HERITAGE FINANCIAL CORP /WA/
Form 10-K
March 01, 2019
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 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, 2018 or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from __________ to __________
Commission File Number 000-29480

HERITAGE FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Washington	91-1857900
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

201 Fifth Avenue SW, Olympia, WA	98501
(Address of principal executive offices)	(Zip Code)

(360) 943-1500
(Registrant’s telephone number, including area code)
Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock	NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: None
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No ý
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 ý
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 ý No ¨
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes ý No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) 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, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer", "accelerated filer", "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act

Large accelerated filer ý	Accelerated filer ¨
Non-accelerated filer ¨	Smaller reporting company ¨
	Emerging growth company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards pursuant to Section 13(a) of the Exchange Act. ¨

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2018, based on the closing price of its common stock on such date, on the NASDAQ Global Select Market, of $34.85 per share, and 33,420,421 shares held by non-affiliates was $1,164,701,672. The registrant had 36,879,557 shares of common stock outstanding as of February 19, 2019.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for the 2019 Annual Meeting of Shareholders will be incorporated by reference into Part III of this Form 10-K.

HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
FORM 10-K
December 31, 2018
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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K ("Form 10-K") may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements often include the words “believes,” “expects,” “anticipates,” “estimates,” “forecasts,” “intends,” “plans,” “targets,” “potentially,” “probably,” “projects,” “outlook” expressions or future or conditional verbs such as “may,” “will,” “should,” “would” and “could.” These forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from the results anticipated, including:

- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel from our recent mergers with Puget Sound Bancorp, Inc., and Premier Commercial Bancorp, or may in the future acquire, into our operations and our ability to realize related revenue synergies and cost savings within expected time frames or at all, and any goodwill charges related thereto and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, which might be greater than expected;
- the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets, which may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to increase our allowance for loan losses and provision for loan losses;
- changes in general economic conditions, either nationally or in our market areas;
- changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources;
- risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar;
- fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas;
- results of examinations of us by the bank regulators, including the possibility that any such regulatory authority may, among other things, require us to increase our allowance for loan losses, write-down assets, change our regulatory capital position, affect our ability to borrow funds or maintain or increase deposits, or impose additional requirements on us, any of which could affect our ability to continue our growth through mergers, acquisitions or similar transactions and adversely affect our liquidity and earnings;
- legislative or regulatory changes that adversely affect our business including but not limited to, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act"), the Expected Credit Loss model required by the Financial Accounting Standards Board through Accounting Standard Update 2016-13 beginning with the Form 10-Q as of the first quarter of 2020, and implementing regulations, changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules as a result of Basel III;
- our ability to control operating costs and expenses;
- increases in premiums for deposit insurance;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;
- disruptions, security breaches, or other adverse events, failures or interruptions in, or attacks on, our information technology systems or on the third-party vendors who perform several of our critical processing functions;
- our ability to retain key members of our senior management team;
- costs and effects of litigation, including settlements and judgments;
- our ability to implement our growth strategies;
- increased competitive pressures among financial service companies;
- changes in consumer spending, borrowing and savings habits;
- the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions;

- adverse changes in the securities markets;
- inability of key third-party providers to perform their obligations to us;
- changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board ("FASB"), including additional guidance and

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interpretation on accounting issues and details of the implementation of new accounting methods; and

- other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and the other risks described elsewhere in this Form 10-K.

Some of these and other factors are discussed in this Form 10-K under the caption Item 1A. Risk Factors and elsewhere in this Form 10-K. Such developments could have a material adverse impact on our business, financial position and results of operations.

We caution readers not to place undue reliance on any forward-looking statements on any forward-looking statements discussed in this Form 10-K. Moreover, you should treat these statements as speaking only as of the date they are made and based only on information then actually known to us. We do not undertake and specifically disclaim any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements. These risks could cause our actual results for future periods to differ materially from those expressed in any forward-looking statements by, or on behalf of, us, and could negatively affect our operating results and stock price performance.

As used throughout this report, the terms “we”, “our”, “us”, “Heritage” or the “Company” refers to Heritage Financial Corporation and its consolidated subsidiaries, unless the context otherwise requires.

PART I

ITEM 1. BUSINESS

General

Heritage Financial Corporation is a bank holding company that was incorporated in the State of Washington in August 1997. We are primarily engaged in the business of planning, directing, and coordinating the business activities of our wholly owned subsidiary, Heritage Bank (the "Bank"). The deposits of the Bank are insured by the Federal Deposit Insurance Corporation (“FDIC").

Heritage Bank is headquartered in Olympia, Washington and conducts business from its 64 branch offices located primarily along the I-5 corridor in the western Washington and the greater Portland, Oregon area. We additionally have offices located in central Washington, primarily in Yakima County.

Our business consists primarily of commercial lending and deposit relationships with small and medium sized businesses and their owners in our market areas, and attracting deposits from the general public. We also make real estate construction and land development loans and consumer loans. The Bank also originates for sale or investment purposes one-to-four family residential loans on residential properties located primarily in our market.

Business Strategy

Our business strategy is to be a community bank, seeking deposits from our communities and making loans to customers with local ties to our markets. We believe we have an innovative team providing financial services and focusing on the success of our customers. We are committed to being the leading community bank in the Pacific Northwest by continuously improving customer satisfaction, employee empowerment, community investment and shareholder value. Our commitment defines our relationships, sets expectations for our actions and directs decision-making in these four fundamental areas. We will seek to achieve our business goals through the following strategies:

Expand geographically as opportunities present themselves. We are committed to continuing the controlled expansion of our franchise through strategic acquisitions designed to increase our market share and enhance franchise value. We believe that consolidation across the community bank landscape will continue to take place and further believe that, with our capital and liquidity positions, our approach to credit management, and our extensive acquisition experience, we are well-positioned to take advantage of acquisitions or other business opportunities in our market areas. In markets where we wish to enter or expand our business, we will also consider opening de novo branches. In the past, we have successfully integrated acquired institutions and opened de novo branches. We will continue to be disciplined and opportunistic as it pertains to future acquisitions and de novo branching, focusing on the Pacific Northwest markets we know and understand.

Focus on Asset Quality. A strong credit culture is a high priority for us. We have a well-developed credit approval structure that has enabled us to maintain a standard of asset quality that we believe is conservative while at the same time allowing us to achieve our lending objectives. We will continue to focus on loan types and markets that we know well and where we have a historical record of success. We focus on loan relationships that are well-diversified in both size and industry types. With respect to commercial business lending, which is our predominant lending activity,

we view ourselves as cash-flow lenders obtaining additional support from realistic collateral values, personal guarantees and other secondary sources of repayment. We have a problem loan resolution process that is focused on quick detection and implementing feasible solutions. We seek to maintain strong internal controls and subject our loans to periodic internal loan reviews.

Maintain Strong Balance Sheet. In addition to our focus on underwriting, we believe that the strength of our balance sheet provides us with the flexibility to manage through a variety of scenarios including additional growth-related activities. As of December 31, 2018, the ratio of our allowance for loan losses to loans receivable, net was 0.96% and the ratio of the allowance for loan losses to nonperforming loans was 255.73%. Our liquidity position was also strong, with $161.9 million in cash and cash equivalents as of December 31, 2018. As of December 31, 2018, the regulatory capital ratios of our subsidiary bank were well in excess of the levels required for "well-capitalized" status, and our consolidated common equity tier 1 capital to risk-weighted assets, total risk-based capital, Tier 1 risk-based capital and leverage capital ratios were 11.7%, 12.9% 12.1% and 10.5%, respectively.

Deposit Growth. Our strategic focus is to continuously grow deposits with emphasis on total relationship banking with our business and retail customers. We continue to seek to increase our market share in the communities we serve by providing exceptional customer service, focusing on relationship development with local businesses and strategic branch expansion. Our primary focus is to maintain a high level of non-maturity deposits to internally fund our loan growth with a low reliance on maturity (certificate) deposits. At December 31, 2018, our non-maturity deposits were 89.5% of our total deposits. Our technology-based products, including on-line personal financial management, business cash management and business remote deposit products enable us to compete effectively with banks of all sizes. Our retail and commercial management teams are well-seasoned and have strong ties to the communities we serve with a strong focus on relationship building and customer service.

Emphasize business relationships with a focus on commercial lending. We will continue to market primarily commercial business loans and the deposit balances that accompany these relationships. Our seasoned lending staff has extensive knowledge and can add value through a focused advisory role that we believe strengthens our customer relationships and develops loyalty. We currently have and will seek to maintain a diversified portfolio of lending relationships without significant concentrations in any industry.

Recruit and retain highly competent personnel to execute our strategies. Our compensation and staff development programs are aligned with our strategies to grow our loans and core deposits while maintaining our focus on asset quality. Our incentive systems are designed to achieve balanced, high quality asset growth while maintaining appropriate mechanisms to reduce or eliminate incentive payments when appropriate. Our equity compensation programs and retirement benefits are designed to build and encourage employee ownership at all levels of the Company and we align employee performance objectives with corporate growth strategies and shareholder value. We have a strong corporate culture, which is supported by our commitment to internal development and promotion from within as well as the retention of management and officers in key roles.

History

Heritage Bank celebrated its 90th anniversary during 2017. The Bank was established in 1927 as a federally-charted mutual savings bank. In 1992, the Bank converted to a state-charted mutual savings bank under the name Heritage Savings Bank. Through the mutual holding company reorganization of the Bank and the subsequent conversion of the mutual holding company, the Bank became a stock savings bank and a wholly-owned subsidiary of the Company effective August 1997. 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.

The Company acquired North Pacific Bancorporation in June 1998 and Washington Independent Bancshares and its wholly-owned subsidiary, Central Valley Bank, in March 1999. In June 2006, the Company completed the acquisition of Western Washington Bancorp and its wholly owned subsidiary, Washington State Bank, N.A., at which time Washington State Bank, N.A. was merged into Heritage Bank.

Effective July 30, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Cowlitz Bank, a Washington state-chartered

commercial bank headquartered in Longview, Washington. The acquisition included nine branches of Cowlitz Bank, including its division Bay Bank, which opened as branches of Heritage Bank on August 2, 2010. The acquisition also included the Trust Services Division of Cowlitz Bank.

Effective November 5, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Pierce Commercial Bank, a Washington state-chartered commercial bank headquartered in Tacoma, Washington. The acquisition included one branch, which opened as a branch of Heritage Bank on November 8, 2010.

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On September 14, 2012, the Company announced that it had entered into a definitive agreement along with Heritage Bank, to acquire Northwest Commercial Bank, a full-service commercial bank headquartered in Lakewood, Washington that operated two branch locations in Washington State. The acquisition was completed on January 9, 2013, at which time Northwest Commercial Bank was merged with and into Heritage Bank.

On March 11, 2013, the Company entered into a definitive agreement to acquire Valley Community Bancshares, Inc. and its wholly-owned subsidiary, Valley Bank, both headquartered in Puyallup, Washington, and its eight branches. The acquisition was completed on July 15, 2013.

On April 8, 2013, the Company announced its intent to merge two of its wholly-owned bank subsidiaries, Central Valley Bank and Heritage Bank, with Central Valley Bank merging into Heritage Bank. The common control merger was completed on June 19, 2013. Central Valley Bank operated as a division of Heritage Bank until September 2018 at which time the five Central Valley Bank branches were renamed to Heritage Bank branches.

On October 23, 2013, the Company, the Bank, Washington Banking Company and its wholly-owned subsidiary bank, Whidbey Island Bank, jointly announced the signing of a definitive merger agreement pursuant to which Heritage and Washington Banking Company entered into a strategic merger with Washington Banking Company merging into Heritage ("Washington Banking Merger"). Washington Banking Company branches adopted the Heritage Bank name in all markets, with the exception of six branches in Whidbey Island markets which continue to operate using the Whidbey Island Bank name, as a division of Heritage Bank. The Washington Banking Merger was completed on May 1, 2014.

On July 26, 2017, the Company announced the execution of a definitive agreement to purchase Puget Sound Bancorp, Inc., ("Puget Sound"), the holding company of Puget Sound Bank, a one-branch business bank headquartered in Bellevue, Washington (the "Puget Sound Merger"). The Puget Sound Merger was completed on January 16, 2018.

On March 8, 2018, the Company announced the signing of a definitive agreement to purchase Premier Commercial Bancorp ("Premier Commercial"), the holding company for Premier Community Bank, both of Hillsboro, Oregon, and its six branches (the "Premier Merger"). The Premier Merger was completed on July 2, 2018.

For additional information regarding the Puget Sound Merger and Premier Merger (collectively the "Premier and Puget Mergers"), see Note (2) Business Combinations of the Notes to Consolidated Financial Statements included in Item 8. Financial Statements And Supplementary Data.

Retail Banking

We offer a full range of products and services to customers for personal and business banking needs designed to attract both short-term and long-term deposits. Deposits are our primary source of funds. Our personal and business banking customers have the option of selecting from a variety of accounts. The major categories of deposit accounts that we offer are described below. These accounts, with the exception of noninterest demand 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.

Noninterest Demand Deposits. Deposits are noninterest bearing and may be charged service fees based on activity and balances.

Interest Bearing Demand Deposits. Deposits are interest bearing and may be charged service fees based on activity and balances. Interest bearing demand deposits pay interest, but require a higher minimum balance to avoid service charges.

Money Market Accounts. Deposits pay an interest rate that is tiered depending on the balance maintained in the account. Minimum opening balances vary.

Savings Accounts. Deposits are interest bearing and allow for unlimited deposits and withdrawals, provided that a minimum balance is maintained.

Certificate of Deposit Accounts. Deposits require a minimum deposit of $2,500 and have maturities ranging from three months to five years. Jumbo certificate of deposit accounts are offered in amounts of $100,000 or more for terms of 30 days to five years.

Our personal checking accounts feature an array of benefits and options, including online banking, online statements, mobile banking with mobile deposit, VISA debit cards and access to more than 32,000 surcharge free Automated

Teller Machines ("ATMs") through the MoneyPass network.
We also offer trust services through trust powers in the states of Washington and Oregon, and a Wealth Management department that provides objective advice from trusted advisors.

Lending Activities

Our lending activities are conducted through Heritage Bank. While our focus is on commercial business lending, we also originate consumer loans, real estate construction and land development loans and one-to-four family residential loans. Our loans are originated under policies that are reviewed and approved annually by our Board of Directors. In addition, we have established internal lending guidelines that are updated as needed. These policies and guidelines address underwriting standards, structure and rate considerations, and compliance with laws, regulations and internal lending limits. We conduct post-approval reviews on selected loans and routinely perform internal loan reviews of our loan portfolio to confirm credit quality, proper documentation and compliance with laws and regulations. Loan repayments are considered one of the primary sources of funding for the Bank.

The Company has also acquired loans through mergers and acquisitions, which are designated as "purchased" loans.

Commercial Business Lending

We offer different types of commercial business loans, including lines of credit, term equipment financing and term owner-occupied and non-owner occupied commercial real estate loans. We also originate loans that are guaranteed by the U.S. Small Business Administration (“SBA”), for which Heritage Bank is a “preferred lender”, and the Federal Agricultural Mortgage Corporation. Before extending credit to a business we review and analyze the borrower’s management ability, financial history, including cash flow of the borrower and all guarantors, and the liquidation value of the collateral. Emphasis is placed on having a comprehensive understanding of the borrower’s global cash flow and performing necessary financial due diligence.

At December 31, 2018 we had $2.94 billion, or 80.4%, of our loans receivable, net in commercial business loans with an average outstanding loan balance of approximately $476,000 at December 31, 2018, excluding loans with no outstanding balance.

We originate commercial real estate loans within our primary market areas with a preference for loans secured by owner-occupied properties. Our underwriting standards require that non-owner occupied and owner occupied commercial real estate loans not exceed 75% and 80%, respectively, of the lower of appraised value at origination or cost of the underlying collateral. Cash flow debt coverage requirements range from 1.15 times to 1.25 times, depending on the type of property. We also stress test debt coverage using an “underwriting” interest rate that is higher than the note rate.

Commercial real estate loans typically involve a greater degree of risk than one-to-four family residential loans. Payments on loans secured by commercial real estate properties are dependent on successful operation and management of the properties and 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 determining the financial condition of the borrower and tenants, the quality and value of the collateral, and the management of the property securing the loan. We also generally obtain personal guarantees from the owners of the collateral after a thorough review of personal financial statements. In addition, we review our commercial real estate loan portfolio annually for performance of individual loans, and stress-test loans for potential changes in interest rates, occupancy, and collateral values.

See also Item 1A. Risk Factors—Our loan portfolio is concentrated in loans with a higher risk of loss.

The Bank enters into non-hedging interest rate swap contracts with its commercial customers, as necessary, to accommodate the business needs of borrowers. For additional information, see Note (15) Derivative Financial Instruments of the Notes to Consolidated Financial Statements included in Item 8. Financial Statements And Supplementary Data.

One-to-Four Family Residential Loans, Originations and Sales

At December 31, 2018, one-to-four family residential loans totaled $101.8 million. 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 one-to-four family residential loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms typically range from 15 to 30 years. As part of our asset/liability management strategy, we typically sell a significant portion of our one-to-four family residential loans in the secondary market with no recourse and servicing released. See Item 7. Management’s Discussion And Analysis Of Financial Condition And Results Of Operations—Asset/Liability Management. We did not

service any of these sold loans during the years ended December 31, 2018, 2017 or 2016.

Real Estate Construction and Land Development

At December 31, 2018, we had $215.5 million of real estate construction and land development loans. We originate one-to-four family residential construction loans for the construction of custom homes (where the home buyer is the borrower). We also provide financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Because of the higher risks present in the residential construction industry, our lending to builders is limited to those who have demonstrated a favorable record of performance and who are building in markets that management understands.

We further endeavor to limit our construction lending risk through adherence to strict underwriting guidelines and procedures. Speculative construction loans are short term in nature and have a variable rate of interest. We require builders to have tangible equity in each construction project and have prompt and thorough documentation of all draw requests, and we inspect the project prior to paying any draw requests.

See also Item 1A. Risk Factors—Our loan portfolio is concentrated in loans with a higher risk of loss.

Consumer

At December 31, 2018, we had $395.5 million of consumer loans. We originate consumer loans and lines of credit that are both secured and unsecured. The majority of our consumer loans are for relatively small amounts disbursed among many individual borrowers.

We also originate indirect consumer loans. These loans are for new and used automobile and recreational vehicles that are originated indirectly by selected dealers located in our market areas. We have limited our indirect loans purchased primarily to dealerships that are established and well-known in their market areas and to applicants that are not classified as sub-prime.

Liquidity

As indicated above, our primary sources of funds are deposits and loan repayments. 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, may not be stable. 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. In addition to customer deposits, management may utilize brokered deposits on an as-needed basis and repurchase agreements. At December 31, 2018, we had brokered deposits of $28.1 million and securities sold under agreement to repurchase of $31.5 million which were secured by investment securities available for sale.

As secondary sources of funding, we might utilize other borrowings 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. Other borrowings include advances from Federal Home Loan Bank ("FHLB") of Des Moines and other credit facilities.

Federal Home Loan Bank:

The Bank is a member of the FHLB of Des Moines which is one of 11 regional FHLBs that administer the home financing credit function of savings institutions. Each FHLB serves as a reserve or central bank for its member financial institutions within its assigned region. It is funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB system. It makes loans or advances to members in accordance with policies and procedures, established by the Board of Directors of the FHLB, which are subject to the oversight of the Federal Housing Finance Agency. We rely upon advances from the FHLB as a secondary source of liquidity to supplement our supply of lendable funds and meet deposit withdrawal requirements. Advances are made pursuant to several different programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based on a percentage of an institution's assets or on the FHLB's assessment of the institution's creditworthiness. Under its current credit policies, the FHLB of Des Moines limits advances to 35% of the Bank's assets.

Advances from the FHLB of Des Moines are typically secured by our first lien one-to-four family residential loans, commercial real estate loans and stock issued by the FHLB, which is owned by us. At December 31, 2018, the Bank maintained a credit facility with the FHLB of Des Moines in the amount of $921.7 million, of which there were no advances.

For membership purposes, the Bank is required to maintain an investment in the stock of the FHLB of Des Moines in an amount equal to 0.12% of the Bank's assets as calculated on an annual basis. In addition to the FHLB stock required for membership, the Bank must purchase activity stock equal to 4.0% of all outstanding borrowing

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balances. The activity stock is automatically redeemed in amounts equal to the FHLB advance balances as they are repaid. At December 31, 2018 the Bank had an investment in stock issued by the FHLB of Des Moines carried at a cost basis (par value) of $6.1 million, which entirely represented its membership stock. The Bank was not required to have any activity stock because it did not have any outstanding FHLB advance balance at December 31, 2018.

Other borrowings:

In addition to liquidity provided by FHLB, the Bank maintained an uncommitted credit facility with the Federal Reserve Bank of San Francisco of $37.4 million, of which there were no advances or borrowings outstanding as of December 31, 2018. The Bank also maintains advance lines with Wells Fargo Bank, US Bank, The Independent Bankers Bank and Pacific Coast Bankers' Bank to purchase federal funds of up to $90.0 million, of which there were no advances or borrowings outstanding as of December 31, 2018.

Supervision and Regulation

We are subject to extensive legislation, regulation, and supervision under federal law and the law of Washington State, which are primarily intended to protect depositors and the FDIC, and not shareholders. The laws and regulations affecting banks and bank holding companies have changed significantly particularly in connection with the enactment of the Dodd-Frank Act in 2010. Among other changes, the Dodd-Frank Act established the Consumer Protection Financial Bureau ("CFPB") as an independent bureau of the Board of Governors of the Federal Reserve System ("Federal Reserve"). The CFPB assumed responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations and has authority to impose new requirements. See "—Other Regulatory Developments—The Dodd-Frank Act" herein for a discussion of this legislation. Any change in applicable laws, regulations, or regulatory policies may have a material effect on our business, operations, and prospects. We cannot predict the nature or the extent of the effects on our business and earnings that any fiscal or monetary policies or new Federal or State legislation may have in the future.

The following is a summary discussion of certain laws and regulations applicable to Heritage and Heritage Bank which is qualified in its entirety by reference to the actual laws and regulations.

Heritage Financial

As a bank holding company registered with the Federal Reserve, we are subject to comprehensive regulation and supervision by the Federal Reserve under the Bank Holding Company Act of 1956, as amended ("BHCA"), and the regulations of the Federal Reserve. This regulation and supervision is generally intended to ensure that we limit our activities to those allowed by law and that we operate in a safe and sound manner without endangering the financial health of Heritage Bank. We are required to file annual and periodic reports with the Federal Reserve and provide additional information as the Federal Reserve may require. The Federal Reserve may examine us, and any of our subsidiaries, and assess us for the cost of such examination.

The Federal Reserve has extensive enforcement authority over bank holding companies, including, among other things, the ability to assess civil money penalties, to issue cease and desist or removal orders, or require that a holding company divest subsidiaries (including its bank subsidiary). In general, enforcement actions may be initiated for violations of laws and regulations and unsafe or unsound practices. The Company is also required to file certain reports with, and otherwise comply with, the rules and regulations of the Securities and Exchange Commission ("SEC"). The Federal Reserve may also order termination of non-banking activities by non-banking subsidiaries of bank holding companies, or divestiture of ownership and control of a non-banking subsidiary by a bank holding company. Some violations may also result in criminal penalties.

The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Dodd Frank Act and Federal Reserve policy provides that a bank holding company shall be required to serve as a source of financial strength for its subsidiary bank. A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary banks is generally considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve's regulations or both.

Under the prompt corrective action provisions of the Federal Deposit Insurance Act, a bank holding company with an undercapitalized subsidiary bank must guarantee, within limitations, the capital restoration plan that is required to be

implemented for its undercapitalized subsidiary bank. If an undercapitalized subsidiary bank fails to file an acceptable capital restoration plan or fails to implement an accepted plan the Federal Reserve may, among other restrictions, prohibit the bank holding company or its undercapitalized subsidiary bank from paying any dividend or making any other form of capital distribution without the prior approval of the Federal Reserve. Federal Reserve policy also provides that a bank holding company may pay cash dividends only to the extent that the company's net income for the past year is sufficient to cover both the cash dividend and a rate of earnings retention that is consistent with

the company’s capital needs, asset quality and overall financial condition. A bank holding company or bank that does not meet the capital conservation buffer requirement is subject to restrictions on the payment of dividends. See “—Capital Adequacy” below. In addition, under Washington corporate law, a company generally may not pay dividends if after that payment the company would not be able to pay its liabilities as they become due in the usual course of business, or its total assets would be less than its total liabilities.

