

HERITAGE FINANCIAL CORP /WA/
Form 10-Q
November 03, 2006
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number 0-29480

HERITAGE FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of incorporation or organization)

91-1857900
(I.R.S. Employer Identification No.)

201 Fifth Avenue SW, Olympia, WA
(Address of principal executive office)

98501
(ZIP Code)

(360) 943-1500

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date:

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As of October 12, 2006 there were 6,568,180 common shares outstanding, with no par value, of the registrant.

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HERITAGE FINANCIAL CORPORATION

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Table of Contents**ITEM 1. HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(Dollars in thousands, except for per share data)

(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2006 | September 30, 2005 | September 30, 2006 | September 30, 2005 |
| INTEREST INCOME: | | | | |
| Interest and fees on loans | \$ 14,179 | \$ 11,123 | \$ 39,015 | \$ 31,970 |
| Taxable interest on investment securities | 445 | 408 | 1,285 | 1,166 |
| Nontaxable interest on investment securities | 42 | 39 | 122 | 111 |
| Interest on federal funds sold and interest bearing deposits | 16 | 11 | 42 | 47 |
| Dividends on Federal Home Loan Bank stock | | | | 15 |
| Total interest income | 14,682 | 11,581 | 40,464 | 33,309 |
| INTEREST EXPENSE: | | | | |
| Deposits | 4,962 | 2,795 | 12,750 | 7,304 |
| Other borrowings | 329 | 231 | 1,054 | 744 |
| Total interest expense | 5,291 | 3,026 | 13,804 | 8,048 |
| Net interest income | 9,391 | 8,555 | 26,660 | 25,261 |
| Provision for loan losses | 240 | 210 | 480 | 585 |
| Net interest income after provision for loan losses | 9,151 | 8,345 | 26,180 | 24,676 |
| NONINTEREST INCOME: | | | | |
| Gains on sales of loans, net | 34 | 85 | 124 | 231 |
| Brokered mortgage income | 216 | 43 | 442 | 104 |
| Service charges on deposits | 857 | 745 | 2,421 | 2,053 |
| Rental income | 85 | 79 | 241 | 232 |
| Merchant visa income | 705 | 587 | 1,891 | 1,630 |
| Other income | 269 | 180 | 735 | 575 |
| Total noninterest income | 2,166 | 1,719 | 5,854 | 4,825 |
| NONINTEREST EXPENSE: | | | | |
| Salaries and employee benefits | 3,646 | 3,150 | 10,765 | 9,364 |
| Occupancy and equipment | 1,039 | 960 | 3,018 | 2,913 |
| Data processing | 376 | 302 | 1,020 | 918 |
| Marketing | 210 | 145 | 460 | 369 |
| Office supplies and printing | 128 | 100 | 331 | 308 |
| Merchant visa | 555 | 468 | 1,481 | 1,274 |
| Professional services | 144 | 147 | 466 | 509 |
| State and local taxes | 229 | 174 | 620 | 516 |
| Other expense | 653 | 620 | 1,920 | 1,821 |
| Total noninterest expense | 6,980 | 6,066 | 20,081 | 17,992 |
| Income before federal income taxes | 4,337 | 3,998 | 11,953 | 11,509 |

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| | | | | |
|-------------------------------|----------|----------|----------|----------|
| Federal income taxes | 1,447 | 1,275 | 3,964 | 3,725 |
| Net income | \$ 2,890 | \$ 2,723 | \$ 7,989 | \$ 7,784 |
| Earnings per share: | | | | |
| Basic | \$ 0.45 | \$ 0.44 | \$ 1.26 | \$ 1.26 |
| Diluted | \$ 0.43 | \$ 0.43 | \$ 1.22 | \$ 1.23 |
| Dividends declared per share: | \$ 0.205 | \$ 0.185 | \$ 0.600 | \$ 0.523 |

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

(Dollars in thousands)

(Unaudited)

| | September 30, 2006 | December 31, 2005 |
|--|-----------------------|----------------------|
| Assets | | |
| Cash on hand and in banks | \$ 23,298 | \$ 24,972 |
| Interest earning deposits | 1,517 | 3,030 |
| Investment securities available for sale | 40,898 | 41,856 |
| Investment securities held to maturity | 4,155 | 3,966 |
| Loans held for sale | | 263 |
| Loans receivable | 733,224 | 652,034 |
| Less: Allowance for loan losses | (9,900) | (8,496) |
| Loans receivable, net | 723,324 | 643,538 |
| Other real estate owned | 225 | 371 |
| Premises and equipment, at cost, net | 15,097 | 15,801 |
| Federal Home Loan Bank and Federal Reserve stock, at cost | 3,227 | 3,072 |
| Accrued interest receivable | 4,189 | 3,566 |
| Prepaid expenses and other assets | 4,092 | 2,811 |
| Deferred federal income taxes, net | 1,806 | 1,266 |
| Intangible assets, net | 600 | |
| Goodwill | 13,015 | 6,640 |
| Total assets | \$ 835,443 | \$ 751,152 |
| Liabilities and Stockholders Equity | | |
| Deposits | \$ 728,344 | \$ 636,504 |
| Advances from Federal Home Loan Bank | 19,436 | 39,900 |
| Other borrowings | 3,700 | |
| Accrued expenses and other liabilities | 6,560 | 8,628 |
| Total liabilities | 758,040 | 685,032 |
| Stockholders' equity: | | |
| Common stock, no par value per share, 15,000,000 shares authorized; 6,565,641 and 6,255,921 shares outstanding at September 30, 2006 and December 31, 2005, respectively | 24,097 | 17,606 |
| Unearned compensation - ESOP and other | (557) | (1,151) |
| Retained earnings, substantially restricted | 54,453 | 50,347 |
| Accumulated other comprehensive loss, net | (590) | (682) |
| Total stockholders' equity | 77,403 | 66,120 |
| Commitments and contingencies | | |
| Total liabilities and stockholders' equity | \$ 835,443 | \$ 751,152 |

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY FOR THE NINE MONTHS ENDED
SEPTEMBER 30, 2006 AND COMPREHENSIVE INCOME FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30,
2006 AND 2005**

(In Thousands)

(Unaudited)

| | Number of common shares | Common stock | Unearned Compensation- ESOP and Restricted Stock Awards | Retained earnings | Accumulated other comprehensive income (loss), net | Total stockholders equity |
|---|----------------------------------|-----------------|---|----------------------|---|---------------------------------|
| Balance at December 31, 2005 | 6,253 | \$ 17,606 | \$ (1,151) | \$ 50,347 | \$ (682) | \$ 66,120 |
| Elimination of unearned compensation restricted stock awards | | (527) | 527 | | | |
| Restricted stock awards granted | 16 | | | | | |
| Restricted stock awards cancelled | (1) | | | | | |
| Stock option compensation expense | | 261 | | | | 261 |
| Earned ESOP shares and restricted stock shares | 7 | 302 | 67 | | | 369 |
| Stock repurchase | (2) | (40) | | | | (40) |
| Exercise of stock options (including tax benefits from nonqualified stock options) | 62 | 833 | | | | 833 |
| Acquisition of Western Washington Bancorp | 231 | 5,662 | | | | 5,662 |
| Net income | | | | 7,989 | | 7,989 |
| Change in fair value of securities available for sale, net of tax | | | | | 92 | 92 |
| Cash dividends declared | | | | (3,883) | | (3,883) |
| Balance at September 30, 2006 | 6,566 | \$ 24,097 | \$ (557) | \$ 54,453 | \$ (590) | \$ 77,403 |

