

HERITAGE

COMMERCE CORP

Company:	<u>Heritage Commerce Corp.</u>
Ticker:	HTBK
P/E:	12.49
Industry & Sector:	Banking
Industry P/E:	12.04
Current Price:	\$7.68
Target Price:	\$9.09
Buy/Hold/Sell:	HOLD

Company Summary:

Based in San Jose, CA, Heritage Commerce Corp. is the parent company of Heritage Bank of Commerce, which was established in 1994. They have approximately 19 branches scattered across Silicon Valley, as well as in Santa Clara, Alameda, Contra Costa, and San Benito counties. This company offers a range of commercial banking services to small and medium-sized businesses and their owners, managers and employees.

Industry Outlook:

Using data gathered from IBISWorld, we created a chart that shows the relationship between the 3 external drivers for regional banks. First, Aggregate household debt represents all outstanding credit market debt held by consumers, including credit card debt, mortgages, personal loans and more. This generally rises when consumers are optimistic about the economic future and vice versa. It impacts our holdings through a macro-economic effect: when household debt increases, output growth stalls, unemployment rises, and there becomes a greater probability of a future banking crisis in the form of massive default risk regardless of the mix of loans a bank has. Secondly, the Prime Rate (represented by the green line) is typically set near the federal funds rate which is the interest rate charged by banks for loaning excess funds to banks needing to meet reserve requirements. This impacts our holdings as they should have a significantly lower Net Interest Margin on their loans that will be refinanced during this time of economic distress. Meanwhile, the current prime rate is 3.25% compared to 5.00% a year ago. So, as the prime rate falls, the banking sector as a whole will end up with lower Net Income. Finally, the 30-Year fixed rate mortgage is the most common type of loan for home buying in the U.S. This is represented in all of our holdings as they all have some portion of mortgage loans outstanding. As COVID-19 took its toll on the U.S. in the first half of this year, unemployment skyrocketed leading to increased risk of default. In an attempt to save higher risk loans from default, banks have been willing to renegotiate outstanding loans with lower interest rates and delaying payments. Our forward projection shows that there will be minimal percentage change in the prime rate and 30-year conventional mortgage rate. Leading us to believe that the economic recovery from COVID-19 will rely on consumer aggregate household

debt to remain low. However, this does not mean that consumers should stop spending and save. Simply, this means that consumers should refrain from overextending credit on large purchases.