We, and any subsidiaries which we may control, are considered “affiliates” of the Bank within the meaning of the Federal Reserve Act, and transactions between our bank subsidiary and affiliates are subject to numerous restrictions. With some exceptions, we and our subsidiaries are prohibited from tying the provision of various products or services, such as extensions of credit, to other products or services offered by us, or our affiliates.

Bank regulations require bank holding companies and banks to maintain minimum capital ratios. For additional information, see “—Capital Adequacy” below.

Subsidiary Bank

Heritage Bank is a Washington state-chartered commercial bank, the deposits of which are insured by the FDIC. Heritage Bank is subject to regulation by the FDIC and the Division of Banks of the Washington State Department of Financial Institutions ("Division").

Applicable Federal and State statutes and regulations which govern a bank’s operations relate to minimum capital requirements, required reserves against deposits, investments, loans, legal lending limits, mergers and consolidation, borrowings, issuance of securities, payment of dividends, establishment of branches, and other aspects of its operations, among other things. The Division and the FDIC also have authority to prohibit banks under their supervision from engaging in what they consider to be unsafe and unsound practices.

The Bank is required to file periodic reports with the FDIC and the Division and is subject to periodic examinations and evaluations by those regulatory authorities. Based upon these evaluations, the regulators may revalue the assets of an institution and require that it establish specific reserves to compensate for the differences between the determined value and the book value of such assets. These examinations must be conducted at least every 12 months.

Dividends paid by the Bank provide substantially all of our cash flow. The FDIC and the Division also have the general authority to restrict capital distributions by the Bank, including dividends paid by the Bank to Heritage. Such restrictions are generally tied to the Bank’s capital levels after giving effect to such distributions. For additional information regarding the restrictions on the payment of dividends, see ”—Capital Adequacy" below and Item 5. Market For Registrant’s Common Equity, Related Stockholder Matters And Issuer Purchases Of Equity Securities herein.

Capital Adequacy

The Federal Reserve and FDIC have issued substantially similar risk-based and leverage capital guidelines applicable to bank holding companies and banks. In addition, these regulatory agencies may from time to time require that a bank holding company or bank maintain capital above the minimum levels, based on its financial condition or actual or anticipated growth.

Effective January 1, 2015 (with some changes transitioned into full effectiveness over several years), the Company and the Bank became subject to new capital regulations adopted by the Federal Reserve and the FDIC, which establish minimum required risk-based ratios for CET1 capital, Tier 1 and total capital, as well as a minimum leverage ratio risk-weightings of assets and certain other assets for purposes of the risk-based capital ratios; require an additional capital conservation buffer over the minimum required risk-based capital ratios; and define what qualifies as capital for purposes of meeting the capital requirements. These regulations implement the regulatory capital reforms required by the Dodd-Frank Act and the “Basel III” requirements.

Under these capital regulations, the minimum capital ratios are: (1) a CET1 capital ratio of 4.5% of risk-weighted assets; (2) a Tier 1 capital ratio of 6.0% of risk-weighted assets; (3) a total capital ratio of 8.0% of risk-weighted assets; and (4) a leverage ratio (the ratio of Tier 1 capital to average total adjusted assets) of 4.0%. CET1 generally consists of common stock; retained earnings; accumulated other comprehensive income (loss), net unless an institution elects to exclude accumulated other comprehensive income (loss), net from regulatory capital; and certain minority interests; all subject to applicable regulatory adjustments and deductions. Tier 1 capital generally consists of CET1 and noncumulative perpetual preferred stock. Tier 2 capital generally consists of other preferred stock and

subordinated debt meeting certain conditions plus an amount of the allowance for loan and lease losses up to 1.25% of assets. Total capital is the sum of Tier 1 and Tier 2 capital.

In addition to the minimum CET1, Tier 1, leverage ratio and total capital ratios, the Company and the Bank must maintain a capital conservation buffer consisting of additional CET1 capital greater than 2.5% of risk-weighted assets above the required minimum risk-based capital levels in order to avoid limitations on paying dividends,

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repurchasing shares, and paying discretionary bonuses. The new capital conservation buffer requirement began to be phased in on January 1, 2016, when requiring a buffer greater than 0.625% of risk-weighted assets, was required which amount increased 0.625% each year until the buffer requirement was fully implemented on January 1, 2019.

To be considered "well capitalized," a bank holding company must have, on a consolidated basis, a total risk-based capital ratio of 10.0% or greater and a Tier 1 risk-based capital ratio of 6.0% or greater and must not be subject to an individual order, directive or agreement under which the Federal Reserve requires it to maintain a specific capital level. To be considered “well capitalized,” a depository institution must have a Tier 1 risk-based capital ratio of at least 8%, a total risk-based capital ratio of at least 10%, a CET1 capital ratio of at least 6.5% and a leverage ratio of at least 5% and not be subject to an individualized order, directive or agreement under which its primary federal banking regulator requires it to maintain a specific capital level. As of December 31, 2018, the Company and the Bank met the requirements to be "well capitalized" and the fully phased-in capital conservation buffer requirement.

For a complete description of the Company’s and the Bank's required and actual capital levels as of December 31, 2018, see Note (22) Regulatory Capital Requirements of the Notes to Consolidated Financial Statements included in Item 8. Financial Statements And Supplementary Data.

Prompt Corrective Action

Federal statutes establish a supervisory framework for FDIC-insured institutions based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution’s category depends upon where its capital levels are in relation to relevant capital measures. The well capitalized category is described above. An institution that is not well capitalized is subject to certain restrictions on brokered deposits, including restrictions on the rates it can offer on its deposits generally. To be considered adequately capitalized, an institution must have the minimum capital ratios described above. Any institution which is neither well capitalized nor adequately capitalized is considered undercapitalized.

Undercapitalized institutions are subject to certain prompt corrective action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by Heritage Bank to comply with applicable capital requirements would result in progressively more severe restrictions on its activities and lead to enforcement actions, including, but not limited to, the issuance of a capital directive to ensure the maintenance of required capital levels and, ultimately, the appointment of the FDIC as receiver or conservator. Banking regulators will take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Additionally, approval of any regulatory application filed for their review may be dependent on compliance with capital requirements.

As of December 31, 2018, the Bank met the requirements to be classified as “well capitalized.” See Note (22) Regulatory Capital Requirements of the Notes to Consolidated Financial Statements included in Item 8. Financial Statements And Supplementary Data.

Classification of Loans

Federal regulations require the Bank to periodically evaluate the risks inherent in its loan portfolio. In addition, the Division and the FDIC have the authority to identify adverse loans and, if appropriate, require them to be reclassified. There are three types of classified loans: Substandard, Doubtful, and Loss. Substandard loans 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 loans have the weaknesses of Substandard loans, with 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 probability of some loss in loans classified as Doubtful. A loan classified as Loss is considered uncollectible and of such little value that continuance as a loan of the institution is not warranted. If a loan or a portion of the loan is classified as Loss, the institution must charge-off this amount.

Deposit Insurance and Other FDIC Programs

The deposits of the Bank are insured up to $250,000 per separately insured category by the Deposit Insurance Fund, which is administered by the FDIC. The FDIC is an independent federal agency that insures the deposits, up to applicable limits, of depository institutions. As insurer of the Bank's deposits, the FDIC has supervisory and enforcement authority over Heritage Bank and this insurance is backed by the full faith and credit of the United States

government. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by institutions insured by the FDIC. It also may prohibit any FDIC-insured institution from engaging in any activity determined by regulation or order to pose a serious risk to the institution and the Deposit Insurance Fund. The FDIC also has the authority to initiate enforcement actions and may terminate the deposit insurance if it determines that an institution has engaged in unsafe or unsound practices or is in an unsafe or unsound condition.

The Dodd-Frank Act broadened the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. In addition, the Dodd-Frank Act raised set the minimum designated reserve ratio ("DRR") of the Deposit Insurance Fund (the "DIF") at 1.35%, required the FDIC to set a target DRR each year, and eliminated the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. The FDIC has set the target DRR at 2.0% and adopted a plan to achieve that target ratio. The FDIC has announced that the DRR surpassed 1.35% as of September 30, 2018. Currently, total base assessment rates range- from 1.5 to 40 basis points on an annualized basis, subject to certain adjustments. Under current regulations, the ranges of assessment rates are scheduled to decrease as the DRR increases in increments above 2.0%. No institution may pay a dividend if it is in default on its federal deposit insurance assessment.

Other Regulatory Developments

Significant federal legislation affecting banking has been enacted in recent years. The following summarizes some of such recent significant federal legislation.

The Dodd-Frank Act. The Dodd-Frank-Act imposes restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions and implements new capital regulations that we are subject to and that are discussed above under "—Capital Adequacy."

The federal banking and securities regulators have issued final rules to implement Section 619 of the Dodd-Frank Act, commonly known as the "Volcker Rule" pursuant to the Dodd-Frank Act. Generally, subject to a transition period and certain exceptions, the Volcker Rule restricts insured depository institutions and their affiliated companies from engaging in short-term proprietary trading of certain securities, investing in funds with collateral comprised of any loans that are not registered with the SEC and from engaging in hedging activities that do not hedge a specific identified risk. In accordance with the transition period, the Volcker Rule prohibitions and restrictions apply to banking entities, including the Company and the Bank, unless an exception applies. We are continuously reviewing our investment portfolio to determine if changes to our investment strategies may be required in order to comply with the various provisions of the Volcker Rule.

In addition, among other changes, the Dodd-Frank Act requires public companies, like us, to (i) provide their shareholders with a non-binding vote (a) at least once every three years on the compensation paid to executive officers and (b) at least once every six years on whether they should have a "say on pay" vote every one, two or three years; (ii) have a separate, non-binding shareholder vote regarding golden parachutes for named executive officers when a shareholder vote takes place on mergers, acquisitions, dispositions or other transactions that would trigger the parachute payments; (iii) provide disclosure in annual proxy materials concerning the relationship between the executive compensation paid and the financial performance of the issuer; and (iv) amend Item 402 of Regulation S-K to require companies to disclose the ratio of the Chief Executive Officer's annual total compensation to the median annual total compensation of all other employees.

Economic Growth Act. In May 2018 the Economic Growth, Regulatory Relief and Consumer Protection Act (the "Economic Growth Act"), was enacted to modify or remove certain financial reform rules and regulations, including some of those implemented under the Dodd-Frank Act. While the Economic Growth Act maintains most of the regulatory structure established by the Dodd-Frank Act, it amends certain aspects of the regulatory framework for small depository institutions with assets of less than $10 billion and for large banks with assets of more than $50 billion. Many of these changes could result in meaningful regulatory changes for community banks such as the Bank, and their holding companies.

The Economic Growth Act, among other matters, expands the definition of qualified mortgages which may be held by a financial institution and simplifies the regulatory capital rules for financial institutions and their holding companies with total consolidated assets of less than $10 billion by instructing the federal banking regulators to establish a single "Community Bank Leverage Ratio" of between 8 and 10 percent. Any qualifying depository institution or its holding company that exceeds the "community bank leverage ratio" will be considered to have met generally applicable leverage and risk-based regulatory capital requirements and any qualifying depository institution that exceeds the new ratio will be considered to be "well capitalized" under the prompt corrective action rules. In addition, the Economic Growth Act

includes regulatory relief for community banks regarding regulatory examination cycles, call reports, the Volcker Rule (proprietary trading prohibitions), mortgage disclosures and risk weights for certain high-risk commercial real estate loans.

It is difficult at this time to predict when or how any new standards under the Economic Growth Act will ultimately be applied to us or what specific impact the Act and the yet-to-be-written implementing rules and regulations will have on community banks.

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CECL. The Financial Accounting Standards Board has adopted a new accounting standard for U.S. Generally Accepted Accounting Principles that will be effective for us for our first fiscal year beginning after December 15, 2019. This standard, referred to as Current Expected Credit Loss, or CECL, requires FDIC-insured institutions and their holding companies (banking organizations) to recognize credit losses expected over the life of certain financial assets. CECL covers a broader range of assets than the current method of recognizing credit losses and generally results in earlier recognition of credit losses. Upon adoption of CECL, a banking organization must record a one-time adjustment to its credit loss allowances as of the beginning of the fiscal year of adoption equal to the difference, if any, between the amount of credit loss allowances under the current methodology and the amount required under CECL. For a banking organization, implementation of CECL is generally likely to reduce retained earnings, and to affect other items, in a manner that reduces its regulatory capital.

The federal banking regulators (the Federal Reserve, the OCC and the FDIC) have adopted a rule that gives a banking organization the option to phase in over a three-year period the day-one adverse effects of CECL on its regulatory capital.

Sarbanes-Oxley Act. As a public company that files periodic reports with the SEC, under the Securities Exchange Act of 1934, Heritage is subject to the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"), which addresses, among other issues, corporate governance, auditing and accounting, executive compensation and enhanced and timely disclosure of corporate information.

The Sarbanes-Oxley Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees. Our policies and procedures have been updated to comply with the requirements of the Sarbanes-Oxley Act.

Website Access to Company Reports

We post publicly available reports required to be filed with the SEC on our website, www.hf-wa.com, as soon as reasonably practicable after filing such reports. The required reports are available free of charge through our website.

Code of Ethics

We have adopted a Code of Ethics that applies to our principal executive officer, principal financial officer and controller. We have posted the text of our Code of Ethics at www.hf-wa.com in the section titled Overview: Governance Documents. Any waivers of the code of ethics will be publicly disclosed to shareholders.

Competition

We compete for loans and deposits with other commercial banks, credit unions, mortgage bankers, and other providers of financial services, including finance companies, mutual funds, insurance companies, and more recently with financial technology (or "FinTech") companies that rely on technology to provide financial services. Many of our competitors have substantially greater resources than we do. Particularly in times of high or rising interest rates, we also face significant competition for investors’ funds from short-term money market securities and other corporate and government securities.

We compete for loans principally through the range and quality of the services we provide, interest rates and loan fees, and the locations of our Bank's branches. We actively solicit deposit-related clients and compete for deposits by offering depositors a variety of savings accounts, checking accounts, cash management and other services.

Employees

We had 859 full-time equivalent employees at December 31, 2018. We believe that employees play a vital role in the success of a service company. Employees are provided with a variety of benefits such as medical, vision, dental and life insurance, a retirement plan, and paid vacations and sick leave. None of our employees are covered by a collective bargaining agreement.

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Executive Officers

The following table sets forth certain information with respect to the executive officers of the Company at December 31, 2018.

Name	Age as of December 31, 2018	Position	Has Served the Company or Heritage Bank Since
Brian L. Vance	64	Chief Executive Officer of Heritage	1996
Jeffrey J. Deuel	60	President of Heritage; President and Chief Executive Officer of Heritage Bank	2010
Donald J. Hinson	57	Executive Vice President and Chief Financial Officer of Heritage and Heritage Bank	2005
David A. Spurling	65	Executive Vice President and Chief Credit Officer of Heritage and Heritage Bank	2001
Bryan McDonald	47	Executive Vice President and Chief Operating Officer of Heritage and Heritage Bank	2014

The business experience of each executive officer is set forth below.

Brian L. Vance is the Chief Executive Officer of Heritage. During 2018, Mr. Vance announced his intent to retire on July 1, 2019. Upon his retirement, Mr. Vance will assume the role of Executive Board Chair of Heritage and oversee board activities. Mr. Vance was appointed President and Chief Executive Officer of Heritage and Heritage Bank in 2006. In 2003, Mr. Vance was appointed President and Chief Executive Officer of Heritage Bank and in 1998, Mr. Vance was named President and Chief Operating Officer of Heritage Bank. Mr. Vance joined Heritage Bank in 1996 as its Executive Vice President and Chief Credit Officer. Prior to joining Heritage Bank, Mr. Vance was employed for 24 years with West One Bank, a bank with offices in Idaho, Utah, Oregon and Washington. Prior to leaving West One, he was Senior Vice President and Regional Manager of Banking Operations for the south Puget Sound region.

Jeffrey J. Deuel is the President of Heritage and President and Chief Executive Officer of Heritage Bank. Mr. Deuel was appointed President of Heritage and President and Chief Executive Officer of Heritage Bank in July 2018. Mr. Deuel was previously promoted to President and Chief Operating Officer of Heritage Bank and Executive Vice President of Heritage in 2012, Chief Operating Officer of Heritage Bank and Executive Vice President of the Company in 2010, and joined Heritage Bank in February 2010 as Executive Vice President of Corporate Strategies. Mr. Deuel came to the Company with 28 years of banking experience and most recently held the position of Executive Vice President Commercial Operations with JPMorgan Chase, formerly Washington Mutual. Prior to joining Washington Mutual, Mr. Deuel was based in Philadelphia where he worked for Bank United, First Union Bank, CoreStates Bank, and First Pennsylvania Bank. During his career Mr. Deuel held a variety of leadership positions in commercial banking including lending, retail and support services, corporate strategies, credit administration, and portfolio management. He earned his Bachelor’s degree at Gettysburg College.

Donald J. Hinson became Executive Vice President and Chief Financial Officer of Heritage and Heritage Bank in September 2012. In 2007, Mr. Hinson was appointed to Senior Vice President and Chief Financial Officer of Heritage and Heritage Bank. Mr. Hinson joined Heritage Bank in 2005 as Vice President and Controller. Prior to that, he served in the banking audit practice of local and national accounting firms of Knight, Vale and Gregory and RSM McGladrey from 1994 to 2005. Mr. Hinson holds a Bachelor's of Science degree in Accounting from Central Washington University and is a licensed Certified Public Accountant.

David A. Spurling became Executive Vice President and Chief Credit Officer of Heritage and Heritage Bank in January 2014. Prior to that, he was the Senior Vice President and Chief Credit Officer of Heritage Bank beginning in 2007. Mr. Spurling joined Heritage Bank in 2001 as a commercial lender, followed by a role as a commercial team leader. He began his banking career as a middle market lender at Seafirst Bank, followed by positions as a commercial lender at Bank of America in Small Business Banking and as a regional manager for Bank of America’s government-guaranteed lending division. Mr. Spurling holds a Master’s Degree in Business Administration from the

University of Washington and is Credit Risk Certified by the Risk Management Association.

Bryan McDonald was appointed Executive Vice President and Chief Operating Officer of Heritage Bank in July of 2018. Mr. McDonald became Executive Vice President and Chief Lending Officer of Heritage Bank upon

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completion of the Washington Banking Merger effective on May 1, 2014. Mr. McDonald had served as President and Chief Executive Officer of Whidbey Island Bank since January 1, 2012. Mr. McDonald joined Whidbey Island Bank in 2006 as Commercial Banking Manager and he served as Senior Vice President and Chief Operating Officer of Whidbey Island Bank from April 1, 2010 until his promotion to Executive Vice President on August 26, 2010. Mr. McDonald has been serving in the banking industry since 1994, including regional commercial lending management roles with Washington Mutual and Peoples Bank. Mr. McDonald holds a Bachelor's and Master's Degree in Business Administration from Washington State University.

ITEM 1A. RISK FACTORS

We assume and manage a certain degree of risk in order to conduct our business strategy. The following provides a discussion of certain risks that management believes are specific to our business. This discussion should not be viewed as an all-inclusive list or in any particular order.

Our strategy of pursuing acquisitions and de novo branching exposes us to financial and operational risks that could adversely affect us.

We are pursuing a strategy of supplementing organic growth by acquiring other financial institutions or their businesses that we believe will help us fulfill our strategic objectives and enhance our earnings. There are risks associated with this strategy, however, including the following:

- we may be exposed to potential asset quality issues or unknown or contingent liabilities of the banks, businesses, assets and liabilities we acquire. If these issues or liabilities exceed our estimates, our results of operations and financial condition may be materially negatively affected;
- higher than expected deposit attrition;
- potential diversion of our management's time and attention;
- prices at which acquisitions are made can fluctuate with market conditions. We have experienced times during which acquisitions could not be made in specific markets at prices we considered acceptable and expect that we may continue to experience this condition in the future;
- the acquisition of other entities generally requires integration of systems, procedures and personnel of the acquired entity into our company to make the transaction economically successful. This integration process is complicated and time consuming and can also be disruptive to the customers of the acquired business. If the integration process is not conducted successfully and with minimal effect on the acquired business and its customers, we may not realize the anticipated economic benefits of an acquisition within the expected time frame, and we may lose customers or employees of the acquired business. We may also experience greater than anticipated customer losses even if the integration process is successful. These risks may be present in our Puget Sound Merger and Premier Merger that were completed during the first and third quarters of 2018, respectively;
- to finance an acquisition, we may borrow funds, thereby increasing our leverage and diminishing our liquidity, or raise additional capital, which could dilute the interests of our existing shareholders;
- from 2006 through 2018, we completed eight acquisitions or mergers, including one acquisition in 2006, two acquisitions during 2010, two acquisitions during 2013, one merger in 2014 and two acquisitions in 2018 that enhanced our rate of growth. We may not be able to continue to sustain our past rate of growth or to grow at all in the future;
- we expect our net income will increase following our acquisitions; however, we also expect our general and administrative expenses and consequently our efficiency ratios will also increase. Ultimately, we would expect our efficiency ratio to improve; however, if we are not successful in our integration process, this may not occur, and our acquisitions or branching activities may not be accretive to earnings in the short or long-term; and
- to the extent our costs of an acquisition exceed the fair value of the net assets acquired, the acquisition will generate goodwill. As discussed below under “-If the goodwill we have recorded in connection with acquisitions becomes impaired, our earnings and capital could be reduced,” we are required to assess our goodwill for impairment at least annually, and any goodwill impairment charge could have a material adverse effect on our results of operations and financial condition.

Our business strategy includes significant growth plans, and our financial condition and results of operations could be negatively affected if we are not successful in executing this strategy or if we fail to grow or manage our growth effectively.

We intend to pursue a growth strategy for our business. We regularly evaluate potential acquisitions and expansion opportunities. If appropriate opportunities present themselves, we expect to engage in selected acquisitions of financial institutions in the future, including branch acquisitions, or other business growth initiatives or undertakings. There can be no assurance that we will successfully identify appropriate opportunities, that we will be able to negotiate or finance such activities or that such activities, if undertaken, will be successful.

Our growth initiatives may require us to recruit experienced personnel to assist in such initiatives, which will increase our compensation costs. In addition, the failure to identify and retain such personnel would place significant limitations on our ability to successfully execute our growth strategy. To the extent we expand our lending beyond our current market areas, we also could incur additional risk related to those new market areas. We may not be able to expand our market presence in our existing market areas or successfully enter new markets.

If we do not successfully execute our acquisition growth plan, it could adversely affect our business, financial condition, results of operations, reputation and growth prospects. In addition, if we were to conclude that the value of an acquired business had decreased and that the related goodwill had been impaired, that conclusion would result in an impairment of goodwill charge to us, which would adversely affect our results of operations. While we believe we have the executive management resources and internal systems in place to successfully manage our future growth, there can be no assurance that suitable growth opportunities will be available or that we will successfully manage our growth. See below “-If the goodwill we have recorded in connection with acquisitions becomes impaired, our earnings and capital could be reduced” and “-Our strategy of pursuing acquisitions and de novo branching exposes us to financial and operational risks that could adversely affect us” for additional risks related to our acquisition strategy.

The required accounting treatment of purchased loans we acquire through acquisitions could result in higher net interest margins and interest income in current periods and lower net interest margins and interest income in future periods.

Under generally accepted accounting principles ("GAAP"), we are required to record purchased loans acquired through acquisitions at fair value, which may differ from the outstanding balance of such loans. Estimating the fair value of such loans requires management to make estimates based on available information and facts and circumstances on the acquisition date. Actual performance could differ from management’s initial estimates. If these loans outperform our original fair value estimates, the difference between our original estimate and the actual performance of the loan (the “discount”) is accreted into net interest income. Thus, our net interest margins may initially increase due to the discount accretion. This accretable yield may change due to changes in expected timing and amount of future cash flows. The yields on our loans could decline as our acquired loan portfolio pays down or matures, and we expect downward pressure on our interest income to the extent that the runoff on our acquired loan portfolio is not replaced with comparable high-yielding loans. This could result in higher net interest margins and interest income in current periods and lower net interest rate margins and lower interest income in future periods.

New or changing tax, accounting, and regulatory rules and interpretations could significantly impact strategic initiatives, results of operations, cash flows, and financial condition.