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Comprehensive Income | | | | |
| Net income | \$ 2,890 | \$ 2,723 | \$ 7,989 | \$ 7,784 |
| Change in fair value of securities available for sale, net of tax of \$165, \$(75), \$49, \$(134) | 306 | (140) | 92 | (253) |
| Comprehensive income | \$ 3,196 | \$ 2,583 | \$ 8,081 | \$ 7,531 |

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**HERITAGE FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****For the nine months ended September 30, 2006 and 2005**

(Dollars in thousands)

(Unaudited)

| | 2006 | 2005 |
|--|-----------------|-----------------|
| Cash flows from operating activities: | | |
| Net income | \$ 7,989 | \$ 7,784 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Depreciation and amortization | 1,236 | 1,332 |
| Deferred loan fees, net of amortization | 320 | 177 |
| Provision for loan losses | 480 | 585 |
| Federal Home Loan Bank stock dividends | | (34) |
| Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities | (3,703) | (3,914) |
| Recognition of compensation related to ESOP shares and restricted stock awards | 369 | 298 |
| Stock option compensation expense | 261 | |
| Tax benefit realized from stock options exercised | (22) | |
| Amortization of intangible assets | 26 | |
| Gain on sale of other real estate owned | (14) | (7) |
| Gain on sale of premises and equipment | (70) | (4) |
| Deferred income taxes | (291) | |
| Net (increase) decrease in loans held for sale | 263 | (94) |
| Net cash provided by operating activities | 6,844 | 6,123 |
| Cash flows from investing activities: | | |
| Loans originated, net of principal payments and loan sales | (39,892) | (35,552) |
| Purchase of Western Washington Bancorp, net of cash acquired | (2,036) | |
| Proceeds from maturities/calls of investment securities available for sale | 4,500 | 5,191 |
| Proceeds from maturities/calls of investment securities held to maturity | 206 | 108 |
| Proceeds from sales of investment securities available for sale | 2,248 | |
| Proceeds from redemption of Federal Reserve Bank stock | 141 | |
| Purchase of investment securities available for sale | (737) | (2,921) |
| Purchase of investment securities held to maturity | (415) | (2,170) |
| Purchase of premises and equipment | (502) | (562) |
| Proceeds from sale of other real estate owned | 430 | 183 |
| Proceeds from sale of premises and equipment | 131 | 9 |
| Net cash used in investing activities | (35,926) | (35,714) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 47,558 | 52,941 |
| Net decrease in borrowed funds | (22,417) | (21,375) |
| Proceeds from issuance of long-term debt | 3,700 | |
| Cash dividends paid | (3,739) | (3,143) |
| Proceeds from exercise of stock options | 811 | 583 |
| Tax benefit realized from stock options exercised | 22 | |
| Stock repurchased | (40) | (1,604) |

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| | | |
|--|-----------|-----------|
| Net cash provided by financing activities | 25,895 | 27,402 |
| Net decrease in cash and cash equivalents | (3,187) | (2,189) |
| Cash and cash equivalents at beginning of period | 28,002 | 25,339 |
| Cash and cash equivalents at end of period | \$ 24,815 | \$ 23,150 |
| Supplemental disclosures of cash flow information: | | |
| Cash payments for: | | |
| Interest | \$ 13,928 | \$ 8,092 |
| Federal income taxes | 4,728 | 3,852 |
| Supplemental disclosures of cash flow information: | | |
| Elimination of unearned compensation restricted stock awards | 527 | |
| Loans transferred to/from other real estate owned | 45 | 176 |
| Tax benefit from nonqualified stock options | | 56 |
| Stock dividend to be distributed | | 6,338 |
| See Notes to Condensed Consolidated Financial Statements. | | |

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HERITAGE FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Three and Nine Months Ended September 30, 2006 and 2005

(Unaudited)

NOTE 1. Description of Business and Basis of Presentation

(a.) Description of Business

Heritage Financial Corporation (Company) is a bank holding company that was incorporated in the State of Washington in August 1997. We were organized for the purpose of acquiring all of the capital stock of Heritage Savings Bank upon our reorganization from a mutual holding company form of organization to a stock holding company form of organization. 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. Effective September 1, 2005, Central Valley Bank changed its charter from a Nationally Chartered Commercial Bank to a State Chartered Commercial Bank.

We are primarily engaged in the business of planning, directing, and coordinating the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. Heritage Bank is a Washington state-chartered commercial bank whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) under the Deposit Insurance Fund (DIF). Heritage Bank conducts business from its main office in Olympia, Washington and its thirteen branch offices located in Thurston, Pierce, Mason and south King Counties of Washington State. Central Valley Bank is also a Washington state-chartered commercial bank whose deposits are insured by the FDIC under the DIF. Central Valley Bank conducts business from its main office in Toppenish, Washington and its five branch offices located in Yakima and Kittitas Counties of Washington State.

Our business consists primarily of lending and deposit relationships with small businesses including agribusiness and their owners in our market area, attracting deposits from the general public and originating for sale or investment purposes first mortgage loans on residential properties located in western and central Washington. We also make residential construction loans, income property loans, and consumer loans.

(b.) Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. These condensed consolidated financial statements should be read with our December 31, 2005 audited consolidated financial statements and its accompanying notes included in our Annual Report on Form 10-K. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three months and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ended December 31, 2006. In preparing the consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates.

Certain amounts in the consolidated financial statements for the prior year have been reclassified to conform to the current consolidated financial statement presentation.

All prior year share and per share amounts have been restated to reflect the 5% stock dividend declared by the Board of Directors on September 15, 2005, payable to shareholders of record on September 30, 2005 and distributed on October 14, 2005.

(c.) Recently Issued Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainties in Income Taxes, an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company is assessing the impact of adopting the new pronouncement, which will become effective January 1, 2007, but it is not expected to have a material impact.

