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# State of the Art



**Brad L. Smith**  
CEO, Heritage Commerce Corp

## A Message from the CEO

Dear Clients, Shareholders and Friends:

As I reflect on 2003, it is important to highlight several key accomplishments that have moved our organization further along the pathway to greater financial performance. Heritage ended 2003 with an asset base of \$1 billion! This milestone confirms the vision of our founders – that a business-based community bank in a defined service area can grow and prosper. We intend to build on that strategy as we transition into 2004 and toward the anniversary of our tenth year of operations in June.

I am pleased to report that our earnings were up 8% over 2002 year-end results, despite 2003's persistent economic challenges. Businesses, professionals and residents in our Valley continued to feel the economic pressure that began some time ago and were forced to look closely at their operations to determine more efficient ways to do business.

In 2003, the Company completed significant changes to its corporate structure, successfully merging three of its wholly owned bank subsidiaries into one. This restructure has allowed us to maximize our efficiency, and the cost savings are making their way directly to the bottom line. We have also made great strides in redefining and developing powerful internal training programs for the delivery of a consistently applied high level of customer service.

Our Regional Boards have expanded with new members in all divisions and now function as a conduit to the communities we serve. The members work directly with our banking staff to enhance outreach efforts and, as a direct result, we are acquiring new clients.

The expansion with a full service office in Los Gatos in December is producing excellent results. To date, Los Gatos has garnered a significant and growing base of deposits and loans from local businesses and professionals and we anticipate its continued contribution to the growth of the bank. Heritage's other divisions, East Bay, South Valley and Los Altos, report similar growth potential that will support 2004 objectives.

Heritage met or exceeded its 2003 financial performance objectives, keeping us on track with our strategic vision. You will find our year-end financial summary later in this issue. The positive results confirm our commitment to progress in spite of the impact of a weakened economy.

At Heritage, our customers and shareholders remain our most valued asset and I thank you for allowing us the opportunity to serve you.

Sincerely,

A handwritten signature in blue ink that reads "Brad L. Smith". The signature is fluid and cursive, matching the printed name below it.

Brad L. Smith  
Chief Executive Officer

# Will the Real Recovery Come in 2004?

Economists' forecasts may vary, but many are feeling optimistic. Several signs point to a strengthening U.S. economy in the latter part of 2003 and into 2004.



*If all economists were laid end-to-end, they would not reach a conclusion.*

— George Bernard Shaw

For example, the economy as measured by gross domestic product grew at an annual rate of 8.2% in third quarter 2003, compared with just 3.3% in second quarter.\* Also encouraging, corporate profits increased \$80.6 billion in second quarter 2003, nearly four times the first quarter rate.\*\*

Economists surveyed by *The Wall Street Journal*, citing the effect of tax cuts among other influences, expect the U.S. economy to grow at an annualized rate of more than 3.5% during the second half of 2003 and into 2004.\*\*\*

## Other Positive Factors

The U.S. Leading Economic Indicators index, which tends to signal turning points in the economy, increased 0.4% in August, up more than 2.5% from its low in March.† New single-family home sales hit the second-highest pace on record in August 2003.††

Inflation is tame, increasing at an annualized rate of 1.9% as of December 2003,††† and short-term interest rates remain low. The federal funds rate, set by the Federal Reserve Board, stood at just 1% as of January 2004. Short-term rates influence the prime rate, which is the rate that banks charge their best customers for loans. Low business and consumer loan costs tend to encourage spending.

After three calendar years of negative returns, the stock market is making a comeback. As of the end of December, the Dow Jones Industrial Average and the Standard & Poor's 500 Index were both up more than 28% from the beginning of 2003.

## Reality Check

Unemployment continues to cast its shadow. As of December, it stood at 5.7%.††† Economists are not forecasting any near-term improvement.

Thirty-year fixed mortgage loan rates, which are mainly influenced by bond yields, hit more than 6% in October. Higher mortgage rates could dampen the housing market.