The financial services industry is extensively regulated. Federal and state banking regulations are designed primarily to protect the deposit insurance funds and consumers, not to benefit our stockholders. These regulations may sometimes impose significant limitations on operations. Regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of an institution, the classification of assets by the institution and adequacy of an institution's allowance for loan losses. These bank regulators also have the ability to impose conditions in the approval of merger and acquisition transactions.

Our loan portfolio is concentrated in loans with a higher risk of loss.

Repayment of our commercial business loans, consisting of commercial and industrial loans as well as owner-occupied and non-owner occupied commercial real estate loans, is often dependent on the cash flows of the

borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value. We offer different types of commercial business loans to a variety of businesses with a focus on real estate related industries and businesses in agricultural, healthcare, legal, and other professions. The types of commercial business loans offered are lines of credit, term equipment financing and term real estate loans. We also originate loans that are guaranteed by the SBA, and are a "preferred lender" of the SBA. Commercial business lending involves risks that are different from those associated with real estate lending. Our commercial business loans are primarily made based on our assessment of the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrower's cash flow may be unpredictable, and collateral securing these loans may fluctuate in value. Although these commercial

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business loans are often collateralized by equipment, inventory, accounts receivable or other business assets, the liquidation of collateral in the event of default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories may be obsolete or of limited use, among other things. Accordingly, the repayment of commercial business loans depends primarily on the cash flow and creditworthiness of the borrower and secondarily on the underlying collateral provided by the borrower. In addition, as part of our commercial business lending activities, we originate agricultural loans. Agricultural lending involves a greater degree of risk. Payments on agricultural loans are typically dependent on the profitable operation or management of the related farm property. The success of the farm may be affected by many factors outside the control of the borrower, including adverse weather conditions that prevent the planting of a crop or limit crop yields (such as hail, drought and floods), loss of livestock due to disease or other factors, declines in market prices for agricultural products (both domestically and internationally), changes in the economy (such as tariffs) and the impact of government regulations (including changes in price supports, subsidies and environmental regulations). In addition, many farms are dependent on a limited number of key individuals whose injury or death may significantly affect the successful operation of the farm. If the cash flow from a farming operation is diminished, the borrower’s ability to repay the loan may be impaired. Consequently, agricultural loans may involve a greater degree of risk than other types of loans, particularly in the case of loans that are unsecured or secured by rapidly depreciating assets such as farm equipment (some of which is highly specialized with a limited or no market for resale), or assets such as livestock or crops. In such cases, any repossessed collateral for a defaulted agricultural operating loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation or because the assessed value of the collateral exceeds the eventual realization value.

At December 31, 2018, our commercial business loans totaled $2.94 billion, or approximately 80.4% of our total loan portfolio. Approximately $12.6 million, or 0.4%, of our commercial business loans were nonperforming at December 31, 2018. The majority of the nonperforming commercial business loans were commercial and industrial loans. Our agricultural lending totaled $94.3 million, or 2.6% of our total loan portfolio, and 3.2% of our commercial business loans.

Our non-owner occupied commercial real estate loans, which include five or more family residential real estate loans, involve higher principal amounts than other loans and repayment of these loans may be dependent on factors outside our control or the control of our borrowers. We originate commercial and five or more family residential real estate loans for individuals and businesses for various purposes, which are secured by commercial properties. These loans typically involve higher principal amounts than other types of loans, and repayment is dependent upon income generated, or expected to be generated, by the property securing the loan in amounts sufficient to cover operating expenses and debt service, which may be adversely affected by changes in the economy or local market conditions. For example, if the cash flow from the borrower’s project is reduced as a result of leases not being obtained or renewed, the borrower’s ability to repay the loan may be impaired.

Commercial and five or more family residential real estate loans also expose us to greater credit risk than loans secured by one-to-four family residential real estate because the collateral securing these loans typically cannot be sold as easily as one-to-four family residential real estate. In addition, many of our commercial and five or more family residential real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. If we foreclose on a commercial and five or more family residential real estate loan, our holding period for the collateral typically is longer than for one-to-four family residential loans because there are fewer potential purchasers of the collateral. Additionally, commercial and five or more family residential real estate loans generally have relatively large balances to single borrowers or related groups of borrowers. Accordingly, if we make any errors in judgment regarding the collectability of our commercial and five or more family residential real estate loans, any resulting charge-offs may be larger on a per loan basis than those incurred with our residential or consumer loan portfolios.

As of December 31, 2018, our non-owner occupied commercial real estate loans totaled $1.30 billion, or 35.7% of our total loan portfolio. Approximately $1.7 million, or 0.1%, of our non-owner occupied commercial real estate loans

were nonperforming at December 31, 2018.

Our real estate construction and land development loans are based upon estimates of costs and the related value associated with the completed project. These estimates may be inaccurate. Construction lending involves additional risks when compared with permanent residential lending because funds are advanced upon the collateral for the project based on an estimate of costs that will produce a future value at completion. Because of the uncertainties inherent in estimating construction costs, as well as the market value of the complete project and the effects of governmental regulation on real property, it is relatively difficult to evaluate accurately the total funds required to complete a project and the completed project loan-to-value ratio. Changes in demand for new housing and higher than

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anticipated building costs may cause actual results to vary significantly from those estimated. For these reasons, this type of lending also typically involves higher loan principal amounts and may be concentrated with a small number of builders. A downturn in housing, or the real estate market, could increase delinquencies, defaults and foreclosures, and significantly impair the value of our collateral and our ability to sell the collateral upon foreclosure. Some of the builders we deal with have more than one loan outstanding with us. Consequently, an adverse development with respect to one loan or one credit relationship can expose us to a significantly greater risk of loss. In addition, during the term of some of our construction loans, no payment from the borrower is required since the accumulated interest is added to the principal of the loan through an interest reserve. As a result, these loans often involve the disbursement of funds with repayment substantially dependent on the success of the ultimate project and the ability of the borrower to sell or lease the property or obtain permanent take-out financing, rather than the ability of the borrower or guarantor to repay principal and interest. If our appraisal of the value of a completed project proves to be overstated, we may have inadequate security for the repayment of the loan upon completion of construction of the project and may incur a loss. Because construction loans require active monitoring of the building process, including cost comparisons and on-site inspections, these loans are more difficult and more costly to monitor. Increases in market rates of interest may have a more pronounced effect on construction loans by rapidly increasing the end-purchaser's borrowing costs, thereby possibly reducing the homeowner's ability to finance the home upon completion or the overall demand for the project. Properties under construction are often difficult to sell and typically must be completed in order to be successfully sold which also complicates the process of working our problem construction loans. This may require us to advance additional funds and/or contract with another builder to complete construction and assume the market risk of selling the project at a future market price, which may or may not enable us to fully recover unpaid loan funds and associated construction and liquidation costs. Furthermore, in the case of speculative construction loans, there is the added risk associated with identifying an end-purchaser for the finished project. Land development loans also pose additional risk because of the lack of income being produced by the property and potential illiquid nature of the collateral. These risks can be significantly impacted by supply and demand conditions.

As of December 31, 2018, our real estate construction and land development loans totaled $215.5 million, or 5.9% of our total loan portfolio. Of these loans, $102.7 million, or 2.8% of our total loan portfolio, were one-to-four family residential construction related and $112.7 million, or 3.1% of our total loan portfolio, were five or more family residential and commercial property construction related. Approximately $899,000, or 0.4%, of our total construction and land development loans were nonperforming at December 31, 2018.

Our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio.

Lending money is a substantial part of our business. Every loan carries a certain risk that it will not be repaid in accordance with its terms or that any underlying collateral will not be sufficient to assure repayment. This risk is affected by, among other things:

- the cash flow of the borrower, guarantors and/or the project being financed;
- the changes and uncertainties as to the future value of the collateral, in the case of a collateralized loan;
- the character and creditworthiness of a particular borrower or guarantor;
- changes in economic and industry conditions; and
- the duration of the loan.

We maintain an allowance for loan losses, which is a reserve established through a provision for loan losses charged against earnings, which we believe is appropriate to absorb probable incurred losses in our loan portfolio. The amount of this allowance is determined by our management through a periodic comprehensive review and consideration of several factors, including, but not limited to:

- our general reserve, based on our historical default and loss experience;
- our specific reserve, based on our evaluation of impaired loans and their underlying collateral or discounted cash flows; and
- current macroeconomic factors, regulatory requirements and management’s expectation of future events.

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. If our estimates are incorrect, the allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in the need for increases in our allowance for loan losses through the provision for losses on loans which is charged against income. Management also recognizes that significant new growth in loan portfolios, new loan products and the refinancing of existing loans can result in portfolios comprised of unseasoned loans that may not perform in a historical or projected manner and will increase the risk that our allowance may be insufficient to absorb losses without significant additional provisions.

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Deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. If current conditions in the housing and real estate markets weaken, we expect we will experience increased delinquencies and credit losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs, based on their judgments about information available to them at the time of their examination. In addition, if charge-offs in future periods exceed the allowance for loan losses we will need additional provisions to increase the allowance for loan losses.
The FASB has adopted a new accounting standard referred to as Current Expected Credit Loss ("CECL") which will require financial institutions to determine periodic estimates of lifetime expected credit losses on loans and recognize the expected credit losses as allowances for credit losses. This will change the current method of providing allowances for credit losses that are probable, which may require us to increase our allowance for loan losses, and may greatly increase the types of data we would need to collect and review to determine the appropriate level of the allowance for credit losses. This accounting pronouncement is expected to be applicable to us effective for our fiscal year beginning January 1, 2020. We are evaluating the impact the CECL accounting model will have on our accounting, but expect to recognize a one-time cumulative-effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective. We cannot yet determine the magnitude of any such one-time cumulative adjustment or of the overall impact of the new standard on our financial condition or results of operations. The federal banking regulators, including the Federal Reserve and the FDIC, have adopted a rule that gives a banking organization the option to phase in over a three-year period the day-one adverse effects of CECL on its regulatory capital. Any increases in the allowance for loan losses due to the one-time cumulative-effect adjustment will result in a decrease in net income and possibly capital, and may have a material adverse effect on our financial condition and results of operations.
If our allowance for loan losses is not sufficient to cover actual loan losses our earnings could decrease.
For the year ended December 31, 2018 we recorded a provision for loan losses of $5.1 million compared to $4.2 million for the year ended December 31, 2017. We recorded net charge-offs of loans of $2.2 million for the year ended December 31, 2018 compared to $3.2 million for the year ended December 31, 2017. At December 31, 2018 our total nonperforming loans were $13.7 million, or 0.37% of loans receivable, net, compared to $10.7 million or 0.38% of loans receivable, net, at December 31, 2017. Generally, our nonperforming loans reflect operating difficulties of individual borrowers, which may be the result of current economic conditions. If economic conditions deteriorate, we expect that we could experience significantly higher delinquencies and loan charge-offs. As a result, we may be required to make further increases in our provision for loan losses in the future, which could adversely affect our financial condition and results of operations, perhaps materially.
General economic conditions tend to impact loan segments at varying degrees. At December 31, 2018, our commercial and industrial loan portfolio had the greatest percentage of nonaccrual loans of 48.4% as the borrowers are primarily business owners whose business results are influenced by economic conditions as well as impact of the types of collateral generally securing these loans. Our owner-occupied commercial real estate loans and non-owner occupied commercial real estate loans portfolio, which contained 30.7% and 12.5%, respectively, of our nonaccrual loans at December 31, 2018, generally have a large percentage of nonperforming loans because of the same reasons as the commercial and industrial loan portfolio noted above.
The current economic condition in the market areas we serve may adversely impact our earnings and could increase the credit risk associated with our loan portfolio.
Substantially all of our loans are to businesses and individuals in the states of Washington and Oregon. A decline in the economies of our primary market areas of the Pacific Northwest in which we operate could have a material adverse effect on our business, financial condition, results of operations and prospects. Weakness in the global economy has adversely affected many businesses operating in our markets that are dependent upon international trade and it is not known how the recent changes in tariffs being imposed on international trade may also affect these businesses.

While real estate values and unemployment rates have improved, a deterioration in economic conditions in our market areas of the Pacific Northwest could result in the following consequences, any of which could have a materially adverse impact on our business, financial condition and results of operations:

- loan delinquencies, problem assets and foreclosures may increase;
- we may increase our allowance for loan losses;
- the sale of foreclosed assets may be slow;
- our provision for loan losses may increase;
- demand for our products and services may decline, possibly resulting in a decrease in our total loans;

- collateral for loans made may decline further in value, exposing us to increased risk of loss on existing loans;
- the net worth and liquidity of loan guarantors may decline, impairing their ability to honor commitments to us; and
- the amount of our deposits may decrease and the composition of our deposits may be adversely affected.

A decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose real estate loans are geographically diverse. Many of the loans in our portfolio are secured by real estate. Deterioration in the real estate markets where collateral for a mortgage loan is located could negatively affect the borrower's ability to repay the loan and the value of the collateral securing the loan. Real estate values are affected by various other factors, including changes in general or regional economic conditions, governmental rules or policies and natural disasters such as earthquakes and flooding.

Adverse changes in the regional and general economy could reduce our growth rate, impair our ability to collect loans and generally have a negative effect on our financial condition and results of operations.

If the goodwill we have recorded in connection with acquisitions becomes impaired, our earnings and capital could be reduced.

Accounting standards require that we account for acquisitions using the purchase method of accounting. Under purchase accounting, if the purchase price of an acquired company exceeds the fair value of its net assets, the excess is carried on the acquirer's balance sheet as goodwill. In accordance with GAAP, our goodwill is evaluated for impairment on an annual basis or more frequently if events or circumstances indicate that a potential impairment exists. The evaluation is based on a variety of factors, including the quoted price of our common stock, market prices of common stock of other banking organizations, common stock trading multiples, discounted cash flows, and data from comparable acquisitions. At December 31, 2018, we had goodwill with a carrying amount of $240.9 million. Declines in our stock price or a prolonged weakness in the operating environment of the financial services industry may result in a future impairment charge. Any such impairment charge could have a material adverse effect on our operating results and financial condition.

Fluctuating interest rates can adversely affect our profitability.

Our profitability is dependent to a large extent upon net interest income, which is the difference (or "spread") between the interest earned on loans, securities and other interest earning assets and the interest paid on deposits, borrowings, and other interest bearing liabilities. Because of the differences in maturities and repricing characteristics of our interest earning assets and interest bearing liabilities, changes in interest rates do not produce equivalent changes in interest income earned on interest earning assets and interest paid on interest bearing liabilities.

We principally manage interest rate risk by managing our volume and mix of our earning assets and funding liabilities. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investments and the amount of interest we pay on deposits and borrowings, but these changes could also affect (i) our ability to originate and/or sell loans and obtain deposits, (ii) the fair value of our financial assets and liabilities, which could negatively impact shareholders' equity, and our ability to realize gains from the sale of such assets, (iii) our ability to obtain and retain deposits in competition with other available investment alternatives, (iv) the ability of our borrowers to repay adjustable or variable rate loans, and (v) the average duration of our investment securities portfolio and other interest-earning assets. In a changing interest rate environment, we may not be able to manage this risk effectively. If we are unable to manage interest rate risk effectively, our business, financial condition and results of operations could be materially affected.

Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve. In an attempt to help the overall economy, the Federal Reserve has kept interest rates low through its targeted Fed Funds rate. The Federal Reserve has steadily increased the targeted Fed Funds rate over the last three fiscal years to 2.50% at December 31, 2018. The Federal Reserve may make additional increases in interest rates during 2019 subject to economic conditions. As the Federal Reserve increases the targeted federal funds rates, overall interest rates will likely rise, which may negatively impact both the housing markets by reducing refinancing activity and new home purchases and the U.S. economic recovery.

A sustained increase in market interest rates could adversely affect our earnings. As a result of the exceptionally low interest rate environment, an increasing percentage of our deposits have been comprised of deposits bearing no or a relatively low rate of interest and having a shorter duration than our assets. We would incur a higher cost of funds to retain these deposits in a rising interest rate environment. If the interest rates paid on deposits and other borrowings

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increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected.

Changes in interest rates also affect the value of our interest-earning assets and in particular our securities portfolio. Generally, the fair value of fixed-rate securities fluctuates inversely with changes in interest rates. Unrealized gains and losses on securities available for sale are reported as a separate component of equity, net of tax. Decreases in the fair value of securities available for sale resulting from increases in interest rates could have an adverse effect on stockholders' equity.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial, unexpected or prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet.

Uncertainty relating to the London Interbank Offered Rate ("LIBOR") calculation process and potential phasing out of LIBOR may adversely affect our results of operations.

On July 27, 2017, the Chief Executive of the United Kingdom Financial Conduct Authority, which regulates LIBOR, announced that it intends to stop persuading or compelling banks to submit rates for the calibration of LIBOR to the administrator of LIBOR after 2021. The announcement indicates that the continuation of LIBOR on the current basis cannot and will not be guaranteed after 2021. It is impossible to predict whether and to what extent banks will continue to provide LIBOR submissions to the administrator of LIBOR or whether any additional reforms to LIBOR may be enacted in the United Kingdom or elsewhere. At this time, no consensus exists as to what rate or rates may become acceptable alternatives to LIBOR and it is impossible to predict the effect of any such alternatives on the value of LIBOR-based securities and variable rate loans, subordinated debentures, or other securities or financial arrangements, given LIBOR's role in determining market interest rates globally. Uncertainty as to the nature of alternative reference rates and as to potential changes or other reforms to LIBOR may adversely affect LIBOR rates and the value of LIBOR-based loans, and to a lesser extent securities in our portfolio, and may impact the availability and cost of hedging instruments and borrowings, including the rates we pay on our subordinated debentures and trust preferred securities. If LIBOR rates are no longer available, and we are required to implement substitute indices for the calculation of interest rates under our loan agreements with our borrowers or our existing borrowings, we may incur significant expenses in effecting the transition, and may be subject to disputes or litigation with customers and creditors over the appropriateness or comparability to LIBOR of the substitute indices, which could have an adverse effect on our results of operations.

Our securities portfolio may be negatively impacted by fluctuations in market value and interest rates.

Our securities portfolio may be impacted by fluctuations in market value, potentially reducing accumulated other comprehensive income (loss), net and/or earnings. Fluctuations in market value may be caused by changes in market interest rates, rating agency actions in respect of the securities, defaults by the issuer or with respect to the underlying securities, lower market prices for securities and limited investor demand. Our securities portfolio is evaluated for other-than-temporary impairment. If this evaluation shows impairment to the actual or projected cash flows associated with one or more securities, a potential loss to earnings may occur. Changes in interest rates can also have an adverse effect on our financial condition, as our available-for-sale securities are reported at their estimated fair value, and therefore are impacted by fluctuations in interest rates. We increase or decrease our shareholders' equity by the amount of change in the estimated fair value of the available-for-sale securities, net of taxes. There can be no assurance that the declines in market value will not result in other-than-temporary impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our net income and capital levels.

Decreased volumes and lower gains on sales of mortgage loans sold could adversely impact our noninterest income.

We originate and sell one-to-four family residential loans. Our mortgage banking income is a significant portion of our noninterest income. We generate gains on the sale of one-to-four family residential loans pursuant to programs currently offered by the Federal Home Loan Mortgage Corporation ("Freddie Mac") and other secondary market purchasers. Any future changes in their purchase programs, our eligibility to participate in such programs, the criteria

for loans to be accepted or laws that significantly affect the activity of such entities could, in turn, materially adversely affect our results of operations. Further, in a rising or higher interest rate environment, our originations of mortgage loans may decrease, resulting in fewer loans that are available to be sold to investors. This would result in a decrease in mortgage banking revenues and a corresponding decrease in noninterest income. In addition, our results of operations are affected by the amount of noninterest expense associated with mortgage banking activities, such as salaries and employee benefits, occupancy, equipment and data processing expense and other operating costs. During

periods of reduced loan demand, our results of operations may be adversely affected to the extent that we are unable to reduce expenses commensurate with the decline in loan originations.

Liquidity risk could impair our ability to fund operations and jeopardize our financial condition, growth and prospects.

Liquidity is essential to our business. We rely on a number of different sources in order to meet our potential liquidity demands. We require sufficient liquidity to meet customer loan requests, customer deposit maturities and withdrawals, payments on our debt obligations as they come due and other cash commitments under both normal operating conditions and other unpredictable circumstances, including events causing industry or general financial market stress. A tightening of the credit markets and the inability to obtain adequate funding may negatively affect our liquidity, asset growth and, consequently, our earnings capability and capital levels. In addition to any deposit growth, and the sale of loans or investment securities, maturity of investment securities and loan payments, we rely from time to time on advances from the FHLB of Des Moines, and certain other wholesale funding sources to meet liquidity demands. Our liquidity position could be significantly constrained if we were unable to access funds from the FHLB of Des Moines or other wholesale funding sources. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity as a result of a downturn in the markets in which our loans are concentrated, negative operating results, or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a disruption in the financial markets or negative views and expectations about the prospects for the financial services industry or deterioration in credit markets. Any decline in available funding in amounts adequate to finance our activities or on terms which are acceptable could adversely impact our ability to originate loans, invest in securities, meet our expenses, or fulfill obligations such as repaying our borrowings or meeting deposit withdrawal demands, any of which could, in turn, have a material adverse effect on our business, financial condition and results of operations.

Additionally, collateralized public funds are bank deposits of state and local municipalities. These deposits are required to be secured by certain investment grade securities to ensure repayment, which on the one hand tends to reduce our contingent liquidity risk by making these funds somewhat less credit sensitive, but on the other hand reduces standby liquidity by restricting the potential liquidity of the pledged collateral. Although these funds historically have been a relatively stable source of funds for us, availability depends on the individual municipality's fiscal policies and cash flow needs.

Our growth or future losses may require us to raise additional capital in the future, but that capital may not be available when it is needed or the cost of that capital may be very high; further, the resulting dilution of our equity may adversely affect the market price of our common stock.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. At some point we may need to raise additional capital to support our continued internal growth and growth through acquisitions or be required by our regulators to increase our capital resources. Our ability to raise additional capital, however, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial condition and performance. If we are able to raise capital it may not be on terms that are acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth and acquisitions could be materially impaired and our financial condition and liquidity could be materially and adversely affected. Accordingly, we cannot make assurances that we will be able to raise additional capital when needed.

We are not restricted from issuing additional common stock or preferred stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, common stock or preferred stock or any substantially similar securities. The market price of our common stock could decline as a result of sales of a large number of shares of common stock or preferred stock or similar securities in the market or from the perception that such sales could occur.

Our Board of Directors is authorized generally to cause us to issue additional common stock, as well as series of preferred stock, without any action on the part of our shareholders except as may be required under the listing requirements of the NASDAQ Stock Market. In addition, our Board has the power, without shareholder approval, to set the terms of any such series of preferred stock that may be issued, including voting rights, dividend rights and

preferences over the common stock with respect to dividends or upon the liquidation, dissolution or winding-up of our business and other terms. Any capital we obtain may result in the dilution of the interests of existing holders of our common stock.

In addition, if we issue preferred stock in the future that has a preference over the common stock with respect to the payment of dividends or upon liquidation, dissolution or winding-up, or if we issue preferred stock with voting

rights that dilute the voting power of the common stock, the rights of holders of the common stock or the market price of the common stock could be adversely affected.

Non-compliance with the USA PATRIOT Act, Bank Secrecy Act, or other laws and regulations could result in fines or sanctions and limit our ability to get regulatory approval of acquisitions.

The USA PATRIOT and Bank Secrecy Acts require financial institutions to develop programs to prevent financial institutions from being used for money laundering and terrorist activities. If such activities are detected, financial institutions are obligated to file suspicious activity reports with the U.S. Treasury's Office of Financial Crimes Enforcement Network. These rules require financial institutions to establish procedures for identifying and verifying the identity of customers seeking to open new financial accounts. Failure to comply with these regulations could result in fines or sanctions and limit our ability to get regulatory approval of acquisitions. Recently several banking institutions have received large fines for non-compliance with these laws and regulations. While we have developed policies and procedures designed to assist in compliance with these laws and regulations, no assurance can be given that these policies and procedures will be effective in preventing violations of these laws and regulations.

Failure to maintain and implement adequate programs to combat money laundering and terrorist financing could also have serious reputational consequences for us. Any of these results could have a material adverse effect on our business, financial condition, results of operations and growth prospects.

Our operations rely on numerous external vendors.

