercial business lending generally involves greater risk than residential mortgage lending and these risks differ from those associated with residential and commercial real estate lending. Commercial real estate lending is considered to be collateral based lending with loan amounts based on predetermined loan to collateral values, where liquidation of the underlying real estate collateral is viewed as the primary source of repayment if the borrower defaults. Although our commercial business loans are often collateralized by real estate, the decision to grant a commercial business loan depends primarily on the creditworthiness and cash flow of the borrower (and any guarantors), while liquidation of collateral is a secondary source of repayment.

As of December 31, 2006, we had $440.5 million, or 58.8% of our total loans receivable, in commercial loans. The average loan size is approximately $330,000 with loans generally in amounts of $1,000,000 or less.

Origination and Sales of Loans

We originate real estate and other loans with the majority of the residential mortgage volumes generated from our mortgage loan origination offices. Walk-in customers and referrals from real estate brokers are important sources of loan originations.

Consistent with our asset/liability management strategy, we sell a significant portion of our fixed rate and ARM residential mortgage loans to the secondary market. Commitments to sell mortgage loans generally are made during the period between the taking of the loan application and the closing of the mortgage loan. The timing for making these sale commitments is dependent upon the timing of the borrower s election to lock-in the mortgage interest rate and fees prior to loan closing. Most of these sale commitments are made on a best efforts basis whereby we are only obligated to sell the mortgage if the mortgage loan is approved and closed. As a result, management believes that market risk is minimal. In addition, we have mortgage loan production which is brokered to other lenders prior to funding.

When we sell mortgage loans, we typically sell the servicing of the loans (i.e., collection of principal and interest payments). However, we serviced $0.5 million, $0.7 million, and $0.9 million in mortgage loans for others as of December 31, 2006, 2005, and 2004, respectively. We received fee income for servicing activities on mortgage loans of $2,000, $4,000, and $10,000 for the years ended December 31, 2006, 2005, and 2004, respectively.

The following table presents summary information concerning our origination and sale of residential mortgage loans and the gains achieved on such activities.

	Years ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Residential mortgage loans:					
Originated	$ 19,600	$ 25,097	$ 52,188	$ 125,438	$ 91,614
Sold	8,856	13,632	35,822	105,790	74,318
Gains on sales of loans, net	$ 133	$ 277	$ 640	$ 1,907	$ 1,404

Table of Contents

Commitments and Contingent Liabilities

In the ordinary course of business, we enter into various types of transactions that include commitments to extend credit that are not included in our consolidated financial statements. We apply the same credit standards to these commitments as we use in all our lending activities and have included these commitments in our lending risk evaluations. Our exposure to credit loss under commitments to extend credit is represented by the amount of these commitments. At December 31, 2006, we had outstanding commitments to extend credit, including letters of credit, in the amount of $209.9 million.

Delinquencies and Nonperforming Assets

Delinquency Procedures. We send a borrower a delinquency notice 15 days after the due date when the borrower fails to make a required payment on a loan. If the delinquency is not brought current, additional delinquency notices are mailed at 30 and 45 days for commercial loans. Additional written and oral contacts are made with the borrower between 60 and 90 days after the due date.

If a real estate loan payment is past due for 45 days or more, the collection manager may perform a review of the condition of the property if suspect. We may negotiate and accept a repayment program with the borrower, accept a voluntary deed in lieu of foreclosure or, when considered necessary, begin foreclosure proceedings. If foreclosed on, real property is sold at a public sale and we bid on the property to protect our interest. A decision as to whether and when to begin foreclosure proceedings is based on such factors as the amount of the outstanding loan in relation to the value of the property securing the original indebtedness, the extent of the delinquency, and the borrower s ability and willingness to cooperate in resolving the delinquency.

Real estate acquired by us is classified as real estate owned until it is sold. When property is acquired, it is recorded at the lower of cost or estimated fair value at the date of acquisition, not to exceed net realizable value, and any resulting write-down is charged to the allowance for loan losses. Upon acquisition, all costs incurred in maintaining the property are expensed. Costs relating to the development and improvement of the property, however, are capitalized to the extent of the property s net realizable value.