Table of Contents**NOTE 2. Stockholders Equity***(a.) Earnings per Share*

The following table illustrates the reconciliation of weighted average shares used for earnings per share for the noted periods.

| | Three months ended | | Nine months ended | |
|--|--------------------|--------------------|--------------------|--------------------|
| | September 30, 2006 | September 30, 2005 | September 30, 2006 | September 30, 2005 |
| Basic: | | | | |
| Weighted average shares outstanding | 6,562,869 | 6,247,550 | 6,409,764 | 6,255,615 |
| Less: Weighted average unvested restricted stock awards | (79,475) | (62,475) | (73,369) | (63,625) |
| Basic weighted average shares outstanding | 6,483,394 | 6,185,075 | 6,336,395 | 6,191,990 |
| Diluted: | | | | |
| Basic weighted average shares outstanding | 6,483,394 | 6,185,075 | 6,336,395 | 6,191,990 |
| Incremental shares from unexercised stock options and unvested restricted stock awards | 220,336 | 159,251 | 221,665 | 160,389 |
| Weighted average shares outstanding | 6,703,730 | 6,344,326 | 6,558,060 | 6,352,379 |

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three months and nine months ended September 30, 2006, anti-dilutive shares outstanding related to options to acquire common stock totaled 102,743 and 63,291, respectively. For the three months and nine months ended September 30, 2005, there were no anti-dilutive shares outstanding related to options to acquire common stock.

(b.) Cash Dividend Declared

On September 21, 2006, we announced a quarterly cash dividend of 20.5 cents per share payable on October 31, 2006 to stockholders of record on October 16, 2006.

NOTE 3. Share Based Payment

The Company maintains a number of stock-based incentive programs, which are discussed in more detail in Note 4. Prior to 2006, the Company applied the intrinsic value-based method, as outlined in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB No. 25) and related interpretations, in accounting for stock options granted under these programs. Under the intrinsic value-based method, no compensation expense was recognized if the exercise price of the Company's employee stock options equaled the market price of the underlying stock on the date of the grant. Accordingly, prior to 2006, no compensation cost was recognized in the accompanying consolidated statements of income on stock options granted to employees, since all options granted under the Company's share incentive programs had an exercise price equal to the market value of the underlying common stock on the date of the grant.

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R (SFAS No. 123R) Share-based Payment. This statement replaces SFAS No. 123, Accounting for Stock-Based Compensation, and supersedes APB No. 25. SFAS No. 123R requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award on the grant date. This statement was adopted using the modified prospective method of application, which requires the Company to recognize compensation expense on a prospective basis. Therefore, prior period financial statements have not been restated. Under this method, in addition to reflecting compensation expense for new share-based awards, expense is also recognized to reflect the remaining service period of awards that had been included in pro forma disclosures in prior periods.

Total stock-based compensation expense (excluding ESOP expense) for the nine months ended September 30, 2006 was \$447,000 (\$369,000 after tax), or \$0.06 for basic and diluted earnings per share. Included in this expense is \$261,000 (\$248,000 after tax), or \$0.04 for basic and diluted earnings per share attributable to the Company's adoption of SFAS 123R. As of September 30, 2006, the total unrecognized

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compensation expense related to non-vested stock awards was \$759,000 and the related weighted average period over which it is expected to be recognized is approximately 2.1 years.

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The following table illustrates the effect on net income and earnings per share as if SFAS 123R had been applied to all outstanding awards for the three and nine months ended September 30, 2005 (dollars in thousands, except per share amounts):

| | Pro forma | Pro forma |
|--|----------------------------|----------------------------|
| | Three months | Nine months |
| | Ended September 30, | Ended September 30, |
| | 2005 | 2005 |
| Net Income: | | |
| As Reported | \$ 2,723 | \$ 7,784 |
| Add: Total stock-based compensation expense included in reported net income, net of tax effect | 33 | 102 |
| Deduct: Total stock-based compensation expense, determined under fair value method for all awards, net of tax effect | (78) | (293) |
| Pro Forma | \$ 2,678 | \$ 7,593 |
| Basic earnings per share: | | |
| As Reported | \$ 0.44 | \$ 1.26 |
| Pro Forma | 0.44 | 1.23 |
| Diluted earnings per share: | | |
| As Reported | \$ 0.43 | \$ 1.23 |
| Pro Forma | 0.43 | 1.20 |

The fair value of options granted during the nine months ended September 30, 2006 and 2005 is estimated on the date of grant using the Black-Scholes option pricing model based on the assumptions noted in the following table. The expected term of share options is derived from historical data and represents the period of time that share options granted are expected to be outstanding. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on historical volatility of Company shares. Expected dividend yield is based on dividends expected to be paid during the expected term of the share options.

| | Weighted | | | | |
|---------------------------|----------------------|-----------------|-------------------|-----------------|---------------------|
| | Average | Expected | Expected | Expected | Weighted |
| | Risk Free | Term in | Expected | Dividend | Average Fair |
| Grant period ended | Interest Rate | years | Volatility | Yield | Value |
| September 30, 2006 | 4.93% | 4.50 | 20% | 3.69% | \$ 4.17 |
| September 30, 2005 | 3.91% | 6.00 | 20% | 4.32% | \$ 2.85 |

NOTE 4. Stock Option and Award Plans

In September 1994, Heritage Bank's stockholders approved the adoption of the 1994 stock option plan, providing for the award of a restricted stock award to a key officer, incentive stock options to employees and nonqualified stock options to directors of the Bank at the discretion of the Board of Directors. On September 24, 1996, Heritage Bank's stockholders approved the adoption of the 1997 stock option plan, which is generally similar to the 1994 plan. On October 15, 1998, the Company's stockholders approved the adoption of the 1998 stock option plan, which is similar to the 1994 and 1997 plans. The 1998 plan does not affect any options granted under the 1994 or 1997 plans. On April 25, 2002, the Company's stockholders approved the adoption of the 2002 Incentive Stock Option Plan, the 2002 Director Nonqualified Stock Option Plan and the 2002 Restricted Stock Plan, which are generally similar to the 1994, 1997 and 1998 stock plans. On April 27, 2006, the Company's stockholders approved the adoption of the 2006 Incentive Stock Option Plan, the 2006 Director Nonqualified Stock Option Plan and the 2006 Restricted Stock Plan, which are generally similar to the 1994, 1997, 1998 and 2002 stock plans.

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Under these stock option plans, on the date of grant, the exercise price of the option must at least equal the market value per share of the Company's common stock. The 1994 plan provides for the grant of options and stock awards up to 362,246 shares. The 1997 plan provides for the granting of options and stock awards up to 270,333 common shares. The 1998 plan provides for the grant of stock options for up to 414,750 shares and stock awards for up to 69,431 shares. The 2002 and 2006 Incentive Stock Option plans provide for the grant of stock options for up to 451,500 and 400,000 shares, respectively. The 2002 and 2006 Director Nonqualified Stock Option Plans provide for the grant of stock options for up to 73,500 and 75,000 shares, respectively. The 2002 and 2006 Restricted Stock Plans provide for the grant of stock awards for up to 52,500 and 25,000 shares, respectively.

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Stock options generally vest ratably over three years and expire five years after they become exercisable which amounts to an average term of seven years. Restricted Stock awards issued have a five-year cliff vesting. The Company issues new shares to satisfy share option exercises.