We rely on numerous external vendors to provide us with products and services necessary to maintain our day-to-day operations. Accordingly, our operations are exposed to risk that these vendors will not perform in accordance with the contracted arrangements under service level agreements. The failure of an external vendor to perform in accordance with the contracted arrangements under service level agreements because of changes in the vendor's organizational structure, financial condition, support for existing products and services or strategic focus or for any other reason, could be disruptive to our operations, which in turn could have a material negative impact on our financial condition and results of operations. We also could be adversely affected to the extent a service agreement is not renewed by the third party vendor or is renewed on terms less favorable to us.

We are subject to certain risks in connection with our use of technology.

Our security measures may not be sufficient to mitigate the risk of a cyber-attack. Communications and information systems are essential to the conduct of our business, as we use such systems to manage our customer relationships, our general ledger and virtually all other aspects of our business. Our operations rely on the secure processing, storage, and transmission of confidential and other information in our computer systems and networks. Although we take protective measures and endeavor to modify them as circumstances warrant, the security of our computer systems, software, and networks may be vulnerable to breaches, fraudulent or unauthorized access, denial or degradation of service attacks, misuse, computer viruses, malware or other malicious code and cyber-attacks that could have a security impact. If one or more of these events occur, this could jeopardize our or our customers' confidential and other information processed and stored in, and transmitted through, our computer systems and networks, or otherwise cause interruptions or malfunctions in our operations or the operations of our customers or counterparties. We may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures, and we may be subject to litigation and financial losses that are either not insured against or not fully covered through any insurance maintained by us. We could also suffer significant reputational damage.

Security breaches in our internet banking activities could further expose us to possible liability and damage our reputation. Increases in criminal activity levels and sophistication, advances in computer capabilities, new discoveries, and vulnerabilities in third party technologies (including browsers and operating systems) or other developments could result in a compromise or breach of the technology, processes and controls that we use to prevent fraudulent transactions and to protect data about us, our clients and underlying transactions. Any compromise of our security could deter customers from using our internet banking services that involve the transmission of confidential information. We rely on standard internet security systems to provide the security and authentication necessary to effect secure transmission of data. Although we have developed and continue to invest in systems and processes that

are designed to detect and prevent security breaches and cyber-attacks and periodically test our security, these precautions may not protect our systems from compromises or breaches of our security measures. and could result in losses to us or our customers, our loss of business and/or customers, damage to our reputation the incurrence of additional expenses, disruption to our business, our inability to grow our online services or other businesses, additional regulatory scrutiny or penalties, or our exposure to civil litigation and possible financial liability, any of which could have a material adverse effect on our business, financial condition and results of operations.

Our security measures may not protect us from system failures or interruptions. While we have established policies and procedures to prevent or limit the impact of systems failures and interruptions, there can be no assurance that such events will not occur or that they will be adequately addressed if they do. In addition, we outsource certain aspects of our data processing and other operational functions to certain third-party providers. While the Company selects third-party vendors carefully, it does not control their actions. If our third-party providers encounter difficulties, including those resulting from breakdowns or other disruptions in communication services provided by a vendor, failure of a vendor to handle current or higher transaction volumes, cyber-attacks and security breaches or if we otherwise have difficulty in communicating with them, our ability to adequately process and account for transactions could be affected, and our ability to deliver products and services to our customers and otherwise conduct business operations could be adversely impacted. Replacing these third-party vendors could also entail significant delay and expense. Threats to information security also exist in the processing of customer information through various other vendors and their personnel.

We cannot assure you that such breaches, failures or interruptions will not occur or, if they do occur, that they will be adequately addressed by us or the third parties on which we rely. We may not be insured against all types of losses as a result of third party failures and insurance coverage may be inadequate to cover all losses resulting from breaches, system failures or other disruptions. If any of our third-party service providers experience financial, operational or technological difficulties, or if there is any other disruption in our relationships with them, we may be required to identify alternative sources of such services, and we cannot assure you that we could negotiate terms that are as favorable to us or could obtain services with similar functionality as found in our existing systems without the need to expend substantial resources, if at all. Further, the occurrence of any systems failure or interruption could damage our reputation and result in a loss of customers and business, could subject us to additional regulatory scrutiny, or could expose us to legal liability. Any of these occurrences could have a material adverse effect on our financial condition and results of operations.

The board of directors oversees the risk management process, including the risk of cybersecurity, and engages with management on cybersecurity issues.

If our enterprise risk management framework is not effective at mitigating risk and loss to us, we could suffer unexpected losses and our results of operations could be materially adversely affected.

Our enterprise risk management framework seeks to achieve an appropriate balance between risk and return, which is critical to optimizing stockholder value. We have established processes and procedures intended to identify, measure, monitor, report, analyze and control the types of risk to which we are subject. These risks include liquidity risk, credit risk, market risk, interest rate risk, operational risk, legal and compliance risk, and reputational risk, among others. We also maintain a compliance program to identify, measure, assess, and report on our adherence to applicable laws, policies and procedures. While we assess and improve these programs on an ongoing basis, there can be no assurance that our risk management or compliance programs, along with other related controls, will effectively mitigate all risk and limit losses in our business. However, as with any risk management framework, there are inherent limitations to our risk management strategies as there may exist, or develop in the future, risks that we have not appropriately anticipated or identified. If our risk management framework proves ineffective, we could suffer unexpected losses and our business, financial condition and results of operations could be materially adversely affected.

We are subject to certain risks in connection with our data management or aggregation.

We are reliant on our ability to manage data and our ability to aggregate data in an accurate and timely manner to ensure effective risk reporting and management. Our ability to manage data and aggregate data may be limited by the effectiveness of our policies, programs, processes and practices that govern how data is acquired, validated, stored, protected and processed. While we continuously update our policies, programs, processes and practices, many of our data management and aggregation processes are manual and subject to human error or system failure. Failure to manage data effectively and to aggregate data in an accurate and timely manner may limit our ability to manage current and emerging risks, as well as to manage changing business needs.

We rely on dividends from Heritage Bank for substantially all of our revenue at the holding company level.

We are an entity separate and distinct from our subsidiary, Heritage Bank, and derive substantially all of our revenue at the holding company level in the form of dividends from that subsidiary. Accordingly, we are, and will be, dependent upon dividends from Heritage Bank to pay the principal of and interest on our indebtedness, to satisfy our other cash needs and to pay dividends on our common stock. Heritage Bank's ability to pay dividends is subject to its ability to earn net income and to meet certain regulatory requirements. In the event Heritage Bank is unable to pay dividends to us, we may not be able to pay dividends on our common stock. Also, our right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors.

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Our business may be adversely affected by an increasing prevalence of fraud and other financial crimes.
Our loans to businesses and individuals and our deposit relationships and related transactions are subject to exposure to the risk of loss due to fraud and other financial crimes. Nationally, reported incidents of fraud and other financial crimes have increased. We have also experienced losses due to apparent fraud and other financial crimes, although such losses have been relatively insignificant to date. While we have policies and procedures designed to prevent such losses, there can be no assurance that such losses will not occur.
Managing reputational risk is important to attracting and maintaining customers, investors and employees.
Threats to our reputation can come from many sources, including adverse sentiment about financial institutions generally, unethical practices, employee misconduct, failure to deliver minimum standards of service or quality, compliance deficiencies and questionable or fraudulent activities of our customers. We have policies and procedures in place to protect our reputation and promote ethical conduct, but these policies and procedures may not be fully effective. Negative publicity regarding our business, employees, or customers, with or without merit, may result in the loss of customers, investors and employees, costly litigation, a decline in revenues and increased governmental regulation.
We are dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect our prospects.
Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the community banking industry where we conduct our business. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a significant degree upon our ability to attract and retain qualified management, loan origination, finance, administrative, marketing and technical personnel and upon the continued contributions of our management and personnel. In particular, our success has been and continues to be highly dependent upon the abilities of key executives, including our Chief Executive Officer of Heritage, Mr. Brian L. Vance, and our Chief Executive Officer of Heritage Bank, Jeffrey J. Deuel, and certain other employees. The loss of key personnel could adversely affect our ability to successfully conduct our business.
Our ability to sustain or improve upon existing performance is dependent upon our ability to respond to technological change, and we may have fewer resources than some of our competitors to continue to invest in technological improvements.
The financial services industry is experiencing rapid technological changes with frequent introductions of new technology-driven products and services. Effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Many of our competitors have substantially greater resources to invest in technological improvements than the Company does. Our future success will depend, to some degree, upon its ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience, as well as create additional efficiencies in our operations. We may not be able to effectively implement new technology-driven products or services, or be successful in marketing these products and services. Additionally, the implementation of technological changes and upgrades to maintain current systems and integrate new ones may cause services interruptions, transaction processing errors and system conversion delays and may cause us to fail to comply with applicable laws. There can be no assurance that we will be able to successfully manage the risks associated with increased dependency on technology.

ITEM 1B. UNRESOLVED STAFF COMMENTS
The Company has no unresolved staff comments from the SEC as it relates to the Company's financial information as reported on Form 10-K.

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ITEM 2. PROPERTIES

Our executive offices and the main office of Heritage Bank are located in approximately 22,000 square feet of the headquarters building and adjacent office space and main branch office which are owned by Heritage Bank and located in downtown Olympia. The Company's branch network at December 31, 2018 was comprised of 64 branches located throughout Washington and Oregon. The number of branches per county, as well as occupancy type, is detailed in the following table.

County	State	Number of Branches	Occupancy Type	
			Owned	Leased
Clark	WA	2	1	1
Cowlitz	WA	2	2	—
Island [(1)]	WA	7	6	1
Kittitas [(1)]	WA	1	1	—
King	WA	8	3	5
Mason	WA	1	1	—
Multnomah	OR	2	—	2
Pierce	WA	13	8	5
San Juan	WA	1	—	1
Skagit [(1)]	WA	3	3	—
Snohomish	WA	8	6	2
Thurston [(1)]	WA	4	3	1
Washington	OR	5	1	4
Whatcom	WA	3	3	—
Yakima	WA	4	4	—
Total		64	42	22

(1) One Island County branch, one Skagit County branch, one Thurston County branch and the one branch in Kittitas County have land leases, which are not included in the leased section above as the building is owned.

For additional information concerning our premises and equipment and lease obligations, see Note (7) Premises and Equipment and Note (14) Commitments and Contingencies of the Notes to Consolidated Financial Statements included in Item 8. Financial Statements And Supplementary Data.

ITEM 3. LEGAL PROCEEDINGS

We, and our Bank, are not a party to any material pending legal proceedings other than ordinary routine litigation incidental to the business of the Bank.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

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PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the NASDAQ Global Select Market under the symbol HFWA. At December 31, 2018, we had approximately 1,439 shareholders of record (not including the number of persons or entities holding stock in nominee or street name through various brokerage firms) and 36,874,055 outstanding shares of common stock. This total does not reflect the number of persons or entities who hold stock in nominee or “street” name through various brokerage firms.

Quarterly, the Company reviews the potential payment of cash dividends to common shareholders. The timing and amount of cash dividends paid on our common stock depends on the Company’s earnings, capital requirements, financial condition and other relevant factors.

The dividend activities for the years ended December 31, 2018 and 2017 and through the date of this filing are listed below:

Declared	Cash Dividend per Share	Record Date	Paid	
January 25, 2017	$0.12	February 9, 2017	February 23, 2017	
April 25, 2017	$0.13	May 10, 2017	May 24, 2017	
July 25, 2017	$0.13	August 10, 2017	August 24, 2017	
October 25, 2017	$0.13	November 8, 2017	November 22, 2017	
October 25, 2017	$0.10	November 8, 2017	November 22, 2017	*
January 24, 2018	$0.15	February 7, 2018	February 21, 2018	
April 25, 2018	$0.15	May 10, 2018	May 24, 2018	
July 24, 2018	$0.15	August 9, 2018	August 23, 2018	
October 24, 2018	$0.17	November 7, 2018	November 21, 2018	
October 24, 2018	$0.10	November 7, 2018	November 21, 2018	*
January 23, 2019	$0.18	February 7, 2019	February 21, 2019	

* Denotes special dividend.

The primary source for dividends paid to our shareholders are dividends paid to us from Heritage Bank. There are regulatory restrictions on the ability of the Bank to pay dividends. Under federal regulations, the dollar amount of dividends the Bank may pay depends upon its capital position and recent net income. Generally, if an institution satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed under state law and FDIC regulations. However, an institution that has converted to the stock form of ownership, as Heritage Bank has done, may not declare or pay a dividend on, or repurchase any of, its common stock if the effect thereof would cause the regulatory capital of the institution to be reduced below the amount required for the liquidation account which was established in connection with the mutual to stock conversion.

As a bank holding company, our ability to pay dividends is subject to the guidelines of the Federal Reserve regarding capital adequacy and dividends. The Federal Reserve’s policy is that a bank holding company should pay cash dividends only to the extent that its net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the holding company’s capital needs, asset quality and overall financial condition, and that it is inappropriate for a bank holding company experiencing serious financial problems to borrow funds to pay dividends. Under Washington law, we are prohibited from paying a dividend if, after making such dividend payment, we would be unable to pay our debts as they become due in the usual course of business, or if our total liabilities, plus the amount that would be needed, in the event we were to be dissolved at the time of the dividend payment, to satisfy preferential rights on dissolution of holders of preferred stock ranking senior in right of payment to the capital stock on which the applicable distribution is to be made exceed our total assets.

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Stock Repurchases

The Company has had various stock repurchase programs since March 1999. On October 23, 2014, the Company's Board of Directors authorized the repurchase of up to 5% of the Company's outstanding common shares, or approximately 1,513,000 shares, under the eleventh stock repurchase plan. At December 31, 2018, there were approximately 933,004 shares remaining to be purchased under the eleventh stock repurchase plan. The number, timing and price of shares repurchased will depend on business and market conditions, and other factors, including opportunities to deploy the Company's capital.

Since the inception of the eleventh plan, the Company has repurchased 579,996 shares at an average share price of $16.67. No shares were repurchased under this plan during the year ended December 31, 2018 and 2017. During the year ended December 31, 2016, the Company repurchased 138,000 shares at an average share price of $17.16.

In addition to the stock repurchases under a plan, the Company repurchases shares to pay withholding taxes on the vesting of restricted stock awards and units. The following table provides total repurchased shares for the periods indicated:

	Year Ended December 31,		
	2018	2017	2016
Repurchased shares to pay withholding taxes [(1)]	53,256	29,429	29,512
Stock repurchase to pay withholding taxes average share price	$31.99	$25.01	$17.82

(1) During the year ended December 31, 2018, the Company repurchased 26,741 shares related to the withholding taxes due on the accelerated vesting of the restricted stock units of Puget Sound which were converted to Heritage common stock shares with a share price of $31.80 under the terms of the Puget Sound Merger.

The following table sets forth information about the Company's purchases of its outstanding common stock during the quarter ended December 31, 2018.

Period	Total Number of Shares Purchased [(1)]	Average Price Paid Per Share [(1)]	Cumulative 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
October 1, 2018— October 31, 2018	—	$ —	7,893,389	935,034
November 1, 2018—November 30, 2018	—	—	7,893,389	935,034
December 1, 2018—December 31, 2018	68	31.79	7,893,389	935,034
Total	68	$ 31.79		

(1) All of the common shares repurchased by the Company between October 1, 2018 and December 31, 2018, were shares of restricted stock that represented the cancellation of stock to pay withholding taxes.

Stock Performance Graph

The following graph depicts total return to shareholders during the five-year period beginning December 31, 2013 and ending December 31, 2018. Total return includes appreciation or depreciation in market value of the Company's common stock as well as actual cash and stock dividends paid to common shareholders. The graph additionally shows the five-year comparison of the total return to shareholders of the Company's common stock as compared to the NASDAQ Composite Index and the SNL U.S. Bank NASDAQ Index. The NASDAQ Composite Index is a comparative broad market index comprised of all domestic and international common stocks listed on the Nasdaq Stock Market. The SNL U.S. Bank NASDAQ Index is a comparative peer index comprised of banks and related holding companies listed on the NASDAQ Stock Market. The graph assumes that the value of the investment in Heritage's common stock and each of the three indices was $100 on December 31, 2013, and that all dividends were

reinvested.

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Index	Years Ended December 31, 2013	2014	2015	2016	2017	2018
Heritage Financial Corporation	$100.00	$105.74	$116.98	$166.45	$203.56	$200.82
NASDAQ Composite Index	100.00	114.75	122.74	133.62	173.22	168.30
SNL U.S. Bank NASDAQ Index	100.00	103.57	111.80	155.02	163.20	137.56

*Information for the graph was provided by S&P Global Market Intelligence.

ITEM 6. SELECTED FINANCIAL DATA

The following tables set forth certain information concerning our consolidated financial position and results of operations at and for the dates indicated and have been derived from our audited Consolidated Financial Statements. The information below is qualified in its entirety by the detailed information included elsewhere herein and should be read along with Item 7. Management’s Discussion And Analysis Of Financial Condition And Results Of Operations and Item 8. Financial Statements And Supplementary Data.

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Matters affecting comparability in the five-year summary detailed below include the Washington Banking Merger in 2014, and the Premier and Puget Mergers in 2018, as discussed below.

	Year Ended December 31,				
	2018	2017	2016	2015	2014
	(Dollars in thousands, except per share amounts)				
Operations Data:					
Interest income	$199,359	$147,709	$138,512	$135,739	$121,106
Interest expense	12,413	8,346	6,006	6,120	5,681
Net interest income	186,946	139,363	132,506	129,619	115,425
Provision for loan losses	5,129	4,220	4,931	4,372	4,594
Noninterest income	31,665	35,579	31,619	32,268	16,467
Noninterest expense	149,395	110,575	106,473	106,208	99,379
Income tax expense [1]	11,030	18,356	13,803	13,818	6,905
Net income	53,057	41,791	38,918	37,489	21,014
Earnings per common share					
Basic	$1.49	$1.39	$1.30	$1.25	$0.82
Diluted	1.49	1.39	1.30	1.25	0.82
Dividend payout ratio to common shareholders [2]	48.3 %	43.9 %	55.4 %	42.4 %	61.0 %
Performance Ratios:					
Net interest spread [3]	4.15 %	3.83 %	3.89 %	4.04 %	4.45 %
Net interest margin [4]	4.29	3.93	3.96	4.11	4.53
Efficiency ratio [5]	68.34	63.21	64.87	65.61	75.35
Noninterest expense to average assets	3.00	2.78	2.84	3.01	3.49
Return on average assets	1.07	1.05	1.04	1.06	0.74
Return on average common equity	7.72	8.36	8.01	8.08	5.61

(1) The Tax Cuts and Jobs Act enacted December 22, 2017 decreased the federal corporate income tax rate from 35% to 21% beginning January 1, 2018 and impacted the comparability of our results. The results for the year ended December 31, 2017 included a $2.6 million increase to the income tax expense as a result of the revaluation of our deferred tax assets and liabilities to account for the tax rate change.

(2) Dividend payout ratio is declared dividends per common share divided by diluted earnings per common share.

(3) Net interest spread is the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities.

(4) Net interest margin is net interest income divided by average interest earning assets.

(5) The efficiency ratio is noninterest expense divided by the sum of net interest income and noninterest income.

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	December 31,				
	2018	2017	2016	2015	2014
	(Dollars in thousands)				
Balance Sheet Data:					
Total assets	$5,316,927	$4,113,270	$3,878,981	$3,650,792	$3,457,750
Total loans receivable, net	3,619,118	2,816,985	2,609,666	2,372,296	2,223,348
Investment securities	976,095	810,530	794,645	811,869	778,660
Goodwill and other intangible assets	261,553	125,117	126,403	127,818	129,918
Deposits	4,432,402	3,393,060	3,229,648	3,108,287	2,906,331
Federal Home Loan Bank advances	—	92,500	79,600	—	—
Junior subordinated debentures	20,302	20,009	19,717	19,424	19,082
Securities sold under agreement to repurchase	31,487	31,821	22,104	23,214	32,181
Stockholders’ equity	760,723	508,305	481,763	469,970	454,506
Financial Measures:					
Book value per common share	$20.63	$16.98	$16.08	$15.68	$15.02
Stockholders' equity to assets ratio	14.3 %	12.4 %	12.4 %	12.9 %	13.1 %
Net loans to deposits [(1)]	82.4 %	84.0 %	81.8 %	77.3 %	77.5 %
Capital Ratios:					
Total risk-based capital ratio	12.9 %	12.8 %	13.0 %	13.7 %	15.1 %
Tier 1 risk-based capital ratio	12.1	11.8	12.0	12.7	13.9
Leverage ratio	10.5	10.2	10.3	10.4	10.2
Common equity Tier 1 capital to risk-weighted assets	11.7	11.3	11.4	12.00	N/A
Asset Quality Ratios:					
Nonperforming loans to loans receivable, net	0.37 %	0.38 %	0.41 %	0.40 %	0.51 %
Allowance for loan losses to loans receivable, net	0.96	1.13	1.18	1.24	1.23
Allowance for loan losses to nonperforming loans	255.73	299.79	284.93	307.67	239.62
Nonperforming assets to total assets	0.30	0.26	0.30	0.32	0.43
Net charge-off on loans to average loans receivable, net	0.06	0.12	0.14	0.10	0.30
Other Data:					
Number of banking offices	64	59	63	67	66
Number of full-time equivalent employees	859	735	760	717	748
Deposits per branch	69,256	57,509	51,264	46,392	44,035
Assets per full-time equivalent	6,190	5,596	5,104	5,092	4,623

[(1)] Loans receivable, net of deferred costs divided by deposits.

The Company has focused on expanding its business over the past several years. In May 2014, the Company completed the merger with Washington Banking Company. In 2018, the Company completed two bank acquisitions of Puget Sound Bancorp in January 2018 and Premier Commercial Bancorp in July 2018. These acquisitions and merger, together with organic growth of the business, have significantly increased the Company's assets and liabilities. During the period from December 31, 2014 through December 31, 2018 total assets have increased $1.86 billion, or 53.8%, to $5.32 billion as of December 31, 2018 from $3.46 billion at December 31, 2014. The total loans receivable, net of allowance for loan losses increased $1.40 billion, or 62.8%, to $3.62 billion as of December 31, 2018 from $2.22 billion at December 31, 2014. Loan increases during the five-year period are attributable primarily to the

Premier and Puget Mergers with the acquisitions of loans at fair value of $718.6 million as of the merger dates. The remaining five-year period increase in loans of $677.2 million, or 6.9% annualized growth, was due to organic growth.

Deposits increased $1.53 billion, or 52.5%, to $4.43 billion at December 31, 2018 from $2.91 billion at December 31, 2014. Deposit increases during the five-year period are also attributable to the Premier and Puget Mergers with the assumptions of deposits at fair value of $824.6 million as of the merger dates. From December 31, 2014 to December 31, 2018, non-maturity deposits (total deposits less certificate of deposit accounts), including acquired deposits, increased $1.58 billion, or 66.6%, to $3.97 billion at December 31, 2018. The percentage of certificate of deposit accounts to total deposits decreased to 10.5% at December 31, 2018 from 18.1% at December 31, 2014.

Stockholders' equity increased by $306.2 million, or 67.4%, to $760.7 million at December 31, 2018 from $454.5 million at December 31, 2014 due primarily to a combination of earnings and issuances of common stock, partially offset by repurchases of common stock and declarations of cash dividends. Our net income increased $32.0 million, or 152.5%, to $53.1 million for the year ended December 31, 2018 from $21.0 million for the year ended December 31, 2014 as a result of growth in the Company due primarily through acquisitions and merger. Net interest income increased $71.5 million, or 62.0%, to $186.9 million for the year ended December 31, 2018 from $115.4 million during the year ended December 31, 2014. The increase in net interest income was primarily a result of an increase in interest income of $78.3 million, or 64.6%, to $199.4 million for the year ended December 31, 2018 from $121.1 million for the year ended December 31, 2014. Additionally, the increase in net income includes an increase in noninterest income of $15.2 million, or 92.3%, to $31.7 million for the year ended December 31, 2018 compared to $16.5 million for the year ended December 31, 2014. The increase in net income was partially offset by an increase in noninterest expense of $50.0 million, or 50.3%, to $149.4 million for the year ended December 31, 2018 from $99.4 million for the year ended December 31, 2014 as a result of the growth of the Company primarily through acquisitions and merger.

ITEM 7. 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 operations of the Company. The information contained in this section should be read with the December 31, 2018 audited Consolidated Financial Statements and Notes thereto included in Item 8. Financial Statements And Supplementary Data of this Form 10-K.