We consider loans as an in-substance foreclosure if the borrower has little or no equity in the property based upon its estimated fair value, repayment can be expected only from operation or sale of the collateral, the borrower has effectively abandoned control of the collateral, or it is doubtful the borrower will be able to repay the loan in the foreseeable future because of the borrower s current financial status. In-substance foreclosures are accounted for as if the properties were held as real estate owned .

Delinquencies in the commercial business loan portfolio are handled on a case-by-case basis. Generally, notices are sent and personal contact is made with the borrower when the loan is 15 days past due. Loan officers are responsible for collecting loans they originate or which are assigned to them. Depending on the nature of the loan and the type of collateral securing the loan, we may negotiate and accept a modified payment program or take other actions as circumstances warrant.

Classification of Assets. Federal regulations require that our banks periodically evaluate the risk inherent in their loan portfolio. In addition, the Division of Banks of the Washington State Department of Financial Institutions (Division) and the FDIC have authority to identify problem assets and, if appropriate, require them to be classified by risk. There are three classifications for problem assets: Substandard, Doubtful, and Loss. Substandard assets have one or more defined weaknesses and are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of Substandard assets, with the additional characteristics that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values questionable. There is a high possibility of loss in assets classified as Doubtful. An asset classified as Loss is considered uncollectible and of such little value that continuance as an asset of the institution is not warranted. If an asset or a portion of the asset is classified as Loss, the institution must charge off this amount. We also have assets we classify as Watch and other assets especially mentioned (OAEM). Assets classified as watch are performing assets but have elements of risk that require more monitoring than other performing assets. Assets classified as OAEM are assets that continue to perform but have shown deterioration in credit quality and require close monitoring.

Nonperforming Assets. Nonperforming assets consist of nonaccrual loans, restructured loans, and real estate owned. The following table provides information about our nonaccrual loans, restructured loans, and real estate owned for the indicated dates.

	At December 31,				
	2006	**2005**	**2004**	**2003**	**2002**
			(Dollars in thousands)		
Nonaccrual loans	$ 2,807	$ 836	$ 319	$ 297	$ 1,987
Real estate and other assets owned	225	371		389	296
Total nonperforming assets	$ 3,032	$ 1,207	$ 319	$ 686	$ 2,283
Accruing loans past due 90 days or more	$	$	$	$ 19	$ 19
Potential problem loans	$ 5,509	$ 9,882	$ 12,184	$ 10,502	$ 11,261
Allowance for loan losses	$ 10,105	$ 8,496	$ 8,295	$ 7,748	$ 6,874
Nonperforming loans to loans	0.37%	0.13%	0.05%	0.06%	0.42%
Allowance for loan losses to loans	1.35%	1.30%	1.38%	1.49%	1.46%
Allowance for loan losses to nonperforming loans	360.05%	1,016.27%	2,603.60%	2,611.97%	346.05%
Nonperforming assets to total assets	0.36%	0.16%	0.05%	0.11%	0.38%

Nonaccrual Loans. Our financial statements are prepared on the accrual basis of accounting, including the recognition of interest income on our loan portfolio, unless a loan is placed on nonaccrual. Loans are considered to be impaired and are placed on nonaccrual when there are serious doubts about the collectibility of principal or interest. Our policy is to place a loan on nonaccrual when the loan becomes past due for 90 days or more, is less than fully collateralized, and is not in the process of collection. Amounts received on nonaccrual loans generally are applied first to principal and then to interest only after all principal has been collected.

Potential Problem Loans. 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. As of December 31, 2006, potential problem loans decreased by $4.4 million to $5.5 million from $9.9 million at December 31, 2005.

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.

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

Risk rating of the credit portfolio;

Levels and trends in delinquencies and nonaccruals;

Trends in loan demand and structure including terms and interest rates;

National and local economic trends;

Specific industry conditions such as commercial and residential construction;

Concentrations of credits in specific industries;

Table of Contents

Bank regulatory examination results and our own credit examinations; and

Recent loss experience in the portfolio.