The following table summarizes stock option and award activity for the nine months ended September 30, 2006.

| | Outstanding Awards | | | |
|---------------------------------------|-----------------------------|----------|-----------------------------|----------|
| | Outstanding Options Avg. | | of Restricted Stock Avg. | |
| | Shares | Price | Shares | Price |
| Balance at December 31, 2005 | 610,348 | \$ 16.88 | 64,475 | \$ 16.15 |
| Options and awards granted | 106,500 | 26.04 | 16,000 | 26.05 |
| Less: Options exercised/Awards vested | (61,421) | 13.21 | | |
| Expired or canceled | (3,975) | 24.81 | (1,000) | 27.73 |
| Balance at September 30, 2006 | 651,452 | \$ 18.67 | 79,475 | \$ 18.00 |

Financial data pertaining to outstanding stock options and exercisable stock options at September 30, 2006 follows:

| Exercise Price | Number of Outstanding Option Shares | Weighted Average Remaining Contractual Life (in years) | Weighted Average Exercise Price | Number of Exercisable Option Shares | Weighted Average Exercise Price |
|-----------------|--|---|--|--|--|
| | | | | | |
| \$7.35 \$10.60 | 80,882 | 1.3 | \$ 8.92 | 80,882 | \$ 8.92 |
| \$11.67 | 86,180 | 2.4 | 11.67 | 86,180 | 11.67 |
| \$15.19 \$18.14 | 9,819 | 3.4 | 18.03 | 9,819 | 18.03 |
| \$20.11 | 107,104 | 4.5 | 20.11 | 69,631 | 20.11 |
| \$20.36 | 121,335 | 3.5 | 20.36 | 121,335 | 20.36 |
| \$20.50 | 127,092 | 5.4 | 20.50 | 41,160 | 20.50 |
| \$20.71 \$24.05 | 14,940 | 5.8 | 21.85 | 3,780 | 21.15 |
| \$25.94 \$27.32 | 104,100 | 6.6 | 26.00 | | |
| | 651,452 | 4.2 | \$ 18.67 | 412,787 | \$ 16.23 |

At September 30, 2006, the aggregate intrinsic value of stock options outstanding and stock options exercisable was \$5.1 million and \$4.2 million, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005, was \$811,000 and \$582,000, respectively. The weighted average remaining contractual life of exercisable option shares as of September 30, 2006 was 4.1 years. The total fair value of shares vested during the nine months ended September 30, 2006 and 2005 was \$400,000 and \$339,000, respectively.

NOTE 5. Business Combination

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On June 1, 2006 the Company acquired Western Washington Bancorp, Inc. (WWB) and its wholly-owned subsidiary, Washington State Bank, N.A., in an acquisition accounted for under the purchase method of accounting. The results of WWB have been included in the consolidated financial statements since the date of acquisition. This merger was consistent with the Company's growth strategy and provides the opportunity to expand into the south King County market in Washington State.

The aggregate purchase price was \$10.1 million and included cash of \$3.8 million, 231,225 shares of common stock valued at \$5.7 million and \$0.7 million in direct merger costs. The value of the 231,235 shares issued was determined based on the \$24.49 average closing market price of the Company's common stock for the two trading days before and after the measurement date of January 24, 2006 when the number of shares to be issued was determined. Total transaction expenses of \$1.2 million included \$710,000 of direct expenses noted above and \$464,000 of merger expenses that were paid by WWB prior to the close of the transaction.

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The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition.

(Dollars in thousands)

| | |
|---|------------------|
| Assets acquired: | |
| Cash and cash equivalents | \$ 2,455 |
| Securities | 4,887 |
| Loans, net of allowance for loan losses | 40,739 |
| Goodwill | 6,375 |
| Core deposit intangible | 626 |
| Premises and equipment, net | 95 |
| Other assets | 1,374 |
| Total assets | \$ 56,551 |
| Liabilities assumed: | |
| Deposits | 44,282 |
| FHLB advances and other borrowings | 1,953 |
| Other liabilities | 179 |
| Total liabilities | \$ 46,414 |
| Net assets acquired | \$ 10,137 |

The core deposit intangible of \$626,000 is being amortized on a straight-line basis over 8 years. Goodwill of \$6.4 million is not amortized but will be reviewed for potential impairment on an annual basis, or more often if events or circumstances indicate a potential impairment.

Additional adjustments to the purchase price allocation may occur as certain items are based on estimates at the time of acquisition, including income taxes, direct costs and compensation adjustments.

The following table presents unaudited pro forma results of operations for the nine months ended September 30, 2006 and 2005 assuming the acquisition occurred on January 1, 2005. The Company expects to realize cost savings as a result of the WWB merger that are not reflected in the pro forma consolidated condensed statements of income. No assurance can be given with respect to the ultimate level of such cost savings. The pro forma results do not necessarily indicate the results that would have been obtained had the acquisition actually occurred on January 1, 2005.

For the nine months ended September 30, 2006

| | | | Pro Forma | Pro Forma |
|--|-----------------|-----------------|--------------------|------------------|
| (\$ in thousands, except per share amounts) | HFWA | WWB | Adjustments | Combined |
| Net interest income | \$ 26,660 | \$ 1,131 | \$ 34(a) | \$ 27,825 |
| Provision for loan losses | 480 | 176 | | 656 |
| Noninterest income | 5,854 | 136 | | 5,990 |
| Noninterest expense | 20,081 | 1,648 | (431)(b) | 21,298 |
| Income before provision for income taxes | 11,953 | (557) | 465 | 11,861 |
| Provision for income taxes | 3,964 | (119) | 87(c) | 3,932 |
| Net Income | \$ 7,989 | \$ (438) | \$ 378 | \$ 7,929 |
| Basic earnings per share | \$ 1.26 | | | \$ 1.23 |

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| | | |
|---|-----------|-----------|
| Diluted earnings per share | \$ 1.22 | \$ 1.19 |
| Basic weighted average shares outstanding | 6,336,395 | 6,464,859 |
| Diluted weighted average shares outstanding | 6,558,060 | 6,686,524 |

- (a) Amount represents amortization of purchase adjustments.
- (b) Amount represents merger related costs of \$464 less amortization of intangibles of \$33.
- (c) Income tax effect of proforma adjustments.

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For the nine months ended September 30, 2005

| | | | Pro Forma | Pro Forma |
|---|-----------|----------|-------------|-----------|
| (\$ in thousands, except per share amounts) | HFWA | WWB | Adjustments | Combined |
| Net interest income | \$ 25,261 | \$ 2,084 | \$ 34(a) | \$ 27,379 |
| Provision for loan losses | 585 | (28) | | 557 |
| Noninterest income | 4,825 | 186 | | 5,011 |
| Noninterest expense | 17,992 | 1,703 | 58(b) | 19,753 |
| Income before provision for income taxes | 11,509 | 595 | (24) | 12,080 |
| Provision for income taxes | 3,725 | 204 | (8)(c) | 3,921 |
| Net Income | \$ 7,784 | \$ 391 | \$ (16) | \$ 8,159 |
| Basic earnings per share | \$ 1.26 | | | \$ 1.27 |
| Diluted earnings per share | \$ 1.23 | | | \$ 1.24 |
| Basic weighted average shares outstanding | 6,191,990 | | | 6,423,225 |
| Diluted weighted average shares outstanding | 6,352,379 | | | 6,583,614 |

(a) Amount represents amortization of purchase adjustments.