Critical Accounting Policies

The Company's Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Companies may apply certain critical accounting policies requiring management to make subjective or complex judgments, often as a result of the need to estimate the effect of matters that are inherently uncertain.

The Company considers its most critical accounting estimates to be the allowance for loan losses, estimations of expected cash flows related to purchased credit impaired loans, business combinations, other-than-temporary impairments in the fair value of investments and consideration of potential impairment of goodwill.

Allowance for Loan Losses

The allowance for loan losses is established through a provision for loan losses charged against earnings. The balance of the allowance for loan losses is maintained at the amount management believes will be appropriate to absorb probable incurred credit losses in the loan portfolio at the balance sheet date. The allowance for loan losses is determined by applying estimated loss factors to the credit exposure from outstanding loans.

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

- historical loss experience in the loan portfolio;
- impact of environmental factors, including:
  - levels of and trends in delinquencies, classified and impaired loans;
  - levels of and trends in charge-offs and recoveries;

trends in volume and terms of loans;
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;
other external factors such as competition, legal and regulatory;

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effects of changes in credit concentrations; and
other factors.

We calculate an appropriate allowance for loan losses for the loans in our loan portfolio by applying historical loss factors for homogeneous classes of the portfolio, adjusted for changes to the above-noted environmental factors. We may record a specific allowance for impaired loans, including loans on nonaccrual status and troubled-debt restructured ("TDR") loans, after a careful analysis of each loan's credit and collateral factors. Our analysis of an appropriate allowance for loan losses combines the provisions made for our non-impaired 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, our results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. A decline in national and local economic conditions, or other factors, could result in a material increase in the allowance for loan losses and may adversely affect the Company's financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators, as part of their routine examination process, which may result in the establishment of additional allowance for loan losses based upon their judgment of information available to them at the time of their examination.

For additional information regarding the allowance for loan losses, its relation to the provision for loan losses, its risk related to asset quality and lending activity, see "—Results of Operations for the Years Ended December 31, 2018 and 2017—Provision for Loan Losses" and "—Consolidated Financial Condition —Allowance for Loan Losses" below, Item 1A. Risk Factors—Our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio as well as Note (5) Allowance for Loan Losses of the Notes to Consolidated Financial Statements included in Item 8. Financial Statements And Supplementary Data.

Estimated Expected Cash Flows related to Purchased Credit Impaired ("PCI") Loans

Loans purchased in an acquisition with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are accounted for under FASB Accounting Standards Codification ("ASC") 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality. In situations where such PCI loans have similar risk characteristics, loans may be aggregated into pools to estimate cash flows. A pool is accounted for as a single asset with a single interest rate, cumulative loss rate and cash flow expectation.

The cash flows expected over the life of the PCI loan or pool are estimated using an external cash flow model that projects cash flows and calculates the carrying values, book yields, effective interest income and impairment, if any, based on loan or pool level events. Assumptions as to default rates, loss severity and prepayment speeds are utilized to calculate the expected cash flows.

Expected cash flows at the acquisition date in excess of the fair value of loans are considered to be accretable yield, which is recognized as interest income over the life of the loan or pool using a level yield method if the timing and amounts of the future cash flows of the loan or pool are reasonably estimable. Subsequent to the acquisition date, cash flows expected over the life of the PCI loan or pool are estimated quarterly using an external cash flow model that projects cash flows and calculates the carrying values of the loans or pools, book yields, effective interest income and impairment, if any, based on loan or pool level events. Any increases in cash flow over those expected at the prior quarter are recorded as interest income prospectively. Any subsequent decreases in cash flow over those expected at the prior quarter are recognized by recording an allowance for loan losses. Any disposals of loans in pools, including sales of loans, payments in full or foreclosures result in the removal of the loan from the loan pool at the carrying amount and recognition of income if the proceeds from such activity is in excess of the carrying amount removed from the pool.

Business Combinations

The Company applies the acquisition method of accounting for business combinations. Under the acquisition method, the acquiring entity in a business combination recognizes all of the identifiable assets acquired and liabilities assumed at their acquisition date fair values. Management utilizes prevailing valuation techniques appropriate for the asset or liability being measured in determining these fair values. Any excess of the purchase price over amounts allocated to assets acquired, including identifiable intangible assets, and liabilities assumed is recorded as goodwill. Where

amounts allocated to assets acquired and liabilities assumed is greater than the purchase price, a bargain purchase gain is recognized. Acquisition-related costs are expensed as incurred unless they are directly attributable to the issuance of the Company's common stock in a business combination and the Company chooses to record these acquisition-related costs through stockholders' equity.

Other-Than-Temporary Impairments in the Fair Value of Investments

Unrealized losses on investment securities available for sale are evaluated at least quarterly to determine whether declines in value should be considered “other than temporary” and therefore be subject to immediate loss recognition in income. Although these evaluations involve significant judgment, an unrealized loss in the fair value of a debt security is generally deemed to be temporary when the fair value of the security is below the carrying value primarily due to changes in interest rates, there has not been significant deterioration in the financial condition of the issuer, and it is not more likely than not that the Company will be required to sell the security before the anticipated recovery of its remaining carrying value. Other factors that may be considered in determining whether a decline in the value of an investment security is “other than temporary” include ratings by recognized rating agencies; actions of commercial banks or other lenders relative to the continued extension of credit facilities to the issuer of the security; the financial condition, capital strength and near-term prospects of the issuer and recommendations of investment advisors or market analysts. Therefore, continued deterioration of market conditions could result in additional impairment losses recognized within the investment portfolio.

Goodwill

The Company’s goodwill is assigned to Heritage Bank and is evaluated for impairment at the Heritage Bank level (reporting unit). Goodwill is reviewed for impairment annually and between annual tests if an event occurs or circumstances change that might indicate the Company’s recorded value is more than its implied value. Such indicators may include, among others: a significant adverse change in legal factors or in the general business climate; significant decline in the Company’s stock price and market capitalization; unanticipated competition; and an adverse action or assessment by a regulator. Any adverse changes in these factors could have a significant impact on the recoverability of goodwill and could have a material impact on the Company’s Consolidated Financial Statements.

The goodwill impairment test involves a two-step process. The first test for goodwill impairment is done by comparing the reporting unit’s aggregate fair value to its carrying value. Absent other indicators of impairment, if the aggregate fair value exceeds the carrying value, goodwill is not considered impaired and no additional analysis is necessary. If the carrying value of the reporting unit were to exceed the aggregate fair value, a second test would be performed to measure the amount of impairment loss, if any. Alternatively, the testing for impairment may begin with an assessment of qualitative factors to determine whether the existence of events or circumstances leads to a determination that the fair value of goodwill is less than carrying value. The qualitative assessment includes adverse events or circumstances identified that could negatively affect the reporting unit's fair value as well as positive and mitigating events. To measure any impairment loss, the implied fair value would be determined in the same manner as if the reporting unit were being acquired in a business combination. If the implied fair value of goodwill is less than the recorded goodwill an impairment charge would be recorded for the difference.

For the year ended December 31, 2018, the Company completed step one of the two-step process of the goodwill impairment test. Based on the results of the test, the Company concluded that the reporting unit’s fair value was greater than its carrying value and there was no impairment of goodwill.

For additional information regarding goodwill, see Note (8) Goodwill and Other Intangible Assets of the Notes to Consolidated Financial Statements included in Item 8. Financial Statements And Supplementary Data.

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Financial Overview

Heritage Financial Corporation is a bank holding company which primarily engages in the business activities of our wholly-owned financial institution subsidiary, Heritage Bank. We provide financial services to our local communities with an ongoing strategic focus on our commercial banking relationships, market expansion and asset quality.

Consolidated Financial Condition

The Company’s total assets increased $1.20 billion, or 29.3%, to $5.32 billion at December 31, 2018 from $4.11 billion at December 31, 2017. The increase was primarily due to the Premier and Puget Mergers completed during the year ended December 31, 2018 with acquired assets totaling $957.6 million at the respective merger dates. The asset balances at December 31, 2018 and 2017 and the changes in those balances are included in the following table:

	December 31, 2018	December 31, 2017	Change 2018 vs. 2017	Percent Change 2018 vs. 2017
	(Dollars in thousands)			
Cash and cash equivalents	$161,910	$ 103,015	$58,895	57.2 %
Investment securities available for sale, at fair value	976,095	810,530	165,565	20.4
Loans held for sale	1,555	2,288	(733)	(32.0)
Total loans receivable, net	3,619,118	2,816,985	802,133	28.5
Other real estate owned	1,983	—	1,983	—
Premises and equipment, net	81,100	60,325	20,775	34.4
FHLB stock, at cost	6,076	8,347	(2,271)	(27.2)%
Bank owned life insurance	93,612	75,091	18,521	24.7
Accrued interest receivable	15,403	12,244	3,159	25.8
Prepaid expenses and other assets	98,522	99,328	(806)	(0.8)
Other intangible assets, net	20,614	6,088	14,526	238.6
Goodwill	240,939	119,029	121,910	102.4
Total assets	$5,316,927	$ 4,113,270	$1,203,657	29.3 %

Investment Activities

Our investment policy is established by the Board of Directors and monitored by the Risk 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 complements the 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, corporate notes, municipal bonds, and federal funds. Investment in non-investment grade bonds and stripped mortgage-backed securities is not permitted under the policy.

Investment securities available for sale increased $165.6 million, or 20.4%, to $976.1 million at December 31, 2018 from $810.5 million at December 31, 2017. The increase was due primarily to purchases of investment securities of $342.1 million, excluding investment securities acquired in the Premier and Puget Mergers, partially offset by sales of investment securities of $156.0 million and maturities, calls and payments of investment securities of $92.6 million during the year ended December 31, 2018. Included in the sales of investment securities was $80.4 million of investments acquired in the Puget Sound Merger which were sold shortly after the merger.

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The following table provides information regarding our investment securities available for sale at the dates indicated.

	December 31, 2018		December 31, 2017		December 31, 2016	
	Fair Value	% of Total Investments	Fair Value	% of Total Investments	Fair Value	% of Total Investments
	(Dollars in thousands)					
U.S. Treasury and U.S. Government-sponsored agencies	$101,603	10.4 %	$13,442	1.7 %	$1,569	0.2 %
Municipal securities	158,864	16.3	250,015	30.8	237,256	29.9
Mortgage-backed securities and collateralized mortgage obligations[1]:						
Residential	331,602	34.0	280,211	34.5	309,176	38.9
Commercial	333,761	34.2	217,079	26.8	208,318	26.2
Collateralized loan obligations	—	—	4,580	0.6	10,478	1.3
Corporate obligations	25,563	2.6	16,770	2.1	16,706	2.1
Other securities[2][3]	24,702	2.5	28,433	3.5	11,142	1.4
Total	$976,095	100.0 %	$810,530	100.0 %	$794,645	100.0 %

(1) Issued and guaranteed by U.S. Government-sponsored agencies.
(2) Primarily asset-backed securities issued and guaranteed by U.S. Government-sponsored agencies.
(3) As a result of the adoption of FASB Accounting Standard Update 2016-01 on January 1, 2018, equity investments of $146,000 and $123,000 as of December 31, 2017 and 2016, respectively, are no longer classified as investment securities available for sale and their presentation is not comparable to the presentation as of December 31, 2018.

The following table provides information regarding our investment securities available for sale, by contractual maturity, at December 31, 2018.

	One Year or Less		Over One to Five Years		Over Five to Ten Years		Over Ten Years		Total	
	Fair Value	Yield[2]	Fair Value	Yield[2]	Fair Value	Yield[2]	Fair Value	Yield[2]	Fair Value	Yield[2]
	(Dollars in thousands)									
U.S. Treasury and U.S. Government-sponsored agencies	$15,936	2.50 %	$44,462	2.98 %	$35,190	3.56 %	$6,015	2.99 %	$101,603	3.11 %
Municipal securities	13,587	3.14	25,957	3.07	30,601	3.27	88,719	3.24	158,864	3.21
Mortgage-backed securities and collateralized mortgage obligations [1]:										
Residential	206	0.94	3,027	2.33	73,986	2.49	254,383	2.88	331,602	2.78
Commercial	7,901	1.56	94,395	2.55	129,002	2.80	102,463	2.89	333,761	2.72
Corporate obligations	848	2.87	24,715	3.40	—	—	—	—	25,563	3.38
Other securities [3]	—	—	—	—	—	—	24,702	3.81	24,702	3.81
Total	$38,478	2.53 %	$192,556	2.82 %	$268,779	2.87 %	$476,282	3.00 %	$976,095	2.91 %

(1) Issued and guaranteed by U.S. Government-sponsored agencies.
(2) Taxable equivalent weighted average yield.
(3) Primarily asset-backed securities issued and guaranteed by U.S. Government-sponsored agencies.

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Loan Portfolio

The Bank is a full service commercial bank, which originates a wide variety of loans with a focus on commercial business loans. Total loans receivable, net of allowance for loan losses, increased $802.1 million, or 28.5%, to $3.62 billion at December 31, 2018 from $2.82 billion at December 31, 2017 primarily as a result of loans acquired in the Premier and Puget Mergers totaling $718.6 million at the respective merger dates. The year-over-year loan growth included increases in non-owner occupied commercial real estate loans which increased $317.9 million, or 32.2%, to $1.30 billion, in commercial and industrial loans which increased $208.2 million, or 32.3%, to $853.6 million and owner-occupied commercial real estate loans which increased $157.7 million, or 25.3%, to $779.8 million at December 31, 2018.

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

	December 31,									
	2018		2017		2016		2015		2014	
	Balance	% of Total[2]	Balance	% of Total[2]	Balance	% of Total[2]	Balance	% of Total[2]	Balance	% of Total[2]
	(Dollars in thousands)									
Commercial business:										
Commercial and industrial	$853,606	23.4 %	$645,396	22.7 %	$637,773	24.2 %	$596,726	24.8 %	$570,453	25.3 %
Owner-occupied commercial real estate	779,814	21.3	622,150	21.8	558,035	21.1	572,609	23.8	574,687	25.5
Non-owner occupied commercial real estate	1,304,463	35.7	986,594	34.6	880,880	33.4	753,986	31.4	663,935	29.5
Total commercial business	2,937,883	80.4	2,254,140	79.1	2,076,688	78.7	1,923,321	80.0	1,809,075	80.3
One-to-four family residential [1]	101,763	2.8	86,997	3.1	77,391	2.9	72,548	3.0	69,530	3.1
Real estate construction and land development:										
One-to-four family residential	102,730	2.8	51,985	1.8	50,414	1.9	51,752	2.2	49,195	2.2
Five or more family residential and commercial properties	112,730	3.1	97,499	3.4	108,764	4.1	55,325	2.3	64,920	2.9
Total real estate construction and land	215,460	5.9	149,484	5.2	159,178	6.0	107,077	4.5	114,115	5.1

development										
Consumer	395,545	10.8	355,091	12.5	325,140	12.3	298,167	12.4	259,294	11.5
Gross loans receivable	3,650,651	99.9	2,845,712	99.9	2,638,397	99.9	2,401,113	99.9	2,252,014	100.0
Net deferred loan costs (fees)	3,509	0.1	3,359	0.1	2,352	0.1	929	0.1	(937)	—
Loans receivable, net	$3,654,160	100.0%	$2,849,071	100.0%	$2,640,749	100.0%	$2,402,042	100.0%	$2,251,077	100.0%

(1) Excludes loans held for sale of $1.6 million, $2.3 million, $11.7 million, $7.7 million and $5.6 million as of December 31, 2018, 2017, 2016, 2015 and 2014, respectively.

(2) Percent of loans receivable, net.

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The following table presents at December 31, 2018 (i) the aggregate contractual 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.

	Maturing			
	One Year or Less	Over One to Five Years	Over Five Years	Total
	(In thousands)			
Commercial business	$434,492	$637,472	$1,865,919	$2,937,883
One-to-four family residential	112	2,337	99,314	101,763
Real estate construction and land development	137,297	31,313	46,850	215,460
Consumer	19,091	127,153	249,301	395,545
Gross loans receivable	$590,992	$798,275	$2,261,384	$3,650,651
Fixed rate loans	$96,139	$573,664	$642,831	$1,312,634
Variable or adjustable rate loans	494,853	224,611	1,618,553	2,338,017
Total	$590,992	$798,275	$2,261,384	$3,650,651

Included in the balance of variable or adjustable rate loans with maturity over five years in the table above are certain commercial loans in which the Bank entered into non-hedge interest rate swap contracts with the borrower and a third party. Under these derivative contract arrangements, the Bank effectively earns a variable rate of interest based on one-month LIBOR plus various margins while the customer pays a fixed rate of interest. At December 31, 2018, the Bank had 48 separate interest rate swap contracts with borrowers with notional value of $171.8 million compared to 39 separate interest rate swap contracts with borrowers with notional value of $146.5 million at December 31, 2017.

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The following table provides information about our nonaccrual loans, other real estate owned and performing TDR loans for the indicated dates.

	December 31,				
	2018	2017	2016	2015	2014
	(Dollars in thousands)				
Nonaccrual loans:					
Commercial business	$12,564	$9,098	$8,580	$7,122	$8,596
One-to-four family residential	71	81	94	38	—
Real estate construction and land development	899	1,247	2,008	2,414	2,831
Consumer	169	277	227	94	145
Total nonaccrual loans[1]	13,703	10,703	10,909	9,668	11,572
Other real estate owned	1,983	—	754	2,019	3,355
Total nonperforming assets	$15,686	$10,703	$11,663	$11,687	$14,927
Allowance for loan losses	$35,042	$32,086	$31,083	$29,746	$27,729
Allowance for loan losses to loans receivable, net	0.96 %	1.13 %	1.18 %	1.24 %	1.23 %
Allowance for loan losses to nonaccrual loans	255.73 %	299.79 %	284.93 %	307.67 %	239.62 %
Nonperforming loans to loans receivable, net	0.37 %	0.38 %	0.41 %	0.40 %	0.51 %
Nonperforming assets to total assets	0.30 %	0.26 %	0.30 %	0.32 %	0.43 %
Performing TDR loans:					
Commercial business	$22,170	$25,729	$19,837	$17,345	$14,421
One-to-four family residential	208	218	227	236	245
Real estate construction and land development	—	645	2,141	3,014	3,927
Consumer	358	165	83	100	66
Total performing TDR loans	$22,736	$26,757	$22,288	$20,695	$18,659
Accruing loans past due 90 days or more	$—	$—	$—	$—	$—
Potential problem loans	101,349	83,543	87,762	110,357	162,930

[1] At December 31, 2018, 2017, 2016, 2015 and 2014, $6.9 million $5.2 million, $6.9 million, $6.3 million and $7.3 million of nonaccrual loans were considered TDR loans, respectively.

Nonaccrual Loans. Nonaccrual loans increased $3.0 million to $13.7 million, or 0.37% of loans receivable, net, at December 31, 2018 from $10.7 million, or 0.38% of loans receivable, net, at December 31, 2017. The increase was due primarily to the addition of seven commercial and industrial customer relationships totaling $8.9 million during the year ended December 31, 2018. Of these additions, $5.3 million related to two agricultural relationships who subsequently repaid $3.4 million during the year ended December 31, 2018, as included in net principal payments below.

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The following table reflects the changes in nonaccrual loans during the years ended December 31, 2018 and 2017:

	Year Ended December 31,	
	2018	2017
	(In thousands)	
Nonaccrual loans		
Balance, beginning of period	$10,703	$10,909
Addition of previously classified pass graded loans	5,469	2,405
Addition of previously classified potential problem loans	5,319	3,253
Addition of previously classified TDR loans	786	1,556
Addition of acquired loans	130	—
Transfer of loans to accrual status	—	(968)
Charge-offs	(1,027)	(1,219)
Net principal payments	(7,677)	(5,233)
Balance, end of period	$13,703	$10,703

At December 31, 2018, nonaccrual loans of $9.5 million had related allowance for loan losses of $1.9 million and nonaccrual loans of $4.2 million had no related allowance for loan losses. At December 31, 2017 nonaccrual loans of $3.8 million had related allowance for loan losses of $720,000 and nonaccrual loans of $6.9 million had no allowance for loan losses.

At December 31, 2018, nonperforming TDR loans, included in the nonaccrual loan table above, were $6.9 million and had a related allowance for loan losses of $658,000. At December 31, 2017, nonperforming TDR loans were $5.2 million and had a related allowance for loan losses of $379,000.

Nonperforming Assets. Nonperforming assets consist of nonaccrual loans and other real estate owned. Nonperforming assets increased $5.0 million to $15.7 million, or 0.30% of total assets at December 31, 2018 from $10.7 million, or 0.26% of total assets, at December 31, 2017 due primarily to the increase in nonaccrual loans discussed above. Nonperforming assets additionally increased due to the additions of other real estate owned, primarily as a result of other real estate owned acquired in the Premier Merger of $1.8 million. There was no other real estate owned at December 31, 2017.

Troubled Debt Restructured Loans. TDR loans are considered impaired and are separately measured for impairment whether on accrual or nonaccrual status. Performing TDR loans are not considered nonperforming assets as they continue to accrue interest despite being considered impaired due to the restructured status. Our performing TDR loans decreased $4.0 million, or 15.0%, to $22.7 million at December 31, 2018 from $26.8 million at December 31, 2017.

The following table reflects the changes in performing TDR loans during the years ended December 31, 2018 and 2017:

	Year Ended December 31,	
	2018	2017
	(In thousands)	
Performing TDR loans		
Balance, beginning of period	$26,757	$22,288
Addition of previously classified pass graded loans	2,165	12,244
Addition of previously classified potential problem loans	9,651	2,189
Addition of former nonaccrual loans	—	968
Transfers of loans to nonaccrual and troubled debt restructured status	(786)	(1,556)
Charge-offs	—	(16)
Net principal payments	(15,051)	(9,360)
Balance, end of period	$22,736	$26,757

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The related allowance for loan losses on performing TDR loans was $2.3 million as of December 31, 2018 and $2.6 million as of December 31, 2017.

Potential Problem Loans. Potential problem loans increased $17.8 million, or 21.3%, to $101.3 million at December 31, 2018 from $83.5 million at December 31, 2017. The increase was due primarily to the addition of potential problem loans acquired in the Premier and Puget Mergers with an acquired total outstanding balance of $10.1 million and $4.5 million, respectively, at their respective merger dates, and totaling $12.2 million at December 31, 2018.

The following table reflects the changes in potential problem loans during the years ended December 31, 2018 and 2017:

	Year Ended December 31,	
	2018	2017
	(In thousands)	
Potential problem loans		
Balance, beginning of period	$83,543	$87,762
Addition of previously classified pass graded loans	59,238	52,039
Acquired in Premier and Puget Mergers [1]	18,869	—
Net principal payments	(28,184)	(37,636)
Upgrades to pass graded loan status	(16,746)	(5,245)
Transfers of loan to nonaccrual and troubled debt restructured status	(14,970)	(6,866)
Transfers of loans to other real estate owned	—	(32)
Transfer of loan to held for sale	—	(5,779)
Charge-offs	(401)	(700)
Balance, end of period	$101,349	$83,543

[1] Represents the loan balance acquired and post-acquisition classification as potential problem loan of any loan acquired in the Premier and Puget Mergers. The period end balance of these potential problem loans is $17.8 million as of December 31, 2018 due to net principal payments subsequent to the acquisition or classification as a potential problem loan.

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Allowance for Loan Losses

The following table provides information regarding changes in our allowance for loan losses at and for the indicated years:

	At or For the Years Ended December 31,				
	2018	2017	2016	2015	2014
	(Dollars in thousands)				
Allowance for loan losses at beginning of the year	$32,086	$31,083	$29,746	$27,729	$28,824
Provision for loan losses	5,129	4,220	4,931	4,372	4,594
Charge-offs:					
Commercial business	(1,400)	(2,438)	(4,153)	(1,676)	(5,252)
One-to-four family residential	(45)	(30)	—	—	(31)
Real estate construction and land development	—	(556)	(154)	(106)	(345)
Consumer	(2,160)	(1,814)	(1,778)	(1,700)	(969)
Total charge-offs	(3,605)	(4,838)	(6,085)	(3,482)	(6,597)
Recoveries:					
Commercial business	908	947	1,844	476	716
One-to-four family residential	—	2	2	13	7
Real estate construction and land development	11	202	83	100	43
Consumer	513	470	562	538	142
Total recoveries	1,432	1,621	2,491	1,127	908
Net charge-offs	(2,173)	(3,217)	(3,594)	(2,355)	(5,689)
Allowance for loan losses at end of the year	$35,042	$32,086	$31,083	$29,746	$27,729
Gross loans receivable at end of the year [(1)]	$3,650,651	$2,845,712	$2,638,397	$2,401,113	$2,252,014
Average loans receivable during the year [(1)]	3,414,424	2,703,934	2,489,730	2,316,175	1,871,696
Net charge-offs on loans to average loans receivable	0.06 %	0.12 %	0.14 %	0.10 %	0.30 %

[(1)] Excludes loans held for sale.