We calculate an adequate allowance for the non-classified portion of our loan portfolio based on an appropriate percentage lossfactor that is calculated based on the above-noted elements and trends. We may add specific provisions for each classified 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 and the specific provisions made for each classified 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 provides information regarding changes in our allowance for loan losses for the indicated periods:

	Years Ended December 31,				
	2006	**2005**	**2004**	**2003**	**2002**
			(Dollars in thousands)		
Total loans outstanding at end of period(1)	$ 749,701	$ 652,297	$ 599,761	$ 521,413	$ 470,264
Average loans outstanding during period	$ 690,287	$ 613,655	$ 549,445	$ 481,404	$ 472,785
Allowance balance at beginning of period	$ 8,496	$ 8,295	$ 7,748	$ 6,874	$ 5,751
Provision for loan losses	720	810	645	1,125	1,835
Allowance acquired through acquisition	749				
Charge-offs:					
Real estate	(3)		(41)	(138)	(69)
Commercial	(78)	(630)	(55)	(102)	(657)
Agriculture			(10)		
Consumer	(83)	(61)	(3)	(19)	(7)
Total charge-offs	(164)	(691)	(109)	(259)	(733)
Recoveries:					
Real estate	24	7	8	3	1
Commercial	255	55		4	20
Agriculture		10	3		
Consumer	25	10		1	
Total recoveries	304	82	11	8	21
Net (charge-offs) recoveries	140	(609)	(98)	(251)	(712)
Allowance balance at end of period	$ 10,105	$ 8,496	$ 8,295	$ 7,748	$ 6,874
Ratio of net (charge-offs) recoveries during period to average loans outstanding	.02%	(0.10)%	(0.02)%	(0.05)%	(0.15)%

(1) Includes loans held for sale

Table of Contents

The following table shows the allocation of the allowance for loan losses for the indicated periods. The allocation is based upon an evaluation of defined loan problems, historical loan loss ratios, and industry wide and other factors that affect loan losses in the categories shown below:

	At December 31,									
	2006		2005		2004		2003		2002	
	Amount	% of Total Loans (1)	Amount	% of Total Loans (1)	Amount	% of Total Loans (1)	Amount	% of Total Loans (1)	Amount	% of Total Loans (1)
	(Dollars in thousands)									
Commercial	$ 7,276	58.6%	$ 6,117	55.0%	$ 5,971	55.9%	$ 5,578	51.0%	$ 4,949	51.8%
Real Estate Mortgage										
One-four family residential	398	7.8%	335	8.1%	327	9.8%	305	11.0%	271	15.4%
Five or more family residential and commercial properties	1,708	23.0%	1,435	25.2%	1,402	25.4%	1,310	28.7%	1,162	24.4%
Real Estate Construction:										
One-four family residential	547	7.1%	460	6.4%	449	3.9%	419	3.7%	370	6.2%
Five or more family residential and commercial properties	41	1.8%	34	3.3%	34	2.8%	31	3.8%	28	0.6%
Consumer	138	1.7%	115	2.0%	112	2.2%	105	1.8%	94	1.6%
Total loans	$ 10,105	100.0%	$ 8,496	100.0%	$ 8,295	100.0%	$ 7,748	100.0%	$ 6,874	100.0%

(1) Represents the total of all outstanding loans in each category as a percent of total loans outstanding.

Investment Activities

At December 31, 2006, our investment securities portfolio totaled $43.0 million, which consisted of $39.1 million of securities available for sale and $3.9 million of securities held to maturity. This compares with a total portfolio of $45.8 million at December 31, 2005, which was comprised of $41.9 million of securities available for sale and $4.0 million of securities held to maturity. The composition of the two investment portfolios by type of security, at each respective date, is presented in financial statement Notes 4 and 5.

Our investment policy is established by the board of directors and monitored by the Audit and Finance Committee of the Board of Directors. It is designed primarily to provide and maintain liquidity, generate a favorable return on investments without incurring undue interest rate and credit risk, and compliments our bank s lending activities. The policy dictates the criteria for classifying securities as either available for sale or held to maturity. The policy permits investment in various types of liquid assets permissible under applicable regulations, which include U.S. Treasury obligations, U.S. Government agency obligations, some certificates of deposit of insured banks, mortgage backed and mortgage related securities, some corporate notes, municipal bonds, and federal funds. Investment in non-investment grade bonds and stripped mortgage backed securities are not permitted under the policy.

Table of Contents

The following table provides information regarding our investment securities available for sale, by contractual maturity, at December 31, 2006.