HTBK										
Fiscal year is January-December. All values USD Thousands.	2015	2016	2017	2018	2019	2020	2021	2022	2023	
Interest Income	78,743	94,431	106,911	129,845	142,659	146,796	151,053	155,434	159,941	Short Term
										2.90%
Interest and Fees on Loans	68,259	79,284	86,346	105,635	116,808	122,112	124,596	127,751	131,911	Long Term
Other Interest or Dividend Income	10,484	15,147	20,565	24,210	25,851	25,060	26,922	28,257	28,738	3.50%
Interest Income Growth		0.2	0.13	0.21	0.099					Forward PE
Total Interest Expense	2,422	3,211	5,387	7,822	10,847	7,382	8,186	9,051	9,564	11.69
Interest Expense on Bank Deposits	2,403	3,199	3,991	5,506	8,159	5,911	5,604	5,860	6,046	Cost of Equity
Other Interest Expense	19	12	1,396	2,316	2688	1,471	1,809	2,230	2,336	12.05%
Interest Expense on Debt	19	12	1,396	2,316	2688	1,471	1,809	2,230	2,336	Market Price
Total Interest Expense Growth		0.33	0.68	0.45	0.387					\$ 7.49
Net Interest Income	76,321	91,220	101,524	122,023	131,812	139,414	142,868	146,383	150,378	
Net Interest Income Growth		0.2	0.11	0.2	0.080					
Loan Loss Provision	32	1,237	99	7,421	846	2,276	2,798	3,048	3,734	
Loan Loss Provision Growth		37.66	-0.92	73.96	-0.886					
Net Interest Income after Provision	76,289	89,983	101,425	114,602	130,966	137,139	140,070	143,336	146,644	
Net Interest Inc After Loan Loss Prov Growth		0.18	0.13	0.13	0.143					
Net Interest Margin	-	-	-	0.04	0.0428					
Non-Interest Income	8,985	11,625	6,972	9,574	10,244	13,152	12,793	11,970	12,694	
Securities Gain	642	1,099	-6	266	661	776	711	517	640	
Trust Income, Commissions & Fees	3,946	4,514	4,204	4,822	5,146	6,179	6,115	6,065	6,231	
Commission & Fee Income	3,946	4,514	4,204	4,822	5,146	6,179	6,115	6,065	6,231	
Other Operating Income	3,554	5,216	1,666	3,788	3,748	5,032	4,850	4,272	4,776	
Non-Interest Expense	55,127	60,586	60,067	70,845	80,398	88,450	88,069	88,802	91,681	
Labor & Related Expense	35,146	34,660	37,564	44,511	50,754	54,705	54,066	55,351	57,108	
Equipment Expense	3,615	6,562	3,792	4,658	5,801	6,676	6,857	6,307	6,653	
Depreciation & Amortization	685	763	786	753	846	1,053	1,037	1,030	1,036	
Other Operating Expense	15,681	18,601	17,925	20,923	22,997	26,016	26,108	26,115	26,884	
Operating Income	30,147	41,022	48,330	53,331	60,812	61,840	64,794	66,503	67,657	
Operating Income Growth	-	0.33	0.16	0.06	0.06					
Operating Income Margin	-	-	-							
Unusual Expense	6,433	-	671	5,598	4,983	6,093	4,751	4,889	5,836	
Pretax Income	26,601	43,969	50,299	48,655	54,601	59,639	63,437	63,857	63,801	
Pretax Income Growth		0.65	0.14	-0.03						
Pretax Margin	-	-	-	0.35						
Income Taxes	10,104	16,588	26,471	13,324	21,307	23,592	25,254	25,723	23,843	
Income Tax - Current - Domestic	7,989	18,121	17,601	14,603	17,952	20,443	22,177	21,419	21,182	
Income Tax - Deferred - Domestic	2,115	-1,533	8,870	-1,279	3,355	3,149	3,077	4,304	2,661	
Other After Tax Income (Expense)	-	-	-	-	-3,088	-3,318	-3,414	-3,513	-3,615	
Consolidated Net Income	16,497	27,381	23,828	35,331	32,677	35,921	38,026	37,941	39,720	
Net Income	16,497	27,381	23,828	35,331	32,677	35,921	38,026	37,941	39,720	

Capex	(\$1,007)	(\$480)	(\$649)	(\$187)	(\$1,254)	(\$1,003)	(\$852)	(\$895)	(\$911)						
Depreciation	\$685	\$763	\$786	\$753	\$965	\$1,077	\$983	\$1,056	\$1,077						
Change in Noncash working capital	\$14,312	(\$2,665)	\$10,611	\$2,789	(\$5,455)	\$6,930	\$3,066	\$4,663	\$2,583						
New Debt issued	\$3,000	\$0	\$39,073	\$0	\$11,004	\$14,113	\$16,276	\$20,098	\$13,126						
Debt repayments	\$0	\$3,000	\$0	\$0	\$1,444	\$1,230	\$1,519	\$888	\$1,096						
Preferred Stock Dividends	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0						
FCFE	\$6,877	\$28,289	\$53,725	\$33,482	\$40,252	\$43,955	\$51,553	\$54,438	\$51,154						
					Valuation	\$39,226.71	\$41,057.90	\$38,691.75	\$32,446.19	TV	Price Per Share	Number of Shares	Multi-Stage valuation	% Over/Under Valuation	
As a Function of Interest Income											\$392,571.29	\$ 9.09	59,876,000	543,993,842	21.30%

Sensitivity Analysis											
		ST Growth Rate									
	\$	9.09	0.90%	1.90%	2.90%	3.90%	4.90%				
Cost of Equity	10.05%	\$	11.04	\$	11.44	\$	11.85	\$	12.26	\$	12.69
	11.05%	\$	9.60	\$	9.94	\$	10.29	\$	10.64	\$	11.01
	12.05%	\$	8.49	\$	8.79	\$	9.09	\$	9.40	\$	9.72
	13.05%	\$	7.61	\$	7.87	\$	8.14	\$	8.42	\$	8.70
	14.05%	\$	6.90	\$	7.14	\$	7.38	\$	7.62	\$	7.88