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The following table shows the allocation of the allowance for loan losses at the indicated dates. 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:

	December 31,									
	2018		2017		2016		2015		2014	
	Allowance for Loan Losses	% of Total [1]	Allowance for Loan Losses	% of Total [1]	Allowance for Loan Losses	% of Total [1]	Allowance for Loan Losses	% of Total [1]	Allowance for Loan Losses	% of Total [1]
	(Dollars in thousands)									
Commercial business	$23,711	80.5 %	$21,999	79.1 %	$22,382	78.8 %	$22,064	80.1 %	$20,186	80.3 %
One-to-four family residential	1,203	2.8	1,056	3.1	1,015	2.9	1,157	3.0	1,200	3.1
Real estate construction	2,194	5.9	2,052	5.3	2,156	6.0	1,871	4.5	2,758	5.1
Consumer	6,581	10.8	6,081	12.5	5,024	12.3	4,309	12.4	2,769	11.5
Unallocated	1,353	—	898	—	506	—	345	—	816	—
Total allowance for loan losses	$35,042	100.0 %	$32,086	100.0 %	$31,083	100.0 %	$29,746	100.0 %	$27,729	100.0 %

[1] Represents the percent of loans receivable by loan category to total gross loans receivable.

The allowance for loan losses increased $3.0 million, or 9.2%, to $35.0 million at December 31, 2018 from $32.1 million at December 31, 2017. The increase was the result of provision for loan losses of $5.1 million recognized during the year ended December 31, 2018, offset partially by net charge-offs of $2.2 million recorded during the year. The allowance for loan losses to loans receivable, net, decreased to 0.96% at December 31, 2018 from 1.13% at December 31, 2017 primarily as a result of loans acquired from the Premier and Puget Mergers with no related allowance for loan losses at the date of acquisition in accordance with GAAP. Included in the carrying value of loans are net discounts on loans purchased in mergers and acquisitions which may reduce the need for an allowance for loan losses on these loans because they are carried at an amount below the outstanding principal balance. The remaining net discount on purchased loans, including the related fair value discount acquired in the Premier and Puget Mergers, was $11.8 million at December 31, 2018 compared to $10.1 million at December 31, 2017.

The Company recorded charge-offs of $3.6 million during the year ended December 31, 2018 due primarily to a large volume of small charge-offs on consumer loans. The Company recorded recoveries of $1.4 million during the year ended December 31, 2018, primarily as a result of small recoveries on a large volume of small dollar consumer loans. As of December 31, 2018, the Bank identified $13.7 million of nonperforming loans and $22.7 million of performing TDR loans for a total of $36.4 million of impaired loans. Of these impaired loans, $7.6 million had no allowances for loan losses as their estimated collateral value or discounted expected cash flow is equal to or exceeds their carrying costs. The remaining $28.8 million of impaired loans had related allowances for loan losses totaling $4.2 million. As of December 31, 2017, the Bank identified $10.7 million of nonperforming loans and $26.8 million of performing TDR loans for a total of $37.5 million of impaired loans. Of these impaired loans, $10.4 million had no allowances for loan losses. The remaining $27.1 million of impaired loans had related allowances for loan losses totaling $3.4 million.

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The following table outlines the allowance for loan losses and related outstanding loan balances on loans at December 31, 2018 and 2017:

	December 31, 2018	December 31, 2017
	(Dollars in thousands)	
General Valuation Allowance:		
Allowance for loan losses	$27,854	$ 24,732
Gross loans, excluding PCI and impaired loans	3,589,305	2,767,650
Percentage	0.78 %	0.89 %
PCI Allowance:		
Allowance for loan losses	$3,018	$ 3,999
Gross PCI loans	24,907	40,603
Percentage	12.12 %	9.85 %
Specific Valuation Allowance:		
Allowance for loan losses	$4,170	$ 3,355
Gross impaired loans	36,439	37,459
Percentage	11.44 %	8.96 %
Total Allowance for Loan Losses:		
Allowance for loan losses	$35,042	$ 32,086
Gross loans receivable	3,650,651	2,845,712
Percentage	0.96 %	1.13 %

Based on the Bank's established comprehensive methodology, management deemed the allowance for loan losses of $35.0 million at December 31, 2018 (0.96% of loans receivable, net and 255.73% of nonperforming loans) appropriate to provide for probable incurred credit losses based on an evaluation of known and inherent risks in the loan portfolio at that date. This compares to an allowance for loan losses at December 31, 2017 of $32.1 million (1.13% of loans receivable, net and 299.79% of nonperforming loans).

While we believe we use the best information available to determine the allowance for loan losses, our results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. A decline in national and local economic conditions, or other factors, could result in a material increase in the allowance for loan losses and may adversely affect the Company’s financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators, as part of their routine examination process, which may result in the establishment of an additional allowance for loan losses based upon their judgment of information available to them at the time of their examination. Because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is appropriate or that increased provisions will not be necessary should the quality of the loans deteriorate. Any material increase in the allowance for loan losses would adversely affect the Company’s financial condition and results of operations.

Deposits

Total deposits increased $1.04 billion, or 30.6%, to $4.43 billion at December 31, 2018 from $3.39 billion at December 31, 2017 due primarily to the deposits acquired in the Premier and Puget Mergers of $824.6 million at the respective merger dates. Non-maturity deposits as a percentage of total deposits increased to 89.5% at December 31, 2018 from 88.3% at December 31, 2017 and the percentage of certificates of deposit to total deposits decreased to 10.5% at December 31, 2018 from 11.7% at December 31, 2017.

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The following table provides the balances outstanding for each major category of deposits at the dates indicated:

	December 31, 2018		December 31, 2017		December 31, 2016	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
	(Dollars in thousands)					
Noninterest demand deposits	$1,362,268	30.7 %	$944,791	27.8 %	$882,091	27.3 %
Interest bearing demand deposits	1,317,513	29.7	1,051,752	31.1	963,821	29.8
Money market accounts	765,316	17.3	499,618	14.7	523,875	16.2
Savings accounts	520,413	11.8	498,501	14.7	502,460	15.6
Total non-maturity deposits	3,965,510	89.5	2,994,662	88.3	2,872,247	88.9
Certificate of deposit accounts	466,892	10.5	398,398	11.7	357,401	11.1
Total deposits	$4,432,402	100.0%	$3,393,060	100.0%	$3,229,648	100.0%

The following table provides the average balances outstanding and the weighted average interest rates for each major category of deposits for the years indicated:

	Year Ended December 31,					
	2018		2017		2016	
	Average Balance	Average Yield/Rate	Average Balance	Average Yield/Rate	Average Balance	Average Yield/Rate
	(Dollars in thousands)					
Interest bearing demand deposits and money market accounts	$1,916,319	0.23 %	$1,498,619	0.17 %	$1,464,198	0.16 %
Savings accounts	513,680	0.40	499,435	0.26	485,482	0.16
Certificate of deposit accounts	463,124	0.85	378,044	0.59	388,286	0.50
Total interest bearing deposits	2,893,123	0.36	2,376,098	0.25	2,337,966	0.21
Noninterest demand deposits	1,240,621	—	902,716	—	829,912	—
Total deposits	$4,133,744	0.25 %	$3,278,814	0.18 %	$3,167,878	0.16 %

The following table shows the amount and maturity of certificate of deposit accounts of $100,000 or more:

	December 31, 2018
	(In thousands)
Remaining maturity:	
Three months or less	$ 88,527
Over three months through six months	48,781
Over six months through twelve months	63,878
Over twelve months	96,042
Total	$ 297,228

Borrowings

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 interest earning assets. The Bank also

utilizes securities sold under agreement to repurchase as a supplement to its funding sources. Our repurchase agreements are secured by available for sale investment securities. At December 31, 2018, the Bank had securities sold under agreement to repurchase of $31.5 million, a decrease of $334,000, or 1.0%, from $31.8 million at December 31, 2017. The decrease was the result of customer activity during the period.
The Company also has junior subordinated debentures with a par value of $25.0 million which pay quarterly interest based on three-month LIBOR plus 1.56%. The debentures mature in 2037. The balance of the junior subordinated debentures was $20.3 million at December 31, 2018, which reflects the fair value of the junior subordinated debentures established during the Washington Banking Merger, adjusted for the accretion of discount from purchase accounting fair value adjustment.
At December 31, 2018, the Bank maintained credit facilities with the FHLB of Des Moines for $921.7 million and credit facilities with the Federal Reserve Bank for $37.4 million. The Company had no FHLB advances outstanding at December 31, 2018 compared to $92.5 million at December 31, 2017. The average cost of the FHLB advances during the year ended December 31, 2018 and 2017 was 1.98% and 1.16%, respectively. The Bank also maintains lines of credit with four correspondent banks to purchase federal funds totaling $90.0 million as of December 31, 2018. There were no federal funds purchased as of December 31, 2018 or December 31, 2017.

Stockholders' Equity and Capital
Stockholders' equity at December 31, 2018 was $760.7 million compared to $508.3 million at December 31, 2017. The changes to stockholders' equity during the years ended December 31, 2018 and 2017 are as follows:

	Year Ended December 31,	
	2018	2017
	(In thousands)	
Balance, beginning of period	$508,305	$481,763
Common stock issued in the Premier and Puget Mergers	230,043	—
Net income	53,057	41,791
Dividends declared	(25,791)	(18,305)
Other comprehensive (loss) income, net	(6,064)	1,526
Other	1,173	1,530
Balance, end of period	$760,723	$508,305

The Company has historically paid cash dividends to its common shareholders. Payments of future cash dividends, if any, will be at the discretion of our board of directors after taking into account various factors, including our business, operating results and financial condition, capital requirements, current and anticipated cash needs, plans for expansion, any legal or contractual limitation on our ability to pay dividends and other relevant factors. Dividends on common stock from the Company depend substantially upon receipt of dividends from the Bank, which is the Company's predominant source of income. On January 23, 2019, the Company's Board of Directors declared a regular quarterly dividend of $0.18 per common share payable on February 21, 2019 to shareholders of record on February 7, 2019.

	Year Ended December 31,		
	2018	2017	2016
Dividends paid per common share	$0.72	$0.61	$0.72
Dividend payout ratio [1]	48.3 %	43.9 %	55.4 %

[1] Dividend payout ratio is declared dividends per common share divided by diluted earnings per common share.
The Company is a bank holding company under the supervision of the Federal Reserve Bank. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended, and the regulations of the Federal Reserve. Heritage Bank is a federally insured institution and thereby is subject to the capital requirements established by the FDIC. The Federal Reserve capital requirements generally parallel the FDIC requirements. Failure to meet minimum capital requirements can initiate certain

mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company’s consolidated financial statements and operations. Management believes as of December 31, 2018, the Company and the Bank meet all capital adequacy requirements to which they are subject. For additional information

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regarding the Company’s and the Bank’s regulatory capital requirements, see “Supervision and Regulation-Capital Adequacy” in Item 1. Business and Note (22) Regulatory Capital Requirements included in Item 8. Financial Statements And Supplementary Data.

Off-Balance Sheet Arrangements

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. The Company had off-balance sheet loan commitments, including letters of credit, aggregating $990.0 million at December 31, 2018, an increase of $276.8 million, or 38.8%, from $713.2 million at December 31, 2017. For additional information, see Note (14) Commitments and Contingencies included in Item 8. Financial Statements And Supplementary Data.

Average Balances, Yields and Rates Paid for the Years Ended December 31, 2018, 2017 and 2016

Our core profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment portfolios, and our cost of funds, which consists of interest paid on deposits and borrowed funds. Like most financial institutions, our interest income and cost of funds are affected significantly by general economic conditions, particularly changes in market interest rates and government policies.

Changes in net interest income result from changes in volume, net interest spread, and net interest margin. Volume refers to the average dollar amounts of interest earning assets and interest bearing liabilities. Net interest spread refers to the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities. Net interest margin refers to net interest income divided by average interest earning assets and is influenced by the level and relative mix of interest earning assets and interest bearing and noninterest bearing liabilities.

The following table provides relevant net interest income information for selected periods. The average daily 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 presented on a tax-equivalent basis.

	Year Ended December 31,								
	2018			2017			2016		
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)								
Assets:									
Total loans receivable, net	$3,414,424	$175,466	5.14 %	$2,703,934	$129,213	4.78 %	$2,489,730	$122,147	4.91 %
Taxable securities	677,893	17,602	2.60	570,969	12,688	2.22	589,867	11,215	1.90
Nontaxable securities	190,209	4,649	2.44	226,934	5,269	2.32	221,708	4,870	2.20
Other interest earning assets	76,117	1,642	2.16	45,949	539	1.17	44,951	280	0.62
Total interest earning assets	4,358,643	199,359	4.57	3,547,786	147,709	4.16	3,346,256	138,512	4.14
Noninterest earning assets	615,372			433,566			399,279		
Total assets	$4,974,015			$3,981,352			$3,745,535		

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	Year Ended December 31,								
	2018			2017			2016		
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)								
Liabilities and Stockholders' Equity:									
Certificate of deposit accounts	$463,124	$3,959	0.85 %	$378,044	$2,244	0.59 %	$388,286	$1,936	0.50 %
Savings accounts	513,680	2,056	0.40	499,435	1,311	0.26	485,482	756	0.16
Interest bearing demand and money market accounts	1,916,319	4,382	0.23	1,498,619	2,494	0.17	1,464,198	2,318	0.16
Total interest bearing deposits	2,893,123	10,397	0.36	2,376,098	6,049	0.25	2,337,966	5,010	0.21
Junior subordinated debentures	20,145	1,263	6.27	19,860	1,014	5.11	19,565	880	4.50
FHLB advances and other borrowings	33,914	671	1.98	105,648	1,226	1.16	13,349	74	0.55
Securities sold under agreement to repurchase	31,426	82	0.26	25,434	57	0.22	20,392	42	0.21
Total interest bearing liabilities	2,978,608	12,413	0.42	2,527,040	8,346	0.33	2,391,272	6,006	0.25
Demand and other noninterest bearing deposits	1,240,621			902,716			829,912		
Other noninterest bearing liabilities	67,692			51,820			38,474		
Stockholders' equity	687,094			499,776			485,877		
Total liabilities and stock-holders' equity	$4,974,015			$3,981,352			$3,745,535		
Net interest income		$186,946			$139,363			$132,506	
Net interest spread			4.15 %			3.83 %			3.89 %
Net interest margin			4.29 %			3.93 %			3.96 %
Average interest earning assets to average interest bearing liabilities			146.33 %			140.39 %			139.94 %

The following table provides the amount of change in our net interest income attributable to changes in volume and changes in interest rates. Changes attributable to the combined effect of volume and interest rates have been allocated proportionately for changes due specifically to volume and interest rates.

	Year Ended December 31,					
	2018 Compared to 2017			2017 Compared to 2016		
	Increase (Decrease) Due to			Increase (Decrease) Due to		
	Volume	Rate	Total	Volume	Rate	Total
	(In thousands)					
Interest Earning Assets:						
Loans	$36,512	$9,741	$46,253	$10,236	$(3,170)	$7,066
Taxable securities	2,776	2,138	4,914	(420)	1,893	1,473
Nontaxable securities	(898)	278	(620)	121	278	399
Other interest earning assets	651	452	1,103	12	247	259
Interest income	$39,041	$12,609	$51,650	$9,949	$(752)	$9,197
Interest Bearing Liabilities:						
Certificate of deposit accounts	$727	$988	$1,715	$(61)	$369	$308
Savings accounts	57	688	745	37	518	555
Interest bearing demand and money market accounts	955	933	1,888	57	119	176
Total interest bearing deposits	1,739	2,609	4,348	33	1,006	1,039
Junior subordinated debentures	18	231	249	15	119	134
Securities sold under agreement to repurchase	16	9	25	11	4	15
FHLB advances and other borrowings	(1,419)	864	(555)	1,071	81	1,152
Interest expense	$354	$3,713	$4,067	$1,130	$1,210	$2,340
Net Interest Income	$38,687	$8,896	$47,583	$8,819	$(1,962)	$6,857

Results of Operations for the Years Ended December 31, 2018 and 2017

Earnings Summary

Net income was $53.1 million, or $1.49 per diluted common share, for the year ended December 31, 2018 compared to $41.8 million, or $1.39 per diluted common share, for the year ended December 31, 2017. Net income increased $11.3 million, or 27.0%, for the year ended December 31, 2018 compared to the year ended December 31, 2017 primarily due to an increase in net interest income of $47.6 million, or 34.1%, and the impact of utilizing a lower effective tax rate due to the Tax Cuts and Jobs Act, partially offset by an increase in noninterest expense of $38.8 million, or 35.1%. The increases in net interest income and noninterest expense during the year ended December 31, 2018 compared to the same period in 2017 were primarily the result of the Premier and Puget Mergers.

The net interest margin increased 36 basis points to 4.29% for the year ended December 31, 2018 compared to 3.93% for the same period in 2017. The increase in net interest margin was primarily due to the increases in both the average loan balance and loan yield and secondarily due to increases in both the average balances and yields on investments, offset partially by an increase in both the average balance and cost of interest bearing liabilities.

The Company's efficiency ratio was 68.34% for the year ended December 31, 2018 compared to 63.21% for the year ended December 31, 2017. The change in the efficiency ratio for the year ended December 31, 2018 compared to the year ended December 31, 2017 was primarily attributable to acquisition-related expenses included in noninterest expense as a result of the Premier and Puget Mergers.

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Net Interest Income

One of the Company's key sources of earnings is net interest income. There are several factors that affect net interest income including, but not limited to, the volume, pricing, mix and maturity of interest earning assets and interest bearing liabilities; the volume of noninterest bearing deposits and other liabilities and stockholders' equity; the volume of noninterest earning assets; market interest rate fluctuations; and asset quality. Net interest income increased $47.6 million, or 34.1%, to $186.9 million for the year ended December 31, 2018 compared to $139.4 million for the year ended December 31, 2017. The increase in net interest income was primarily due to increases in average interest earning assets, which increased substantially as a result of the Premier and Puget Mergers, and increases in the yield on total interest earning assets due to increasing market rates, offset partially by increases in the average cost of total interest bearing liabilities primarily as a result of rising interest rates and increases in average interest bearing liabilities, also due to the Premier and Puget Mergers.

Interest Income

Total interest income increased $51.7 million, or 35.0%, to $199.4 million for the year ended December 31, 2018 compared to $147.7 million for the same period in 2017. The balance of average interest earning assets increased $810.9 million, or 22.9%, to $4.36 billion for the year ended December 31, 2018 from $3.55 billion for the year ended December 31, 2017 and the yield on total interest earning assets increased 41 basis points to 4.57% for the year ended December 31, 2018 compared to 4.16% for the year ended December 31, 2017. The increase in the interest income was due primarily to interest income from interest and fees on loans and secondarily due to interest income on investment securities.

Interest income from interest and fees on loans increased $46.3 million, or 35.8%, to $175.5 million for the year ended December 31, 2018 from $129.2 million for the same period in 2017 due primarily to increases in both average loans receivable, net and in loan yields. Average total loans receivable, net increased $710.5 million, or 26.3%, to $3.41 billion for the year ended December 31, 2018 compared to $2.70 billion for the year ended December 31, 2017 primarily as a result of the Premier and Puget Mergers. Loan yields increased 36 basis points to 5.14% for the year ended December 31, 2018 from 4.78% for the year ended December 31, 2017 due to a combination of higher contractual loan rates as a result of the increasing interest rate environment and higher loan yields for loans acquired in the Premier and Puget Mergers as compared to the yield of legacy Heritage loans.

Incremental accretion income was $8.0 million and $6.3 million for the year ended December 31, 2018 and 2017, respectively. The increase in the incremental accretion was primarily due to the accretion of the loans acquired in the Premier and Puget Mergers. The impact on loan yield from incremental accretion on purchased loans was 0.23% for both the years ended December 31, 2018 and 2017. The incremental accretion and the impact to loan yield will change during any quarter based on the volume of prepayments, but is expected to decrease over time as the balance of the purchased loans continues to decrease. It is also expected that incremental accretion on portfolios with heavy short-term or revolving loans will experience higher accretion in the first year after the merger date.

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The following table presents a reconciliation of the loan yield calculated in accordance with GAAP to the loan yield excluding the effect of the incremental accretion on purchased loans for the year ended December 31, 2018 and 2017:

	Year Ended December 31,	
	2018	2017
	(Dollars in thousands)	
Loan yield (GAAP)	5.14 %	4.78 %
Exclude impact on loan yield from incremental accretion on purchased loans[1]	0.23 %	0.23 %
Loan yield, excluding incremental accretion on purchased loans (non-GAAP)[1] [2]	4.91 %	4.55 %
Incremental accretion on purchased loans	$7,964	$6,320

[1] As of the date of completion of each merger and acquisition transaction, purchased loans were recorded at their estimated fair value, including our estimate of future expected cash flows until the ultimate resolution of these credits. The difference between the contractual loan balance and the fair value represents the purchased discount. The purchased discount is accreted into income over the estimated remaining life of the loan or pool of loans, based upon results of the quarterly cash flow re-estimation. The incremental accretion income represents the amount of income recorded on the purchased loans in excess of the contractual stated interest rate in the individual loan notes.
[2] For additional information, see "Non-GAAP Financial Information."

Interest income on investment securities increased $4.3 million, or 23.9%, to $22.3 million during the year ended December 31, 2018 compared to $18.0 million for the year ended December 31, 2017. The increase in interest income on investment securities was the result of a combination of an increase in investment yields for the year ended December 31, 2018 compared to the same period in 2017 and an increase in the average balance of investment securities during the period. Yields on taxable securities increased 38 basis points to 2.60% for the year ended December 31, 2018 compared to 2.22% for the same period in 2017. Yields on nontaxable securities increased 12 basis points to 2.44% for the year ended December 31, 2018 from 2.32% for the same period in 2017. The average balance of investment securities increased $70.2 million, or 8.8%, to $868.1 million during the year ended December 31, 2018 from $797.9 million during the year ended December 31, 2017. The Company reduced the balance of its tax exempt securities during the year ended December 31, 2018 compared to the same period in 2017 as holding tax exempt securities was not as beneficial given the decrease in the federal corporate income tax rate in 2018. The Company has actively managed its investment securities portfolio to improve performance in the increasing rate environment.

Income on other interest earning assets increased $1.1 million, or 204.6%, to $1.6 million during the year ended December 31, 2018 compared to $539,000 during the same period in 2017 due to a combination of an increase in both the average balance and yield. Average other interest earning assets increased $30.2 million, or 65.7%, to $76.1 million for the year ended December 31, 2018 compared to $45.9 million for the year ended December 31, 2017. The increase was due primarily to an increase in interest earning deposits, as the Bank held more funds in interest earning accounts compared to the same period in 2017. The yield on other interest earning assets increased 99 basis points to 2.16% during the year ended December 31, 2018 compared to 1.17% during the same period in 2017, reflecting a rise in market rates.

Interest Expense

Total interest expense increased $4.1 million, or 48.7%, to $12.4 million for the year ended December 31, 2018 compared to $8.3 million for the same period in 2017 due primarily to an increase in the cost of funds. The cost of total interest bearing liabilities increased nine basis points to 0.42% for the year ended December 31, 2018 from 0.33% for the year ended December 31, 2017 primarily as a result of rising interest rates. The increase in interest expense was secondarily due to an increase in the total average interest bearing liabilities which increased by $451.6

million, or 17.9%, to $2.98 billion for the year ended December 31, 2018 from $2.53 billion for the year ended December 31, 2017, primarily as a result of liabilities assumed in the Premier and Puget Mergers.