(b) Amount represents amortization of intangibles.

(c) Income tax effect of proforma adjustments.

Table of Contents**ITEM 2. 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 the Company. The information contained in this section should be read with the unaudited condensed consolidated financial statements and its accompanying notes, and the December 31, 2005 audited consolidated financial statements and its accompanying notes included in our recent Annual Report on Form 10-K.

Statements concerning future performance, developments or events, expectations for growth and market forecasts, and any other guidance on future periods, constitute forward-looking statements and are subject to a number of risks and uncertainties, which might cause actual results to differ materially from stated expectations. Specific factors include, but are not limited to, the effect of interest rate changes, risks associated with acquisition of other banks and opening new branches, the ability to control costs and expenses, and general economic conditions. Additional information on these and other factors, which could affect our financial results, are included in our filings with the Securities and Exchange Commission.

Overview

Heritage Financial Corporation is a bank holding company, which primarily engages in the business of planning, directing and coordinating the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. We provide financial services to our local communities with an ongoing strategic focus in expanding our commercial lending relationships, market expansion and a continual focus on asset quality. Effective January 8, 1998, our common stock began to trade on the NASDAQ National Market under the symbol HFWA.

The following tables provide relevant net interest income information for selected time periods. The average loan balances presented in the tables are net of allowances for loan losses. Nonaccrual loans have been included in the tables as loans carrying a zero yield.

| | Average Balance | For the Three Months Ended September 30, | | Average Balance | Average Rate | |
|---|--------------------|--|---|--------------------|------------------|-------------------------------------|
| | | 2006 Interest Earned/ Paid | Average Rate (Dollars in thousands) | | | 2005 Interest Earned/ Paid |
| Interest Earning Assets: | | | | | | |
| Loans | \$ 715,564 | \$ 14,179 | 7.86% | \$ 616,705 | \$ 11,123 | 7.16% |
| Taxable investment securities | 40,395 | 445 | 4.37 | 44,091 | 408 | 3.67 |
| Nontaxable investment securities | 4,620 | 42 | 3.64 | 4,284 | 39 | 3.61 |
| Interest earning deposits | 1,282 | 16 | 4.83 | 1,231 | 11 | 3.59 |
| Federal Home Loan Bank stock | 3,227 | | | 3,157 | | |
| Total interest earning assets | \$ 765,088 | \$ 14,682 | 7.61% | \$ 669,468 | \$ 11,581 | 6.86% |
| Noninterest earning assets | 58,325 | | | 49,485 | | |
| Total assets | \$ 823,413 | | | \$ 718,953 | | |
| Interest Bearing Liabilities: | | | | | | |
| Certificates of deposit | \$ 319,504 | \$ 3,477 | 4.32% | \$ 272,328 | \$ 2,091 | 3.05% |
| Savings accounts | 95,304 | 441 | 1.83 | 95,714 | 239 | 0.99 |
| Interest bearing demand and money market accounts | 198,191 | 1,044 | 2.09 | 167,250 | 465 | 1.10 |
| Total interest bearing deposits | 612,999 | 4,962 | 3.21 | 535,292 | 2,795 | 2.07 |
| FHLB advances and other borrowings | 22,543 | 329 | 5.79 | 24,137 | 231 | 3.80 |
| Total interest bearing liabilities | \$ 635,542 | \$ 5,291 | 3.30% | \$ 559,429 | \$ 3,026 | 2.15% |
| Demand and other noninterest bearing deposits | 102,911 | | | 87,867 | | |
| Other noninterest bearing liabilities | 7,391 | | | 6,040 | | |
| Stockholders' equity | 77,569 | | | 65,617 | | |
| Total liabilities and stockholders' equity | \$ 823,413 | | | \$ 718,953 | | |

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| | | |
|---|----------|----------|
| Net interest income | \$ 9,391 | \$ 8,555 |
| Net interest spread | 4.31% | 4.72% |
| Net interest margin | 4.87% | 5.07% |
| Average interest earning assets to average interest bearing liabilities | 120.38% | 119.67% |

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| | For the Nine Months Ended September 30, | | | | | |
|---|---|-------------------------------------|--------------|-------------------|-------------------------------------|--------------|
| | Average Balance | 2006 Interest Earned/ Paid | Average Rate | Average Balance | 2005 Interest Earned/ Paid | Average Rate |
| (Dollars in thousands) | | | | | | |
| Interest Earning Assets: | | | | | | |
| Loans | \$ 680,290 | \$ 39,015 | 7.67% | \$ 607,645 | \$ 31,970 | 7.03% |
| Taxable investment securities | 40,723 | 1,285 | 4.22 | 44,055 | 1,166 | 3.54 |
| Nontaxable investment securities | 4,495 | 122 | 3.63 | 4,097 | 111 | 3.64 |
| Interest earning deposits | 1,235 | 42 | 4.51 | 2,425 | 47 | 2.62 |
| Federal Home Loan Bank stock | 3,141 | | | 3,095 | 15 | 0.63 |
| Total interest earning assets | \$ 729,884 | \$ 40,464 | 7.41% | \$ 661,317 | \$ 33,309 | 6.73% |
| Noninterest earning assets | 53,743 | | | 47,948 | | |
| Total assets | \$ 783,627 | | | \$ 709,265 | | |
| Interest Bearing Liabilities: | | | | | | |
| Certificates of deposit | \$ 301,053 | \$ 9,018 | 4.00% | \$ 257,048 | \$ 5,327 | 2.77% |
| Savings accounts | 94,710 | 1,204 | 1.70 | 97,944 | 739 | 1.01 |
| Interest bearing demand and money market accounts | 185,760 | 2,528 | 1.82 | 168,622 | 1,238 | 0.98 |
| Total interest bearing deposits | 581,523 | 12,750 | 2.93 | 523,614 | 7,304 | 1.87 |
| FHLB advances and other borrowings | 26,644 | 1,054 | 5.29 | 31,662 | 744 | 3.14 |
| Total interest bearing liabilities | \$ 608,167 | \$ 13,804 | 3.03% | \$ 555,276 | \$ 8,048 | 1.94% |
| Demand and other noninterest bearing deposits | 95,648 | | | 84,250 | | |
| Other noninterest bearing liabilities | 7,126 | | | 5,458 | | |
| Stockholders' equity | 72,686 | | | 64,281 | | |
| Total liabilities and stockholders' equity | \$ 783,627 | | | \$ 709,265 | | |
| Net interest income | | \$ 26,660 | | | \$ 25,261 | |
| Net interest spread | | | 4.38% | | | 4.80% |
| Net interest margin | | | 4.88% | | | 5.11% |
| Average interest earning assets to average interest bearing liabilities | | | 120.01% | | | 119.10% |

The following tables provide 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 to volume and interest rates.