The Congressional Budget Office is projecting a federal budget deficit of \$480 billion in 2004. The government's need to borrow more could have an inflationary effect on the economy.

Finally, global economic and political conditions could have a negative impact.

## Improve Your Economic Outlook

Although no one can accurately predict the direction of the economy, there are several factors pointing toward a real recovery in 2004.

Be poised to make the most of an economic rebound or weather a downturn by developing a spending and savings plan, reducing debt, reviewing your short- and long-term financial objectives and staying abreast of tax law changes. At Heritage Bank of Commerce, we have the products and services you need to help you reach your goals.

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## The CBO's 2004 Economic Forecast

Gross domestic product	3.8%
Consumer price index (inflation)	2.2%
Unemployment	6.2%

Source: Projections for 2004 from "The Budget and Economic Outlook: An Update," Congressional Budget Office, August 2003.

\* Source: Bureau of Economic Analysis, press release, Jan. 30, 2004.

\*\* Source: Bureau of Economic Analysis, press release, Sept. 26, 2003.

\*\*\* Source: *The Wall Street Journal*, Aug. 12, 2003.

† Source: The Conference Board, press release, Sept. 18, 2003.

†† Source: National Association of Home Builders, [www.nahb.org](http://www.nahb.org).

††† Source: Bureau of Labor Statistics, [www.bls.gov](http://www.bls.gov).

# Finding the Right Pricing Strategy

When you're setting prices for your company's products or services, remember Goldilocks. Your goal is something that's not too low, not too high, but just right.

To arrive at "just right," your pricing strategy must deal with three components that can be bears to get a handle on:

- your costs to produce, market and distribute products and services;
- the price customers are willing to pay; and
- the profit you hope to produce.

## Taming the Bears

Careful tracking can help you estimate the cost of getting your product or service to market. But also keep in mind that those costs can change over time. Taking time to think through cost projections carefully can help you understand the costs you'll have to pay in the future.

Guessing what consumers are willing to pay may be the trickiest element of pricing. Consumers set both low-end and upper prices in their minds for specific products and services. You should also be aware of where price points lie in your industry. Price points are levels at which customers balk at prices. Many retailers find that price points tend to occur at \$5 intervals. So consumers might not blink if you raise the price from \$21.95 to \$22.95, but might hesitate when the same increase is applied to a \$19.95 item, making it \$20.95.

The amount of profit you hope to make may vary by product. For instance, loss leaders are intentionally priced low to lure customers to your business, with the hope that once there, they'll buy other, more profitable items as well. Or you may decide to use captive pricing, also known as "razors and blades." With this strategy, you give away or sell at low cost the basic item (the razor) and make your profit on the accessories, replacement parts and service (the blades) your customers will need.

## More Considerations

In addition to those factors, you must also consider that your pricing structure and policies are a major component of your company's image. If prices are too low, consumers will be concerned about quality, no matter how good your products and services are. For unknown products, customers often equate quality with price.



A thorough understanding of your customers' needs and wants also factors into pricing. Do they value the flexibility of being able to buy individual products or is the convenience of buying bundled products more important to them?

Once you've set prices, do you get to settle in for a nice nap, as Goldilocks did? Unfortunately, no. Pricing is a process that's constantly in flux. Your costs, customers' perceptions, competitors' pricing and market conditions all change continually, requiring you to constantly re-evaluate your decisions.

## Our Service Is No Fairytale

Our business bankers can help you keep tabs on your company's finances with a comprehensive array of banking products and services. You'll find that we do everything possible to make sure your accounts are "just right" for you.

Give Yourself a Gift

# Unwrap the Rewards of Home Equity Line of Credit

There's no better time than now to tap your home's equity. Many Americans have already discovered the advantages of home equity borrowing. In fact, home equity lines of credit (HELOCs) grew in popularity by 31% during 2002, according to a Consumer Bankers Association survey.