The Company was able to reduce the impact of the rising market interest rates by increasing the average balance of noninterest bearing deposits at a higher growth rate than for total interest bearing deposits. The average balance of noninterest bearing deposits increased by $337.9 million, or 37.4%, during the year ended December 31,

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2018 to $1.24 billion from $902.7 million for 2017, including $332.7 million acquired in the Premier and Puget Mergers at the respective merger dates. The average balance of total interest bearing deposits increased $517.0 million, or 21.8%, during the year ended December 31, 2018 to $2.89 billion from $2.38 billion for the same period in 2017. The cost of all deposit accounts increased seven basis points to 0.25% for the year ended December 31, 2018 compared to 0.18% for the year ended December 31, 2017.

Interest expense on FHLB advances and other borrowings decreased $555,000, or 45.3%, to $671,000 for the year ended December 31, 2018 from $1.2 million for the year ended December 31, 2017 due to a decrease in the average balance, partially offset by an increase in the cost. The average balance for FHLB advances and other borrowings decreased $71.7 million to $33.9 million for the year ended December 31, 2018 from $105.6 million for the same period in 2017. The Company paid off all the outstanding FHLB advances during the third quarter of 2018. The average rate of the FHLB advances and other borrowings increased 82 basis points to 1.98% for the year ended December 31, 2018 compared to 1.16% for the same period in 2017 as a result of the increase in market rates.

The average cost of the junior subordinated debentures, including the effects of accretion of the discount established as of the date of the merger with Washington Banking Company, increased 116 basis points to 6.27% for the year ended December 31, 2018 compared to 5.11% for the same period in 2017. The increase on the cost of debentures was due to an increase in the three-month LIBOR rate to 2.81% at December 31, 2018 from 1.69% on December 31, 2017.

Net Interest Margin

Net interest margin for the year ended December 31, 2018 increased 36 basis points to 4.29% from 3.93% for the same period in 2017 primarily due to the above mentioned changes in asset yields and costs of funds. The net interest spread for the year ended December 31, 2018 increased 32 basis points to 4.15% from 3.83% for the same period in 2017 primarily due to the increase in yield on total interest earning assets.

Net interest margin is impacted by the incremental accretion on purchased loans. The following table presents a reconciliation of the net interest margin calculated in accordance with GAAP to the net interest margin excluding the effect of the incremental accretion on purchased loans for the year ended December 31, 2018 and 2017:

	Year Ended December 31,	
	2018	2017
Net interest margin (GAAP)	4.29%	3.93%
Exclude impact on net interest margin from incremental accretion on purchased loans[1]	0.18%	0.18%
Net interest margin, excluding incremental accretion on purchased loans (non-GAAP)[1] [2]	4.11%	3.75%

[1] As of the date of completion of each merger and acquisition transaction, purchased loans were recorded at their estimated fair value, including our estimate of future expected cash flows until the ultimate resolution of these credits. The difference between the contractual loan balance and the fair value represents the purchased discount. The purchased discount is accreted into income over the estimated remaining life of the loan or pool of loans, based upon results of the quarterly cash flow re-estimation. The incremental accretion income represents the amount of income recorded on the purchased loans in excess of the contractual stated interest rate in the individual loan notes.

[2] For additional information, see "Non-GAAP Financial Information."

Provision for Loan Losses

The Bank has established a comprehensive methodology for determining its allowance for loan losses. The allowance for loan losses is increased by provisions for loan losses charged to expense, and is reduced by loans charged-off, net of loan recoveries or a recovery of previous provision. The amount of the provision expense recognized during the years ended December 31, 2018 and 2017 was calculated in accordance with the Bank's methodology. For additional information, see "—Critical Accounting Policies" above.

The provision for loan losses is dependent on the Bank's ability to manage asset quality and control the level of net charge-offs through prudent underwriting standards. In addition, a decline in general economic conditions could increase future provisions for loan losses and have a material effect on the Company's net income.

The provision for loan losses increased $909,000, or 21.5% to $5.1 million for the year ended December 31, 2018 from $4.2 million for the year ended December 31, 2017. The increase in the provision for loan losses for the year ended December 31, 2018 from the same period in 2017 was primarily the result of increases in total loan balances

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during the year ended December 31, 2018. Based on a thorough review of the loan portfolio, the Bank determined that the provision for loan losses for the year ended December 31, 2018 was appropriate as it was calculated in accordance with the Bank's methodology for determining the allowance for loan losses.

Noninterest Income

Total noninterest income decreased $3.9 million, or 11.0%, to $31.7 million for the year ended December 31, 2018 compared to $35.6 million for the same period in 2017. The following table presents the change in the key components of noninterest income for the periods noted:

	Year Ended December 31,			
	2018	2017	Change	Percentage Change
	(Dollars in thousands)			
Service charges and other fees	$18,914	$18,004	$910	5.1 %
Gain on sale of investment securities, net	137	6	131	2,183.3
Gain on sale of loans, net	2,759	7,696	(4,937)	(64.2)
Interest rate swap fees	564	1,045	(481)	(46.0)
Other income	9,291	8,828	463	5.2
Total noninterest income	$31,665	$35,579	$(3,914)	(11.0)%

Gain on sale of loans, net decreased $4.9 million, or 64.2% to $2.8 million for the year ended December 31, 2018 compared to $7.7 million for the same period in 2017 due primarily to a $3.0 million gain recognized during 2017 as a result of the sale of a previously classified purchased credit impaired loan. The decrease in gain on sale of loans, net is also due to lower originations of loans held for sale. Volume from sale of mortgage loans decreased $42.2 million, or 34.8%, to $79.2 million for the year ended December 31, 2018 from $121.5 million for the same period in 2017. Volume from sale of the guaranteed portion of SBA loans decreased $10.1 million, or 50.3%, to $10.0 million for the year ended December 31, 2018 from $20.1 million for the same period in 2017. The lower volume of sales of mortgage loans and the guaranteed portion of SBA loans is also due to originating more of these type of loans as held for investment that are retained as portfolio loans in loans receivable, net. The detail of gain on sale of loans, net is included in the following schedule:

	Year Ended December 31,			
	2018	2017	Change	Percentage Change
	(Dollars in thousands)			
Gain on sale of mortgage loans, net	$2,403	$3,412	$(1,009)	(29.6)%
Gain on sale of guaranteed portion of SBA loans, net	356	1,286	(930)	(72.3)
Gain on sale of other loans, net	—	2,998	(2,998)	(100.0)
Gain on sale of loans, net	$2,759	$7,696	$(4,937)	(64.2)%

Interest rate swap fees decreased $481,000, or 46.0%, to $564,000 for the year ended December 31, 2018 compared to $1.0 million for the same period in 2017 as a result of fewer borrower requests for interest rate swap transactions.

The decrease in total noninterest income was partially mitigated by an increase in service charges and other fees of $910,000, or 5.1%, to $18.9 million for the year ended December 31, 2018 compared to $18.0 million for the same period in 2017, due primarily to an increase in deposit balances from acquisition and organic growth and changes in fee structures on deposit accounts, including a business deposit consolidation process completed during the second quarter 2017.

Additionally, other income increased $463,000, or 5.2%, to $9.3 million for the year ended December 31, 2018 compared to $8.8 million for the same period in 2017, due primarily to the total gain of $798,000 on the sales of a branch and a former administrative building during the year ended December 31, 2018.

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Noninterest Expense

Noninterest expense increased $38.8 million, or 35.1%, to $149.4 million during the year ended December 31, 2018 compared to $110.6 million for the year ended December 31, 2017. The following table presents changes in the key components of noninterest expense for the periods noted:

	Year Ended December 31,			
	2018	2017	Change	Percentage Change
	(Dollars in thousands)			
Compensation and employee benefits	$86,830	$64,268	$22,562	35.1 %
Occupancy and equipment	19,779	15,396	4,383	28.5
Data processing	9,888	8,176	1,712	20.9
Marketing	3,228	2,943	285	9.7
Professional services	9,670	4,777	4,893	102.4
State and local taxes	3,210	2,461	749	30.4
Federal deposit insurance premium	1,480	1,435	45	3.1
Other real estate owned, net	106	(70)	176	(251.4)
Amortization of intangible assets	3,819	1,286	2,533	197.0
Other expense	11,385	9,903	1,482	15.0
Total noninterest expense	$149,395	$110,575	$38,820	35.1 %

The Company incurred significant acquisition-related expenses as a result of the Premier and Puget Mergers. The following table presents these expenses by key component in the following table:

	Year Ended December 31,	
	2018	2017
	(In thousands)	
Compensation and employee benefits	$5,455	$—
Occupancy and equipment	45	2
Data processing	1,365	113
Marketing	24	1
Professional services	3,046	690
Other expense	456	4
Total merger related expenses	$10,391	$810

Compensation and employee benefits increased $22.6 million, or 35.1%, to $86.8 million during the year ended December 31, 2018 from $64.3 million during the year ended December 31, 2017 primarily as a result of additional employees, mostly due to the Premier and Puget Mergers, including increases in senior level staffing. The average full time equivalent employees increased to 840 for the year ended December 31, 2018 compared to 749 for the same period in 2017. Compensation and employee benefits additionally increased due to acquisition-related payments for change-in-control bonuses and severance related to the Premier and Puget Mergers of $5.5 million during the year ended December 31, 2018 and increases in standard salary rates.

Professional services increased $4.9 million, or 102.4%, to $9.7 million during the year ended December 31, 2018 from $4.8 million during the year ended December 31, 2017 primarily due to an increase of $2.4 million in professional services acquisition costs. The increase was additionally the result of the buy-out of a third party contract in the amount of $1.7 million during the year ended December 31, 2018. The third party assisted the Company in its deposit product realignment and was compensated based on success factors over three years subsequent to implementation. The Company assessed the contract and determined that it was advantageous to buy-out the contract prior to the system conversions relating to the Premier and Puget Mergers. The Company expects the accumulated savings in future professional services expenses to fully offset the cost of the buy-out by the end of 2019.

Occupancy and equipment increased $4.4 million, or 28.5%, to $19.8 million during the year ended December 31, 2018 from $15.4 million during the year ended December 31, 2017 due substantially to branch or other leased space expansion in the Seattle, Bellevue, Portland and other Oregon markets. The Bellevue expansion included the

lease acquired from the Puget Sound Merger and additional space leased subsequent to the merger. The Oregon expansion included five leases acquired in the Premier Merger.
Amortization of intangible assets increased $2.5 million, or 197.0%, to $3.8 million during the year ended December 31, 2018 from $1.3 million during the year ended December 31, 2017 primarily a result of additional amortization related to acquired core deposit intangibles from the Premier and Puget Mergers of $2.7 million during the year ended December 31, 2018.
Data processing increased $1.7 million, or 20.9%, to $9.9 million during the year ended December 31, 2018 from $8.2 million during the year ended December 31, 2017 primarily due to acquisition-related costs for core system conversions. The increase in the year ended December 31, 2018 compared to 2017 was additionally due to higher transactional activity as a result of the Premier and Puget Mergers and organic growth in loans and deposits.
The ratio of noninterest expense to average total assets was 3.00% for the year ended December 31, 2018, compared to 2.78% for the year ended December 31, 2017. The increase was primarily a result of increased expenses including acquisition-related costs and increases in amortization of intangible assets as a result of the Premier and Puget Mergers during the year ended December 31, 2018.

Income Tax Expense
Income tax expense decreased $7.3 million, or 39.9%, to $11.0 million for the year ended December 31, 2018 from $18.4 million for the year ended December 31, 2017. The effective tax rate was 17.2% for the year ended December 31, 2018 compared to 30.5% for the same period in 2017. The decrease in the income tax expense and effective tax rate during the year ended December 31, 2018 was primarily due to the impact of the Tax Cuts and Jobs Act enacted in December 2017 which lowered the federal corporate income tax rate from 35% to 21%. The decrease in the effective tax rate was partially offset by a change in the estimated current tax benefits form certain low income housing tax credit projects which increased income tax expense in the amount of $898,000 in 2018. Although long-term tax benefits from the projects is still expected to occur, the timing of some of the benefits was extended to future periods.

Results of Operations for the Years Ended December 31, 2017 and 2016
Earnings Summary
Net income was $41.8 million, or $1.39 per diluted common share, for the year ended December 31, 2017 compared to $38.9 million, or $1.30 per diluted common share, for the year ended December 31, 2016. The increase in net income of $2.9 million, or 7.4%, for the year ended December 31, 2017 compared to the year ended December 31, 2016 was primarily the result of an increase in net interest income of $6.9 million, or 5.2%, and an increase in total noninterest income of $4.0 million, or 12.5%, partially offset by an increase in income tax expense of $4.6 million, or 33.0%, and an increase in total noninterest expense of $4.1 million, or 3.9%.
The net interest margin decreased three basis points to 3.93% for the year ended December 31, 2017 compared to 3.96% for the same period in 2016 primarily due to a decrease in loan yields.
The Company’s efficiency ratio improved to 63.21% for the year ended December 31, 2017 from 64.87% for the year ended December 31, 2016. The improvement in the efficiency ratio for the year ended December 31, 2017 compared to the year ended December 31, 2016 was primarily attributable to the increases in net interest income and noninterest income.
Net Interest Income
Net interest income increased $6.9 million, or 5.2%, to $139.4 million for the year ended December 31, 2017 compared to $132.5 million for the year ended December 31, 2016. The increase in net interest income was primarily due to increases in average interest earning assets and yields on interest earning assets.
Interest Income
Total interest income increased $9.2 million, or 6.6%, to $147.7 million for the year ended December 31, 2017 compared to $138.5 million for the year ended December 31, 2016. The balance of average interest earning assets increased $201.5 million, or 6.0%, to $3.55 billion for the year ended December 31, 2017 from $3.35 billion for the

year ended December 31, 2016. The yield on total interest earning assets increased two basis points to 4.16% for the year ended December 31, 2017 from 4.14% for the year ended December 31, 2016.
Interest income from interest and fees on loans increased $7.1 million, or 5.8%, to $129.2 million for the year ended December 31, 2017 from $122.1 million for the same period in 2016 due primarily to an increase in average

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loans receivable, offset partially by a decrease in average loan yields. Average loans receivable increased $214.2 million, or 8.6%, to $2.70 billion for the year ended December 31, 2017 compared to $2.49 billion for the year ended December 31, 2016 as a result of loan growth. Average loan yields decreased 13 basis points to 4.78% for the year ended December 31, 2017 from 4.91% for the year ended December 31, 2016. While variable indexed rates had increased during 2017, loan yield, excluding incremental accretion on purchased loans, decreased seven basis points to 4.55% for the year ended December 31, 2017 compared to 4.62% for the year ended 2016 due primarily to a combination of lower consumer indirect loan yields during 2017, fewer payments in 2017 to resolve nonperforming or charged-off loans and lower prepayment penalties received in 2017 as compared to 2016. Average loan yields secondarily decreased as a result of a decrease in incremental accretion income on purchased loans, which had the impact of loan yields of 0.23% for the year ended December 31, 2017 compared to 0.29% for the year ended December 31, 2017. Incremental accretion income was $6.3 million and $7.2 million for the years ended December 31, 2017 and 2016, respectively. The decrease in the incremental accretion was primarily a result of a continued decline in the purchased loan balances and a decrease in the prepayments of purchased loans during the year ended December 31, 2017 compared to the same period in 2016. The incremental accretion and the impact to loan yield will change during any period based on the volume of prepayments, but is expected to decrease over time as the balance of the purchased loans continues to decrease.

The following table presents the average loan yield and effects of the incremental accretion on purchased loans for the year ended December 31, 2017 and 2016:

	Year Ended December 31,			
	2017		2016	
	(Dollars in thousands)			
Loan yield (GAAP)	4.78	%	4.91	%
Exclude impact on loan yield from incremental accretion on purchased loans[1]	0.23		0.29	
Loan yield, excluding incremental accretion on purchased loans (non-GAAP)[1][2]	4.55	%	4.62	%
Incremental accretion on purchased loans[1]	$6,320		$7,155	

[1] As of the date of completion of each merger and acquisition transaction, purchased loans were recorded at their estimated fair value, including our estimate of future expected cash flows until the ultimate resolution of these credits. The difference between the contractual loan balance and the fair value represents the purchased discount. The purchased discount is accreted into income over the estimated remaining life of the loan or pool of loans, based upon results of the quarterly cash flow re-estimation. The incremental accretion income represents the amount of income recorded on the purchased loans in excess of the contractual stated interest rate in the individual loan notes.
[2] For additional information, see "Non-GAAP Financial Information."

Total interest income increased primarily due to the increase in interest and fees on loans discussed above and secondarily due to an increase in interest income on investment securities of $1.9 million, or 11.6%, to $18.0 million during the year ended December 31, 2017 from $16.1 million for the year ended December 31, 2016. The increase in interest income on investment securities was the result of an increase in average investment yields for the year ended December 31, 2017 compared to the same period in 2016, offset partially by a decrease in the average balance of investment securities. Average yields on taxable securities increased 32 basis points to 2.22% for the year ended December 31, 2017 from 1.90% for the same period in 2016. The increase is primarily the result of the rise in interest rates on the adjustable rate investment securities. Average yields on nontaxable securities increased 12 basis points to 2.32% for the year ended December 31, 2017 from 2.20% for the same period in 2016. The average balance of investment securities decreased $13.7 million, or 1.7%, to $797.9 million during the year ended December 31, 2017 from $811.6 million during the year ended December 31, 2016. The Company has actively managed its investment securities portfolio to mitigate declines in loan yields.

Average other interest earning assets increased $1.0 million, or 2.24%, to $46.0 million for the year ended December 31, 2017 compared to $45.0 million for the year ended December 31, 2016. The increase was due primarily to an increase in interest earning deposits, as the Bank held more funds in interest earning accounts at the Federal Reserve Bank of San Francisco compared to the same period in 2016.

Interest Expense

Total interest expense increased $2.3 million, or 39.0%, to $8.3 million for the year ended December 31, 2017 compared to $6.0 million for the same period in 2016. The average cost of interest bearing liabilities increased eight basis points to 0.33% for the year ended December 31, 2017 from 0.25% for the year ended December 31, 2016. Total average interest bearing liabilities increased $135.8 million, or 5.7%, to $2.53 billion for the year ended December 31, 2017 from $2.39 billion for the year ended December 31, 2016. The increase in costs from the prior year was primarily a result of increases in market rates and the increased use of higher cost borrowings to fund asset growth. The average cost of interest bearing deposits increased four basis points to 0.25% for the year ended December 31, 2017 from 0.21% for the same period in 2016 due primarily to an increase in the cost of savings accounts.

Interest expense on savings accounts increased $555,000, or 73.4%, to $1.3 million for the year ended December 31, 2017 from $756,000 for the same period in 2016 due to increases in both the average balance and cost of savings accounts. The average balance of savings accounts increased $14.0 million, or 2.9%, to $499.4 million for the year ended December 31, 2017 from $485.5 million for the same period in 2016. The cost of savings accounts increased ten basis points to 0.26% for the year ended December 31, 2017 from 0.16% for the same period in 2016.

Interest expense of certificate of deposit accounts increased $308,000, or 15.91%, to $2.2 million for the year ended December 31, 2017. The average balance of certificate of deposit accounts decreased $10.2 million, or 2.64%, to $378.0 million for the year ended December 31, 2017 compared to $388.3 million for the year ended December 31, 2016 while the cost of certificate of deposit accounts increased to 0.59% for the year ended December 31, 2017 from 0.50% for the same period in 2016.

Interest expense on FHLB advances and other borrowings increased to $1.2 million for the year ended December 31, 2017 from $74,000 for the year ended December 31, 2016 due to a combination of an increase in average balances and an increase in the cost of funds. The average balance for FHLB advances and other borrowings increased $92.3 million to $105.6 million for the year ended December 31, 2017 from $13.3 million for the same period in 2016, due primarily to fund loan growth. The average rate of the FHLB advances and other borrowings increased 61 basis points for the year ended December 31, 2017 to 1.16% from 0.55% for the same period in 2016.

The average rate of the junior subordinated debentures, including the effects of accretion of the discount established as of the date of the merger with Washington Banking Company, was 5.11% for the year ended December 31, 2017, an increase of 61 basis points from 4.50% for the same period in 2016. The rate increase on the debentures was due primarily to an increase in the three-month LIBOR rate to 1.69% at December 31, 2017 from 1.00% on December 31, 2016.

Net Interest Margin

Net interest margin for the year ended December 31, 2017 decreased three basis points to 3.93% from 3.96% for the same period in 2016 primarily due to the above mentioned decrease in the loan yields (both including and excluding the impact of incremental accretion on purchased loans) and increase in cost of funds, offset partially by the increase in average loan receivable balances and the increase in yields on taxable and nontaxable securities. The net interest spread for the year ended December 31, 2017 decreased six basis points to 3.83% from 3.89% for the same period in 2016.

Net interest margin is impacted by the incremental accretion on purchased loans. The following table presents the net interest margin and effects of the incremental accretion on purchased loans for the year ended December 31, 2017 and 2016:

	Year Ended December 31,	
	2017	2016
	(Dollars in thousands)	
Net interest margin (GAAP)	3.93 %	3.96 %
Exclude impact on net interest margin from incremental accretion on purchased loans[1]	0.18	0.21
Net interest margin, excluding incremental accretion on purchased loans (non-GAAP)[1] [2]	3.75 %	3.75 %

[1] As of the date of completion of each merger and acquisition transaction, purchased loans were recorded at their estimated fair value, including our estimate of future expected cash flows until the ultimate resolution of these credits. The difference between the contractual loan balance and the fair value represents the purchased discount. The purchased discount is accreted into income over the estimated remaining life of the loan or pool of loans, based upon results of the quarterly

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cash flow re-estimation. The incremental accretion income represents the amount of income recorded on the purchased loans in excess of the contractual stated interest rate in the individual loan notes.
(2) For additional information, see "Non-GAAP Financial Information."

Provision for Loan Losses
The amount of the provision expense recognized during the years ended December 31, 2017 and 2016 was calculated in accordance with the Bank's methodology. For additional information, see "—Critical Accounting Policies" above. The provision for loan losses decreased $711,000, or 14.4% to $4.2 million for the year ended December 31, 2017 from $4.9 million for the year ended December 31, 2016. The decrease in the provision for loan losses for the year ended December 31, 2017 from the same period in 2016 was primarily the result of continued improvements in our asset quality, changes in the volume and mix of loans, changes in certain environmental factors and improvements in certain historical loss factors, partially offset by the impact of loan growth. Based on a thorough review of the loan portfolio, the Bank determined that the provision for loan losses for the year ended December 31, 2017 was appropriate as it was calculated in accordance with the Bank's methodology for determining the allowance for loan losses.
Noninterest Income
Total noninterest income increased $4.0 million, or 12.5%, to $35.6 million for the year ended December 31, 2017 compared to $31.6 million for the year ended December 31, 2016. The following table presents the change in the key components of noninterest income for the periods noted:

	Year Ended December 31,			
	2017	2016	Change 2017 vs. 2016	Percentage Change
	(Dollars in thousands)			
Service charges and other fees	$18,004	$14,354	$3,650	25.4 %
Gain on sale of investment securities, net	6	1,315	(1,309)	(99.5)
Gain on sale of loans, net	7,696	6,994	702	10.0
Interest rate swap fees	1,045	1,854	(809)	(43.6)
Other income	8,828	7,102	1,726	24.3
Total noninterest income	$35,579	$31,619	$3,960	12.5 %

Service charges and other fees increased $3.7 million, or 25.4% to $18.0 million for the year ended December 31, 2017 compared to $14.4 million for the same period in 2016, due primarily to an increase in deposit balances and changes in fee structures on deposit accounts, including a consumer deposit account consolidation process completed at the end of 2016 and a business deposit consolidation process completed during second quarter 2017.
Other income increased $1.7 million, or 24.3%, to $8.8 million for the year ended December 31, 2017 compared to $7.1 million for the same period in 2016, due primarily to net gain on sales of two former Heritage Bank branches held for sale of $682,000 recognized during the year ended December 31, 2017 and increases in recoveries of zero balance purchased loan notes which were charged-off prior to the consummation of the related merger acquisition.
Gain on sale of loans, net increased $702,000, or 10.0% to $7.7 million for the year ended December 31, 2017 compared to $7.0 million for the same period in 2016, due primarily to an increase in gain on sale of other loans of $743,000. During both years ended December 31, 2017 and 2016, the Bank sold one loan previously classified as purchased credit impaired for gain on sale. Secondarily, gain on sale of guaranteed portion of SBA loans, net increased $270,000 due primarily to an increase in proceeds from sale of the guaranteed portion of SBA loans of $3.3 million, or 19.4%, to $20.1 million for the year ended December 31, 2017 compared to $16.8 million for the same period in 2016. The detail of gain on sale of loans, net is included in the following schedule:

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	Year Ended December 31,			
	2017	2016	Change 2017 vs. 2016	Percentage Change
	(Dollars in thousands)			
Gain on sale of mortgage loans, net	$3,412	$3,723	$(311)	(8.4)%
Gain on sale of guaranteed portion of SBA loans, net	1,286	1,016	270	26.6
Gain on sale of other loans, net	2,998	2,255	743	32.9
Gain on sale of loans, net	$7,696	$6,994	$702	10.0 %

The increase in noninterest income was partially offset by a decrease in gain on sale of investment securities, net to $6,000 for the year ended December 31, 2017 from $1.3 million for the year ended December 31, 2016. The decrease was primarily the result of fewer sales as the Bank actively managed its investment portfolio. The proceeds from sale of investment securities was $31.0 million for the year ended December 31, 2017 compared to $140.4 million for the same period in 2016.