For the three months ended September 30,**2006 Compared to 2005**

| | Increase (Decrease) Due to | | |
|----------------------------------|----------------------------|-----------------|-----------------|
| | Volume | Rate | Total |
| (Dollars in thousands) | | | |
| Interest Earning Assets: | | | |
| Loans | \$ 1,959 | \$ 1,097 | \$ 3,056 |
| Taxable investment securities | (41) | 78 | 37 |
| Nontaxable investment securities | 3 | | 3 |
| Interest earning deposits | 1 | 4 | 5 |
| Interest income | \$ 1,922 | \$ 1,179 | \$ 3,101 |

| | | | |
|---|--------|----------|----------|
| Interest bearing liabilities: | | | |
| Certificates of deposit | \$ 513 | \$ 873 | \$ 1,386 |
| Savings accounts | (2) | 204 | 202 |
| Interest bearing demand and money market accounts | 163 | 416 | 579 |
| Total interest bearing deposits | 674 | 1,493 | 2,167 |
| FHLB advances and other borrowings | (23) | 121 | 98 |
| Interest expense | \$ 651 | \$ 1,614 | \$ 2,265 |

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| | For the nine months ended September 30, | | |
|---|---|----------|----------|
| | 2006 Compared to 2005 | | |
| | Increase (Decrease) Due to | | |
| | Volume | Rate | Total |
| | (Dollars in thousands) | | |
| Interest Earning Assets: | | | |
| Loans | \$ 4,166 | \$ 2,879 | \$ 7,045 |
| Taxable investment securities | (105) | 224 | 119 |
| Nontaxable investment securities | 11 | | 11 |
| Interest earning deposits | (40) | 35 | (5) |
| Interest earning deposits | | (15) | (15) |
| Interest income | \$ 4,032 | \$ 3,123 | \$ 7,155 |
| Interest bearing liabilities: | | | |
| Certificates of deposit | \$ 1,318 | \$ 2,373 | \$ 3,691 |
| Savings accounts | (41) | 506 | 465 |
| Interest bearing demand and money market accounts | 233 | 1,057 | 1,290 |
| Total interest bearing deposits | 1,510 | 3,936 | 5,446 |
| FHLB advances and other borrowings | (198) | 508 | 310 |
| Interest expense | \$ 1,312 | \$ 4,444 | \$ 5,756 |

Financial Condition Data

Total assets increased \$84.2 million (11.2%) to \$835.4 million as of September 30, 2006 from the December 31, 2005 balance of \$751.2 million. Of this increase in total assets, \$56.6 million was due to the WWB acquisition. Deposits increased \$91.8 million (14.4%) to \$728.3 million as of September 30, 2006 from the December 31, 2005 balance of \$636.5 million. Of this increase in deposits, \$44.3 million was due to the WWB acquisition. For the same period, net loans, which include loans held for sale but are net of the allowance for loan losses, increased \$79.5 million (12.3%) to \$723.3 million as of September 30, 2006 from the December 31, 2005 balance of \$643.8 million. Of this increase in net loans, \$40.7 million was due to the WWB acquisition. Commercial loans increased by \$59.2 million to \$419.0 million as of September 30, 2006 from the December 31, 2005 balance of \$359.8 million. Commercial loans continue to be the largest segment of loans at 57.2% and 55.2% as a percentage of total loans as of September 30, 2006 and December 31, 2005, respectively.

Earnings Summary

Net income was \$0.43 per diluted share for the three months ended September 30, 2006 and September 30, 2005. Actual earnings for the three months ended September 30, 2006 were \$2,890,000 compared to \$2,723,000 for the same period in 2005, an increase of 6.1%. Net income for the nine months ended September 30, 2006 was \$1.22 per diluted share compared to \$1.23 per diluted share for the same period last year. Actual earnings for the nine months ended September 30, 2006 were \$7,989,000 compared to \$7,784,000 for the same period in 2005, an increase of 2.6%.

Return on average equity for the quarter ended September 30, 2006 was 14.78% compared to 16.47% for the same period last year. Average equity increased by \$12.0 million to \$77.6 million for the three months ended September 30, 2006 versus \$65.6 million for the same period last year. For the nine months ended September 30, 2006, the Company's return on average equity was 14.70% compared to 16.19% for the nine months ended September 30, 2005. Average equity for the nine months ended September 30, 2006 increased to \$72.7 million from \$64.3 million for the nine months ended September 30, 2005. The Company's capital position remains strong at 9.26% of total assets as of September 30, 2006, up from 8.83% at September 30, 2005.

Net Interest Income

Net interest income before provision for loan losses for the three months ended September 30, 2006 increased 9.8% to \$9,391,000 from \$8,555,000 for the same quarter in 2005. Net interest income before provision for loan losses for the nine months ended September 30, 2006

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increased 5.5% to \$26,660,000 from \$25,261,000 for the same period in 2005. The net interest margin (net interest income divided by average interest earning assets) decreased to 4.87% for the current quarter from 5.07% for the same quarter last year. The net interest margin decreased to 4.88% for the nine months ended September 30, 2006 from 5.11% for the same period in 2005. One of the methods in which we have been able to maintain our net interest margin near 5.0% is our continued focus on increasing noninterest bearing deposits. Noninterest bearing deposits averaged \$102.9 million for the quarter ended September 30, 2006 versus \$87.9 million for the quarter ended September 30,

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2005, an increase of 17.1%. Maintaining a margin near 5.0% will continue to be a challenge. Short-term interest rates have increased at a much faster pace than longer-term interest rates this year and this has had the effect of narrowing our net interest margin. While we continue to focus on increasing our asset sensitivity, a continuation of a flat yield curve and a very competitive business environment may have the effect of reducing our net interest margin further.

Interest income increased \$3.1 million, or 26.8%, for the three months ended September 30, 2006 as compared to the same quarter last year and interest expense increased \$2.3 million, or 74.9%, during this same period. Interest income for the nine months ended September 30, 2006 increased \$7.2 million, or 21.5%, as compared to the same period last year and interest expense increased \$5.8 million, or 71.5%, during this same period. Loans averaged \$715.6 million with an average yield of 7.86% for the three months ended September 30, 2006 compared to average loans of \$616.7 million with an average yield of 7.16% for the same period in 2005. Loans averaged \$680.3 million with an average yield of 7.67% for the nine months ended September 30, 2006 compared to average loans of \$607.6 million with an average yield of 7.03% for the same period in 2005. Certificates of deposit averaged \$319.5 million with an average cost of 4.32% for the three months ended September 30, 2006 compared to \$272.3 million with an average cost of 3.05% for the same period in 2005. Certificates of deposit averaged \$301.1 million with an average cost of 4.00% for the nine months ended September 30, 2006 compared to \$257.0 million with an average cost of 2.77% for the same period in 2005.

Provision for Loan Losses

The provision for loan losses was \$240,000 for the three months ended September 30, 2006, an increase of \$30,000 over the provision for loan losses during the third quarter of 2005. The provision for loan losses was \$480,000 for the nine months ended September 30, 2006 down from \$585,000 for the same period in 2005. The decrease was primarily due to net recoveries of \$175,000 for the nine months ended September 30, 2006.