	Book Value	Fair Value	Weighted Average Yield(1)
	(Dollars in thousands)		
Obligations of US Government agencies			
Due within one year	$ 5,157	$ 5,140	4.40%
Due after 1 year but within 5 years	12,382	12,194	4.40
Due after 5 years but within 10 years	1,000	1,008	5.49
	18,539	18,342	
Mortgage backed securities			
Due within one year	11,043	10,744	3.81
Due after 1 year but within 5 years	214	212	4.12
Due after 5 years but within 10 years	20	20	5.75
Due after 10 years	2,238	2,226	5.25
	13,515	13,202	
Collateralized mortgage obligations			
Due after 1 year but within 5 years	109	109	4.75
Due after 5 years but within 10 years	1,499	1,455	3.08
Due after 10 years	6,270	6,016	4.26
	7,878	7,580	
Total all investments available for sale	$ 39,932	$ 39,124	

The following table provides information regarding our investment securities held to maturity, by contractual maturity, at December 31, 2006.

	Book Value	Fair Value	Weighted Average Yield(1)
	(Dollars in thousands)		
Obligations of US Government agencies			
Due after 5 years but within 10 years	$ 905	$ 896	4.78%
Municipal bonds			
Due within one year	100	101	6.44
Due after 1 year but within 5 years	335	339	5.98
Due after 5 years but within 10 years	1,265	1,279	5.51
	1,700	1,718	
Mortgage backed securities			
Due within one year	25	26	7.42
Due after 1 year but within 5 years	1,228	1,221	5.35
	1,253	1,247	

Total all investments held to maturity	$ 3,858	$ 3,861

(1) Taxable equivalent weighted average yield.

We held $3.2 million of FHLB stock at December 31, 2006. The stock has no contractual maturity and amounts in excess of the required minimum for FHLB membership may be redeemed at par subject to certain restrictions. At December 31, 2006, we were required to maintain an investment in the stock of the FHLB of Seattle of at least $1.5 million.

Table of Contents

Deposit Activities and Other Sources of Funds

General. Our primary sources of funds are deposits, loan repayments and borrowings. Scheduled loan repayments are a relatively stable source of funds, while deposits and unscheduled loan prepayments, which are influenced significantly by general interest rate levels, interest rates available on other investments, competition, economic conditions, and other factors are not. Our deposit balances increased by $89.4 million in 2006 over the prior year, with certificates of deposit accounts increasing slightly as a percentage of total deposits. The June 2006 acquisition of WWB included $44.3 million in deposit balances. Customer deposits remain an important source of funding, but these balances have been influenced in the past by adverse market conditions in the industry and may be affected by future developments such as interest rate fluctuations and new competitive pressures. Borrowings may be used on a short-term basis to compensate for reductions in other sources of funds (such as deposit inflows at less than projected levels). Borrowings may also be used on a longer-term basis to support expanded lending activities and match the maturity of repricing intervals of assets.

Deposit Activities. We offer a variety of deposit accounts designed to attract both short-term and long-term deposits. These accounts include certificates of deposit (CDs), regular savings accounts, money market accounts, checking and negotiable order of withdrawal (NOW) accounts, and individual retirement accounts (IRAs). These accounts generally earn interest at rates established by management based on competitive market factors and management s desire to increase or decrease certain types or maturities of deposits. At December 31, 2006, we had no brokered deposits. The more significant deposit accounts are described below.

Certificates of Deposit. We offer several types of CDs with maturities ranging from one to five years, which require a minimum deposit of $100. In addition, we offer a CD that has a maturity of three to eleven months and a minimum deposit of $2,500, and permits additional deposits at the initial rate throughout the CD term. At Heritage Bank, interest is compounded daily and credited quarterly or at maturity. At Central Valley Bank, interest is accrued daily and compounded quarterly or at maturity. Finally, negotiable CDs are offered in amounts of $100,000 or more for terms of 30 days to 12 months. The negotiable CDs pay simple interest credited at maturity.

Regular Savings Accounts. We offer savings accounts that allow for unlimited deposits and withdrawals, provided that a $100 minimum balance is maintained. At Heritage Bank, interest is compounded daily and credited quarterly. At Central Valley Bank, interest is accrued daily and compounded quarterly.

Money Market Accounts. Money market accounts pay a variable interest rate tha