### Consider the Benefits

Choosing a home equity line of credit makes sense for many Americans. Not only are the low interest rates still available, you can also enjoy potentially tax-deductible interest and lower monthly bills.\*

### HELOC Spells Versatility

A HELOC works like a credit card, in that you have access to a revolving

credit line, but you only pay interest on the amount you use. Interest rates typically mirror the prime rate.

College tuition is a great way to use a HELOC. From tuition payments to text books and dorm room supplies, bills come in at various times but can be easily paid using your line of credit. You could also update your living space to make it better fit your family's needs. Or, add some of the luxury features available in new houses without having to buy a new house.

### Get Your Finances Under One Roof

Got debt? The International Mass Retail Association says the average consumer goes over his or her budget by 15% to 30% during the holiday season. If you've found

yourself buried in endless holiday bills, a home equity line of credit can help you consolidate debt. You can enjoy:

- Lower overall finance charges
- Lower monthly payments
- The convenience of making just one payment, rather than several
- Potentially tax-deductible interest

### Look to Us

We can help make your dreams into a reality. Give yourself a gift this winter by taking out a home equity line of credit. Stop by one of our offices or call today for more information.

\* See your tax advisor for details.

## HERITAGE COMMERCE CORP & SUBSIDIARIES

### Financial Highlights (Unaudited)

(Dollars in thousands, except per share amounts)

Statement of Income Data	At and For the Three Months Ended			Percent Change From		At and For the Year Ended		
	Dec. 31, 2003	Sept. 30, 2003	Dec. 31, 2002	Sept. 30, 2003	Dec. 31, 2002	Dec. 31, 2003	Dec. 31, 2002	Percent Change
Net Interest Income	\$ 9,910	\$ 9,187	\$ 10,048	8%	(1)%	\$ 38,093	\$ 37,519	2%
Provision for Loan Losses	\$ 400	\$ 600	\$ 597	(33)%	(33)%	\$ 2,900	\$ 2,663	9%
Noninterest Income	\$ 2,486	\$ 2,463	\$ 2,793	1%	(11)%	\$ 10,429	\$ 9,030	15%
Noninterest Expense	\$ 9,044	\$ 8,310	\$ 8,846	9%	2%	\$ 34,340	\$ 33,209	3%
Net Income	\$ 2,042	\$ 1,940	\$ 2,291	5%	(11)%	\$ 7,782	\$ 7,177	8%
<b>Per Share Data</b>								
Earnings Per Share – Diluted	\$ 0.17	\$ 0.17	\$ 0.20	0%	(15)%	\$ 0.67	\$ 0.63	6%
Book Value Per Common Share	\$ 7.89	\$ 7.72	\$ 7.33	2%	8%	\$ 7.89	\$ 7.33	8%
<b>Balance Sheet Data</b>								
Total Assets	\$1,003,201	\$984,720	\$958,752	2%	5%	\$1,003,201	\$958,752	5%
Loans Held-For-Sale	\$ 30,638	\$ 30,675	\$ 28,084	0%	9%	\$ 30,638	\$ 28,084	9%
Loans	\$ 666,088	\$642,180	\$673,907	4%	(1)%	\$ 666,088	\$673,907	(1)%
Total Deposits	\$ 835,410	\$835,947	\$841,936	0%	(1)%	\$ 835,410	\$841,936	(1)%
<b>Selected Financial Ratios</b>								
Net Interest Margin	4.34%	4.01%	4.55%	8%	(5)%	4.34%	4.39%	(1)%
Return on Average Assets	0.82%	0.78%	0.95%	5%	(14)%	0.81%	0.77%	5%
Return on Average Equity	9.18%	8.80%	11.07%	4%	(17)%	9.01%	9.14%	(1)%

The information contained in this publication should not be acted upon without professional advice. While this newsletter is intended to be helpful, it should not be considered advisory without consulting a professional about your specific situation. Please convey any comments or inquiries to your financial professional or to the editor of this publication.

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