Noninterest Income

Noninterest income increased 26.0% to \$2,166,000 for the three months ended September 30, 2006 compared with \$1,719,000 for the same quarter in 2005. Noninterest income increased 21.3% to \$5,854,000 for the nine months ended September 30, 2006 from \$4,825,000 for same period in 2005. The increases for the three and nine months ended September 30, 2006 were primarily due to increases in service charges of \$112,000 and \$368,000, respectively, brokered mortgage income of \$173,000 and \$338,000, respectively, and in merchant visa income of \$118,000 and \$261,000, respectively.

Noninterest Expense

Noninterest expense increased 15.1% to \$6,980,000 during the three months ended September 30, 2006 compared to \$6,066,000 for the same period during 2005. Noninterest expense increased 11.6% to \$20,081,000 for the nine months ended September 30, 2006 from \$17,992,000 for the same period last year. These increases were due primarily to increases in salaries and benefits expense, which increased by \$496,000 and \$1,401,000 for the three and nine months ended September 30, 2006, respectively, compared to the same periods last year. These increases were due to new loan officer hires in last half of 2005 and first half of 2006, additional personnel associated with the new branch in Sumner and the acquisition of Western Washington Bancorp and adoption of the new accounting pronouncement related to stock option compensation. Merchant visa expense increased \$87,000 and \$207,000 for the three and nine months ended September 30, 2006, respectively, compared to the same periods last year.

The efficiency ratio for the quarter ended September 30, 2006 was 60.4% compared to 59.0% for the comparable quarter in 2005. The efficiency ratio for the nine months ended September 30, 2006 was 61.8% compared to 59.8% for the same period last year. The efficiency ratio increases are primarily a result of increased noninterest expense due to the factors listed above. The efficiency ratio consists of noninterest expense divided by the sum of net interest income before provision for loan losses plus noninterest income.

Table of Contents**Lending Activities**

As indicated in the table below, total loans (including loans held for sale) increased to \$733.2 million at September 30, 2006 from \$652.3 million at December 31, 2005. Of this increase, \$41.5 million was due to the WWB acquisition.

| | At September 30, 2006 | % of Total (Dollars in thousands) | At December 31, 2005 | % of Total |
|---|-----------------------------|---|----------------------------|---------------|
| Commercial | \$ 419,014 | 57.2% | \$ 359,808 | 55.2% |
| Real estate mortgages | | | | |
| One-to-four family residential | 58,906 | 8.0 | 53,098 | 8.1 |
| Five or more family residential and commercial properties | 180,931 | 24.7 | 164,788 | 25.3 |
| Total real estate mortgages | 239,837 | 32.7 | 217,886 | 33.4 |
| Real estate construction | | | | |
| One-to-four family residential | 47,365 | 6.4 | 42,245 | 6.5 |
| Five or more family residential and commercial properties | 14,365 | 2.0 | 21,355 | 3.2 |
| Total real estate construction | 61,730 | 8.4 | 63,600 | 9.7 |
| Consumer | 14,899 | 2.0 | 12,855 | 2.0 |
| Gross loans | 735,480 | 100.3 | 654,149 | 100.3 |
| Less: deferred loan fees | (2,256) | (0.3) | (1,852) | (0.3) |
| Total loans | \$ 733,224 | 100.0% | \$ 652,297 | 100.0% |

Nonperforming Assets

The following table describes our nonperforming assets for the dates indicated.

| | At September 30, 2006 | At December 31, 2005 |
|--|-----------------------------|----------------------------|
| | (Dollars in thousands) | |
| Nonaccrual loans | \$ 2,112 | \$ 836 |
| Other real estate owned | 225 | 371 |
| Total nonperforming assets | \$ 2,337 | \$ 1,207 |
| Accruing loans past due 90 days or more | \$ | \$ |
| Potential problem loans | 11,439 | 9,882 |
| Allowance for loan losses | 9,900 | 8,496 |
| Nonperforming loans to loans | 0.29% | 0.13% |
| Allowance for loan losses to loans | 1.35% | 1.30% |
| Allowance for loan losses to nonperforming loans | 468.75% | 1,016.27% |
| Nonperforming assets to total assets | 0.28% | 0.16% |

Nonperforming assets increased to \$2,337,000, or 0.28% of total assets at September 30, 2006 from \$1,207,000, or 0.16% of total assets at December 31, 2005. We believe that we are adequately reserved for losses in the portfolio as of September 30, 2006. Potential problem loans are those loans that are currently accruing interest, but which are considered possible credit problems because financial information of the borrowers causes us concerns as to their ability to comply with the present repayment program and could result in placing the loan on nonaccrual.

Analysis of Allowance for Loan Losses

Management maintains an allowance for loan losses to absorb estimated credit losses associated with the loan portfolio, including all binding commitments to lend. We determine an adequate allowance through our ongoing quarterly loan quality assessments.

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

Risk rating of the credit portfolio;

Levels and trends in delinquencies and nonaccruals;

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

National and local economic trends;

Specific industry conditions such as commercial and residential construction;

Concentrations of credits in specific industries;

Bank regulatory examination results and our own credit examinations; and

Recent loss experience in the portfolio.

We calculate an adequate allowance for the non-classified portion of our loan portfolio based on an appropriate percentage risk factor that is calculated based on the above-noted elements and trends. For each classified loan, we may have a specific provision based on careful analysis of that loan's credit and collateral factors. Our analysis of an adequate allowance combines the provisions made for both our non-classified loans and the specific provisions made for each classified loan.

While we believe we use the best information available to determine the allowance for loan losses, net income could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance, unforeseen market conditions arise or if we are directed to make adjustments to the allowance for loan losses by our regulators.

The following table summarizes the changes in our allowance for loan losses:

| | Nine Months Ended September 30, | |
|--|--|-------------|
| | 2006 | 2005 |
| | (Dollars in thousands) | |
| Total loans outstanding at end of period (1) | \$ 733,224 | \$ 626,174 |
| Average loans outstanding during period (1) | 680,290 | 607,645 |
| Allowance balance at beginning of period | 8,496 | 8,295 |
| Provision for loan losses | 480 | 585 |
| Allowance acquired through acquisition | 749 | |
| Charge offs: | | |
| Real estate | (4) | |
| Commercial | | (506) |
| Agriculture | (55) | (88) |
| Consumer | (63) | (36) |
| Total charge offs | (122) | (630) |
| Recoveries: | | |
| Real estate | 24 | 6 |
| Commercial | 254 | 41 |
| Agriculture | | 10 |
| Consumer | 19 | 5 |
| Total recoveries | 297 | 62 |

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| | | | |
|--|--|----------|----------|
| Net recoveries (charge offs) | | 175 | (568) |
| Allowance balance at end of period | | \$ 9,900 | \$ 8,312 |
| Allowance for loan losses to loans | | 1.35% | 1.31% |
| Ratio of net recoveries (charge offs) during period to average loans outstanding | | 0.03% | (0.09)% |

(1) Includes loans held for sale

While pursuing our growth strategy, we continue to employ prudent underwriting and sound monitoring procedures to maintain asset quality. The allowance for loan losses during the nine months ended September 30, 2006 increased by \$1,404,000 to \$9.9 million from \$8.5 million at December 31, 2005. Based on management's assessment of loan quality, the Company believes that its allowance for loan losses is at an appropriate level under current economic conditions.