Noninterest Expense

Noninterest expense increased $4.1 million, or 3.9%, to $110.6 million for the year ended December 31, 2017 compared to $106.5 million for the year ended December 31, 2016. The following table presents changes in the key components of noninterest expense for the periods noted:

	Year Ended December 31,			
	2017	2016	Change 2016 vs. 2015	Percentage Change
	(Dollars in thousands)			
Compensation and employee benefits	$64,268	$61,405	$2,863	4.7 %
Occupancy and equipment	15,396	15,763	(367)	(2.3)
Data processing	8,176	7,312	864	11.8
Marketing	2,943	2,835	108	3.8
Professional services	4,777	3,606	1,171	32.5
State and local taxes	2,461	2,616	(155)	(5.9)
Federal deposit insurance premium	1,435	1,620	(185)	(11.4)
Other real estate owned, net	(70)	334	(404)	(121.0)
Amortization of intangible assets	1,286	1,415	(129)	(9.1)
Other expense	9,903	9,567	336	3.5
Total noninterest expense	$110,575	$106,473	$4,102	3.9 %

Compensation and employee benefits increased $2.9 million, or 4.7%, to $64.3 million during the year ended December 31, 2017 from $61.4 million during the year ended December 31, 2016. The increase in the year ended December 31, 2017 compared to 2016 was primarily due to senior level staffing increases, including the addition of the new Portland, Oregon lending team members who started in May 2017, and standard salary increases.

Professional services increased $1.2 million, or 32.5%, to $4.8 million during the year ended December 31, 2017 from $3.6 million during the year ended December 31, 2016. The increase in the year ended December 31, 2017 compared to 2016 was primarily due to due to benefit-based consulting fees related to the consumer deposit account consolidation process, which correspondingly generated an increase in service charges and other fees. Professional services also increased as a result of Trust-related expenses based on a renegotiated contract for 2017, which also increased other noninterest income, and costs incurred in the Puget Sound Merger of $690,000 during the year ended

December 31, 2017.

Data processing increased $864,000, or 11.8%, to $8.2 million during the year ended December 31, 2017 from $7.3 million during the year ended December 31, 2016 primarily due to higher transactional activity in the core operating system and internet banking as a result of the growth in loans and deposits and costs incurred in the Puget Sound Merger of $113,000 during the year ended December 31, 2017.

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Other real estate owned, net decreased $404,000 or 121.0%, to income of $70,000 during the year ended December 31, 2017 compared to expense of $334,000 during the year ended December 31, 2016. The Bank had no other real estate owned at year ended December 31, 2017 compared to $754,000 at year ended December 31, 2016. The income recorded during the year ended December 31, 2017 was due to gain on sale of properties of $144,000, partially offset by maintenance expense of $75,000. For the year ended December 31, 2016, the Bank recorded a valuation adjustment of $383,000 and maintenance expense of $124,000, which was partially offset by the gain on sale of properties of $173,000.

The ratio of noninterest expense to average assets was 2.78% for the year ended December 31, 2017, compared to 2.84% for the year ended December 31, 2016. The decrease was primarily a result of an increase in assets and cost efficiencies gained through efforts by the Company to manage discretionary expenses.

Income Tax Expense

Income tax expense increased by $4.6 million, or 33.0%, to $18.4 million for the year ended December 31, 2017 from $13.8 million for the year ended December 31, 2016. The increase in the income tax expense during the year ended December 31, 2017 was primarily due to higher pre-tax net income and the Tax Cuts and Jobs Act enacted December 22, 2017, which required a revaluation of deferred tax assets and liabilities to account for the future impact of the decrease in the federal corporate income tax rate to 21% from 35% and other provisions of the legislation. The estimated revaluation of the net deferred tax asset increased income tax expense by $2.6 million for the year ended December 31, 2017. Certain amounts of the revaluation are considered reasonable estimates of the impact of the legislation as of December 31, 2017.

The effective tax rate was 30.5% for the year ended December 31, 2017 compared to 26.2% for the same period in 2016. The increase in the effective tax rate during the year ended December 31, 2017 compared to the same period in 2016 was due primarily to the revaluation of net deferred tax asset as a result of the Tax Cuts and Jobs Act and a lower proportion of tax-exempt income to total pre-tax income. For additional information, see Note (21) Income Taxes of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data.”

Non-GAAP Financial Information

This report contains certain financial information determined by methods other than in accordance with accounting principles generally accepted in the United States of America. These measures include net interest income, interest and fees on loans, and loan yield and net interest margin excluding the effect of the incremental accretion on purchased loans acquired through mergers. Our management uses these non-GAAP measures, together with the related GAAP measures, in its analysis of our performance and in making business decisions. Management also uses these measures for peer comparisons. Management believes that presenting loan yield and net interest margin excluding the effect of the acquisition accounting discount accretion on loans acquired through mergers is useful in assessing the impact of acquisition accounting on loan yield and net interest margin, as the effect of loan discount accretion is expected to decrease as the acquired loans mature or roll off our balance sheet. These disclosures should not be viewed as substitutes for the results determined to be in accordance with GAAP, nor are they necessarily comparable to non-GAAP performance measures that may be presented by other companies.

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Reconciliations of the GAAP and non-GAAP financial measures on net interest income, interest and fees on loans, loan yield and net interest margin are presented below:

	Year Ended December 31,		
	2018	2017	2016
	(Dollars in thousands)		
Net interest income and interest and fees on loans:			
Net interest income (GAAP)	$186,946	$139,363	$132,506
Exclude incremental accretion on purchased loans	7,964	6,320	7,155
Adjusted net interest income (non-GAAP)	$178,982	$133,043	$125,351
Average total interest earning assets, net	$4,358,643	$3,547,786	$3,346,256
Net interest margin, annualized (GAAP)	4.29 %	3.93 %	3.96 %
Net interest margin, excluding incremental accretion on purchased loans, annualized (non-GAAP)	4.11 %	3.75 %	3.75 %
Interest and fees on loans (GAAP)	$175,466	$129,213	$122,147
Exclude incremental accretion on purchased loans	7,964	6,320	7,155
Adjusted interest and fees on loans (non-GAAP)	$167,502	$122,893	$114,992
Average total loans receivable, net	$3,414,424	$2,703,934	$2,489,730
Loan yield, annualized (GAAP)	5.14 %	4.78 %	4.91 %
Loan yield, excluding incremental accretion on purchased loans, annualized (non-GAAP)	4.91 %	4.55 %	4.62 %

Liquidity and Capital Resources

Our primary sources of funds are customer and local government deposits, loan principal and interest payments, loan sales, interest earned on and proceeds from sales and maturities of investment securities. 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 loan 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 investments to meet short-term liquidity needs. At December 31, 2018, cash and cash equivalents totaled $161.9 million, or 3.0%, of total assets. Investment securities available for sale totaled $976.1 million at December 31, 2018, of which $264.7 million were pledged to secure public deposits, borrowing arrangements or repurchase agreements. Management considers unpledged investment securities available for sale to be a viable source of liquidity. The fair value of investment securities available for sale that were not pledged to secure public deposits, borrowing arrangements or repurchase agreements totaled $711.4 million, or 13.4%, of total assets at December 31, 2018. The fair value of investment securities available for sale with maturities of one year or less amounted to $38.5 million, or 0.72%, of total assets. At December 31, 2018, the Bank maintained credit facilities with the FHLB of Des Moines for $921.7 million, of which there were no of borrowings outstanding as of December 31, 2018, and credit facilities with the Federal Reserve Bank of San Francisco for $37.4 million, of which there were no borrowings outstanding as of December 31, 2018. The Bank also maintains advance lines with Wells Fargo Bank, US Bank, The Independent Bankers Bank and Pacific Coast Bankers' Bank to purchase federal funds totaling $90.0 million as of December 31, 2018. As of December 31, 2018, there were no overnight federal funds purchased.

Our strategy has been to acquire core deposits (which we define to include all deposits except public funds, brokered certificate of deposit accounts and other wholesale deposits) from our retail accounts, acquire noninterest bearing

demand deposits from our commercial customers and use our available borrowing capacity to fund growth in assets. We anticipate that we will continue to rely on the same sources of funds in the future and use those funds primarily to make loans and purchase investment securities.

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Contractual Obligations

The following table provides the amounts due under specified contractual obligations for the periods indicated as of December 31, 2018:

	December 31, 2018					
	One Year or Less	One to Three Years	Over Three to Five Years	Over Five Years	Other [1]	Total
	(In thousands)					
Contractual payments by period:						
Deposits	$313,830	$108,283	$44,761	$18	$3,965,510	$4,432,402
Junior subordinated debentures	—	—	—	25,000	—	25,000
Operating leases	4,766	6,728	3,272	1,788	—	16,554
Total contractual obligations	$318,596	$115,011	$48,033	$26,806	$3,965,510	$4,473,956

(1) Represents interest bearing and noninterest bearing checking, money market and checking accounts which can generally be withdrawn on demand and thereby have an undefined maturity.

Asset/Liability Management

Our primary financial objective is to achieve long-term profitability while controlling our exposure to fluctuations in market interest rates. To accomplish this objective, we have formulated an interest rate risk management policy that attempts to manage the mismatch between asset and liability maturities while maintaining an acceptable interest rate sensitivity position. The principal strategies which we employ to control our interest rate sensitivity are: originating certain commercial business loans and real estate construction and land development loans at variable interest rates repricing for terms generally one year or less; and offering noninterest bearing demand deposit accounts to businesses and individuals. The longer-term objective is to increase the proportion of noninterest bearing demand deposits, low-rate interest bearing demand deposits, money market accounts, and savings deposits relative to certificate of deposit accounts to reduce our overall cost of funds.

A number of measures are used to monitor and manage interest rate risk, including income simulations, interest sensitivity (gap) analysis and economic value of equity sensitivity. An income simulation model is the primary tool used to assess the direction and magnitude of changes in net interest income resulting from changes in interest rates. Key assumptions in the model include prepayment speeds on loans and investment securities, decay rates on non-maturity deposits, and pricing on investment securities, loans, deposits and borrowings. In order to measure the interest rate risk sensitivity as of December 31, 2018, this simulation model uses a “no growth” assumption and assumes an instantaneous and sustained uniform change in market interest rates at all maturities. These assumptions are inherently uncertain and, as a result, the net interest income projections should be viewed as an estimate of the net interest income sensitivity at the time of the analysis. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes and changes in market conditions and management strategies, among other factors.

Based on the results of the simulation model as of December 31, 2018, we would expect increases in net interest income of $8.0 million and $14.3 million in year one and year two, respectively, if interest rates increased from current rates by 100 basis points. We would expect an increase in net interest income of $16.1 million and $28.7 million in year one and year two, respectively, if interest rates increased from current rates by 200 basis points. If interest rates decreased by 100 basis points, we would expect decreases of $8.3 million and $14.7 million in year one and year two, respectively.

Our asset and liability management strategies have resulted in a negative less than 3 month “gap” of 34.1% as of December 31, 2018. This “gap” measures the difference between the dollar amount of our interest earning assets and interest bearing liabilities that mature or reprice within the designated period (three months or less) as a percentage of

total interest earning assets, based on certain estimates and assumptions as discussed below. We believe that the implementation of our operating strategies has reduced the potential effects of changes in market interest rates on

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our results of operations. The negative gap for the less than three month period indicates that decreases in market interest rates may favorably affect our results over that period.

The following table provides the estimated maturity or repricing and the resulting interest rate sensitivity gap of our interest earning assets and interest bearing liabilities at December 31, 2018. We used certain assumptions in presenting this data so the amounts may not be consistent with other financial information prepared in accordance with generally accepted accounting principles. The amounts in the tables also could be significantly affected by external factors, such as changes in prepayment assumptions, early withdrawal of deposits and competition.

	December 31, 2018					
	Estimated Maturity or Repricing Within					
	Three Months or Less	Over Three Months to 12 Months	Over One to Five Years	Over Five to 15 Years	Over 15 Years	Total
	(Dollars in thousands)					
Interest Earnings Assets:						
Loans receivable [1]	$938,334	$234,894	$1,737,157	$655,536	$84,730	$3,650,651
Investment securities	167,513	74,657	220,039	303,035	210,851	976,095
Interest earning deposits	69,206	—	—	—	—	69,206
Total interest earning assets	$1,175,053	$309,551	$1,957,196	$958,571	$295,581	$4,695,952
Percentage of interest earning assets	25.0 %	6.6 %	41.7 %	20.4 %	6.3 %	100.0 %
Interest Bearing Liabilities:						
Total interest bearing deposits [2]	$2,722,519	$193,211	$154,326	$78	$—	$3,070,134
Junior subordinated debentures	20,302	—	—	—	—	20,302
Securities sold under agreement to repurchase	31,487	—	—	—	—	31,487
Total interest bearing liabilities	$2,774,308	$193,211	$154,326	$78	$—	$3,121,923
Interest bearing liabilities, as a percentage of total interest earning assets	59.1 %	4.1 %	3.3 %	— %	— %	66.5 %
Interest rate sensitivity gap	$(1,599,255)	$116,340	$1,802,870	$958,493	$295,581	$1,574,029
Interest rate sensitivity gap, as a percentage of total interest earning assets	(34.1)%	2.5 %	38.4 %	20.4 %	6.3 %	33.5 %
Cumulative interest rate sensitivity gap	$(1,599,255)	$(1,482,915)	$319,955	$1,278,448	$1,574,029	
Cumulative interest rate sensitivity gap, as a	(34.1)%	(31.6)%	6.8 %	27.2 %	33.5 %	

percentage of total
interest earning assets

(1) Excludes net deferred loan costs and allowance for loan losses.

(2) Adjustable-rate liabilities are included in the period in which interest rates are next scheduled to adjust rather than in the period they are due to mature. Although regular savings, demand, NOW, and money market deposit accounts are subject to immediate withdrawal, based on historical experience management considers a substantial amount of such accounts to be core deposits having significantly longer maturities.

Certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on some types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market interest rates. Additionally, some assets, such as adjustable rate mortgages, have features, which restrict changes in

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the interest rates of those assets both on a short-term basis and over the lives of such assets. Further, if a change in market interest rates occurs, prepayment and early withdrawal levels could deviate significantly from those assumed in calculating the tables. Finally, the ability of many borrowers to service their adjustable rate debt may decrease if market interest rates increase substantially.

The table below provides information about our financial instruments that are sensitive to changes in interest rates as of December 31, 2018. The table presents principal cash flows and related weighted average interest rates by expected maturity dates. The expected maturity is the contractual maturity or earlier call date of the instrument. The data in this table may not be consistent with the amounts in the preceding table, which represents amounts by the estimated repricing date or maturity date, whichever occurs sooner.

	By Expected Maturity Date Year Ended December 31, 2018						
	Three Months or Less	Over Three Months to 12 Months	Over One Year to Five Years	Over Five Years to 15 Years	Over 15 Years	Total	Fair Value
	(Dollars in thousands)						
Investment Securities							
Amounts maturing:							
Fixed rate	$58,389	$60,650	$179,649	$300,244	$210,851	$809,783	
Weighted average interest rate	3.13 %	2.81 %	2.79 %	2.85 %	2.81 %	2.84 %	
Adjustable rate	$4,141	$207	$11,926	$45,338	$104,700	$166,312	
Weighted average interest rate	3.65 %	0.94 %	3.88 %	3.04 %	3.21 %	3.22 %	
Total	$62,530	$60,857	$191,575	$345,582	$315,551	$976,095	$976,095
Loans [1]							
Amounts maturing:							
Fixed rate	$30,154	$65,986	$573,664	$558,100	$84,730	$1,312,634	
Weighted average interest rate	5.37 %	5.31 %	4.65 %	4.44 %	4.50 %	4.60 %	
Adjustable rate	$184,381	$310,472	$224,609	$1,401,867	$216,688	$2,338,017	
Weighted average interest rate	6.20 %	6.06 %	5.55 %	4.71 %	5.09 %	5.13 %	
Total	$214,535	$376,458	$798,273	$1,959,967	$301,418	$3,650,651	$3,614,348
Certificate of Deposit Accounts							
Amounts maturing:							
Fixed rate	$122,420	$191,410	$153,044	$18	$—	$466,892	$470,222
Weighted average interest rate	0.80 %	0.96 %	1.52 %	0.78 %	— %	1.10 %	
Junior Subordinated Debentures							
Amounts maturing:							
Adjustable rate	$—	$—	$—	$—	$20,302	$20,302	$20,500
Weighted average interest rate [2]	— %	— %	— %	— %	6.27 %	6.27 %	

[1] Excludes deferred loan costs (fees), net and allowance for loan losses.

[2] The contractual interest rate of the junior subordinated debentures was 4.37% at December 31, 2018. The weighted average interest rate includes the effects of the discount accretion for the Washington Banking Merger purchase

accounting adjustment.

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Impact of Inflation and Changing Prices
Inflation affects our operations by increasing operating costs and indirectly by affecting the operations and cash flow of our customers. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, changes in interest rates generally have a more significant impact on a financial institution's performance than the effects of general levels of inflation. Although interest rates do not necessarily move in the same direction or the same extent as the prices of goods and services, increases in inflation generally have resulted in increased interest rates.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
We are exposed to interest rate risk through our lending and deposit gathering activities. For a discussion of how this exposure is managed and the nature of changes in our interest rate risk profile during the past year, see Item 7. Management's Discussion And Analysis Of Financial Condition And Results Of Operations.
Neither we, nor the Bank, maintain a trading account for any class of financial instrument, nor do we, or the Bank, engage in hedging activities or purchase high risk derivative instruments. Moreover, neither we, nor the Bank, are subject to foreign currency exchange rate risk or commodity price risk.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

Stockholders and the Board of Directors of Heritage Financial Corporation
Olympia, Washington

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated statements of financial condition of Heritage Financial Corporation and subsidiaries (the "Company") as of December 31, 2018 and 2017, the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2018, and the related notes (collectively referred to as the "financial statements"). We also have audited the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in the 2013 Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2018 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in the 2013 Internal Control - Integrated Framework issued by COSO.

Basis for Opinions

The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's financial statements and an opinion on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the

Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. As permitted, the Company has excluded the operations of Premier Community Bank and Puget Sound Bank both acquired during 2018, which is described in Note 2 of the consolidated financial statements, from the scope of management's report on internal control over financial reporting. As such, it has also been excluded from the scope of our audit of internal control over financial reporting. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Crowe LLP

We have served as the Company's auditor since 2012.

Sacramento, California
March 1, 2019

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(In thousands, except shares)

	December 31, 2018	December 31, 2017
ASSETS		
Cash on hand and in banks	$ 92,704	$ 78,293
Interest earning deposits	69,206	24,722
Cash and cash equivalents	161,910	103,015
Investment securities available for sale, at fair value	976,095	810,530
Loans held for sale	1,555	2,288
Loans receivable, net	3,654,160	2,849,071
Allowance for loan losses	(35,042)	(32,086)
Total loans receivable, net	3,619,118	2,816,985
Other real estate owned	1,983	—
Premises and equipment, net	81,100	60,325
Federal Home Loan Bank stock, at cost	6,076	8,347
Bank owned life insurance	93,612	75,091
Accrued interest receivable	15,403	12,244
Prepaid expenses and other assets	98,522	99,328
Other intangible assets, net	20,614	6,088
Goodwill	240,939	119,029
Total assets	$ 5,316,927	$ 4,113,270
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits	$ 4,432,402	$ 3,393,060
Federal Home Loan Bank advances	—	92,500
Junior subordinated debentures	20,302	20,009
Securities sold under agreement to repurchase	31,487	31,821
Accrued expenses and other liabilities	72,013	67,575
Total liabilities	4,556,204	3,604,965
Stockholders’ equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at December 31, 2018 and 2017	—	—
Common stock, no par value, 50,000,000 shares authorized; 36,874,055 and 29,927,746 shares issued and outstanding at December 31, 2018 and 2017, respectively	591,806	360,590
Retained earnings	176,372	149,013
Accumulated other comprehensive loss, net	(7,455)	(1,298)
Total stockholders’ equity	760,723	508,305
Total liabilities and stockholders’ equity	$ 5,316,927	$ 4,113,270

See accompanying Notes to Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share amounts)

	Year Ended December 31,		
	2018	2017	2016
INTEREST INCOME:			
Interest and fees on loans	$175,466	$129,213	$122,147
Taxable interest on investment securities	17,602	12,688	11,215
Nontaxable interest on investment securities	4,649	5,269	4,870
Interest on other interest earning assets	1,642	539	280
Total interest income	199,359	147,709	138,512
INTEREST EXPENSE:			
Deposits	10,397	6,049	5,010
Junior subordinated debentures	1,263	1,014	880
Other borrowings	753	1,283	116
Total interest expense	12,413	8,346	6,006
Net interest income	186,946	139,363	132,506
Provision for loan losses	5,129	4,220	4,931
Net interest income after provision for loan losses	181,817	135,143	127,575
NONINTEREST INCOME:			
Service charges and other fees	18,914	18,004	14,354
Gain on sale of investment securities, net	137	6	1,315
Gain on sale of loans, net	2,759	7,696	6,994
Interest rate swap fees	564	1,045	1,854
Other income	9,291	8,828	7,102
Total noninterest income	31,665	35,579	31,619
NONINTEREST EXPENSE:			
Compensation and employee benefits	86,830	64,268	61,405
Occupancy and equipment	19,779	15,396	15,763
Data processing	9,888	8,176	7,312
Marketing	3,228	2,943	2,835
Professional services	9,670	4,777	3,606
State and local taxes	3,210	2,461	2,616
Federal deposit insurance premium	1,480	1,435	1,620
Other real estate owned, net	106	(70)	334
Amortization of intangible assets	3,819	1,286	1,415
Other expense	11,385	9,903	9,567
Total noninterest expense	149,395	110,575	106,473
Income before income taxes	64,087	60,147	52,721
Income tax expense	11,030	18,356	13,803
Net income	$53,057	$41,791	$38,918
Basic earnings per common share	$1.49	$1.39	$1.30
Diluted earnings per common share	$1.49	$1.39	$1.30
Dividends declared per common share	$0.72	$0.61	$0.72

See accompanying Notes to Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	Year Ended December 31,		
	2018	2017	2016
Net income	$53,057	$41,791	$38,918
Change in fair value of investment securities available for sale, net of tax of $(1,591), $826 and $(2,316), respectively	(5,956)	1,530	(4,311)
Reclassification adjustment for net gain from sale of investment securities available for sale included in income, net of tax of $(29), $(2) and $(461), respectively	(108)	(4)	(854)
Other comprehensive (loss) income	(6,064)	1,526	(5,165)
Comprehensive income	$46,993	$43,317	$33,753

See accompanying Notes to Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands, except per share amounts)

	Number of common shares	Common stock	Retained earnings	Accumulated other comprehensive income (loss), net	Total stock-holders' equity
Balance at December 31, 2015	29,975	$359,451	$107,960	$ 2,559	$469,970
Restricted stock awards granted, net of forfeitures	110	—	—	—	—
Exercise of stock options (including excess tax benefits from nonqualified stock options)	38	560	—	—	560
Stock-based compensation expense	—	1,840	—	—	1,840
Net excess tax benefits from vesting of restricted stock	—	103	—	—	103
Common stock repurchased	(168)	(2,894)	—	—	(2,894)
Net income	—	—	38,918	—	38,918
Other comprehensive loss, net of tax	—	—	—	(5,165)	(5,165)
Cash dividends declared on common stock ($0.72 per share)	—	—	(21,569)	—	(21,569)
Balance at December 31, 2016	29,955	359,060	125,309	(2,606)	481,763