

HERITAGE FINANCIAL CORP /WA/  
Form 10-K  
March 05, 2007  
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## SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

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### FORM 10-K

**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

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## HERITAGE FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Washington  
(State or other jurisdiction of  
incorporation or organization)

91-1857900  
(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)

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

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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

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 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

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

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.

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**HERITAGE FINANCIAL CORPORATION**

**FORM 10-K**

**December 31, 2006**

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**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 merged 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

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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.

	2006		2005		At December 31, 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.

	Within		Maturing After		Total
	1 year	1-5 years	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



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### **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



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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

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### **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

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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.

	2006	2005	At December 31,		
			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		