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Liquidity and Sources of Funds

Our primary sources of funds are customer and local government deposits, loan repayments, loan sales, interest earned on and proceeds from investment securities, and advances from the Federal Home Loan Bank (FHLB) of Seattle. 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 mortgage 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 short-term investments to meet short-term liquidity needs. At September 30, 2006, cash and cash equivalents totaled \$24.8 million, and investment securities classified as either available for sale or held to maturity with maturities of one year or less amounted to \$14.7 million, or 2.0% of total assets. At September 30, 2006, our banks maintained a credit facility with the FHLB of Seattle for \$153.8 million, with \$19.4 million in FHLB borrowings as of September 30, 2006.

Capital

Stockholders' equity at September 30, 2006 was \$77.4 million compared with \$66.1 million at December 31, 2005. During the nine months ended September 30, 2006, we declared dividends of \$3.9 million, realized income of \$8.0 million, recorded \$92,000 in unrealized gains on securities available for sale, net of tax, and realized the effects of exercising stock options, stock option compensation and earned ESOP and restricted stock shares totaling \$1.5 million. In addition, common stock was issued in the amount of \$5.7 million relating to the acquisition of Western Washington Bancorp.

Banking regulations require bank holding companies and banks to maintain a minimum leverage ratio of core capital to adjusted quarterly average total assets of at least 3%. At September 30, 2006 our leverage ratio was 8.0% compared with 8.2% at December 31, 2005. In addition, banking regulators have adopted risk-based capital guidelines, under which risk percentages are assigned to various categories of assets and off-balance sheet items to calculate a risk-adjusted capital ratio. Tier I capital generally consists of common shareholders' equity, while Tier II capital includes the allowance for loan losses, subject to certain limitations. Regulatory minimum risk-based capital guidelines require Tier I capital of 4% of risk-adjusted assets and total capital (combined Tier I and Tier II) of 8%. Our Tier I and total risk based capital ratios were 9.3% and 10.6%, respectively, at September 30, 2006 compared with 9.5% and 10.8%, respectively, at December 31, 2005.

During 1992, the FDIC published the qualifications necessary to be classified as a well-capitalized bank, primarily for assignment of FDIC insurance premium rates beginning in 1993. To qualify as well-capitalized, banks must have a Tier I risk based capital ratio of at least 6%, a total risk based capital ratio of at least 10%, and a leverage ratio of at least 5%. Heritage Bank and Central Valley Bank qualified as well-capitalized at September 30, 2006.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Our results of operations are highly dependent upon our ability to manage interest rate risk. We consider interest rate risk to be a significant market risk that could have a material effect on our financial condition and results of operations. In our opinion, there has not been a material change in our interest rate risk exposure since our most recent year-end at December 31, 2005.

We do not maintain a trading account for any class of financial instrument nor do we engage in hedging activities or purchase high-risk derivative instruments. Moreover, we have no material risk with foreign currency exchange rate risk or commodity price risk.

ITEM 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures. We maintain controls and procedures designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 are recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those controls and procedures, the Chief Executive and Chief Financial officers of the Company concluded that the Company's disclosure controls and procedures were adequate as of September 30, 2006.

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(b) Changes in internal control over financial reporting. We made no changes in our internal controls over financial reporting during the Company's quarter ended September 30, 2006, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents**PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

None

Item 1A. Risk Factors

There have been no material changes from the risk factors as previously disclosed in Item 1A to Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The Company has had various stock repurchase programs since March 1999. In August 2005, the Board of Directors approved a new stock repurchase plan, allowing the Company to repurchase up to 5% of the then outstanding shares, or approximately 295,000 shares over a period of eighteen months. This marked the Company's eighth stock repurchase plan. On January 25, 2006, the Board of Directors authorized an eighteen-month extension to this program. During the quarter ended September 30, 2006, the Company repurchased 1,176 shares at an average price of \$24.50. From March 31, 1999 through September 30, 2006, the Company has repurchased 88,715 shares at an average price of \$20.84 under this plan.

The following table sets forth information about the Company's purchases of its outstanding common stock during the quarter ended September 30, 2006.

| Period | Total Number of Shares Purchased (1) | Average Price Paid Per Share | 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 (2) |
|--|--------------------------------------|------------------------------|--|--|
| July 1, 2006 - July 31, 2006 | | \$ | 5,935,505 | 222,211 |
| August 1, 2006 - August 31, 2006 | 1,176 | \$ 24.50 | 5,936,681 | 221,035 |
| September 1, 2006 - September 30, 2006 | | \$ | 5,936,681 | 221,035 |
| Total | 1,176 | \$ 24.50 | 5,936,681 | 221,035 |

Item 3. Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

Item 6. Exhibits

- 3.1 Articles of Incorporation (1)
- 3.2 Bylaws of the Company (1)
- 10.1 1998 Stock Option and Restricted Stock Award Plan (2)
- 10.5 Form of Severance Agreement entered into between the Company and seven additional executives, effective as of October 1, 1997 (1)
- 10.6 1997 Stock Option and Restricted Stock Award Plan (3)
- 10.7 Employment Agreement between the Company and Michael Broadhead, effective September 28, 1998 (4)
- 10.8 Employment Agreement between the Company and Brian L. Vance, effective June 1, 2001 (5)
- 10.9 Employment Agreement between the Company and Donald V. Rhodes, effective June 1, 2001 (5)
- 10.10 2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (6)
- 10.11 Employment Agreement between the Company and Donald V. Rhodes, effective January 1, 2005 (8)
- 10.12 2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (9)

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- 14.0 Code of Ethics (7)
- 31.0 Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.0 Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- (1) Incorporated by reference to the Registration Statement on Form S-1 (Reg. No. 333-35573) declared effective on November 12, 1997.
- (2) Incorporated by reference to the definitive Proxy Statement dated September 14, 1998 for the Annual Meeting of Shareholders held on October 15, 1998.
- (3) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-57513).
- (4) Incorporated by reference to the Registration Statement on Form S-4 dated January 20, 1999.
- (5) Incorporated by reference to the Annual Report on Form 10-K dated March 20, 2002.
- (6) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-88980; 333-88982; 333-88976).
- (7) Incorporated by reference to the Annual Report on Form 10-K dated March 8, 2005.
- (8) Incorporated by reference to the Quarterly Report on Form 10-Q dated November 2, 2004.
- (9) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-134473; 333-134474; 333-134475).

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 3, 2006

HERITAGE FINANCIAL CORPORATION

/s/ Brian L. Vance
Brian L. Vance
President and Chief Executive Officer
(Duly Authorized Officer)

/s/ Edward D. Cameron
Edward D. Cameron
Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)