



SMALL BANK

Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

PUBLIC DISCLOSURE

October 15, 2012

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION

Heritage Bank, NA
Charter Number 15401

120 South Street West
Spicer, Minnesota 56288

Office of the Comptroller of the Currency

Sioux Falls Field Office
4900 South Minnesota Avenue, Suite 300
Sioux Falls, SD 57108-2865

NOTE: This document is an evaluation of this institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods consistent with safe and sound operation of the institution. This evaluation is not, nor should it be construed as, an assessment of the financial condition of this institution. The rating assigned to this institution does not represent an analysis, conclusion, or opinion of the federal financial supervisory agency concerning the safety and soundness of this financial institution.

Institution's CRA Rating: This institution is rated Satisfactory.

Heritage Bank, NA (Heritage Bank) does a satisfactory job of meeting the credit needs of its assessment area.

- A majority of the bank's loans by number (81 percent) and dollar volume (62 percent) are located within its assessment area.
- Heritage Bank's average loan-to-deposit ratio of 94 percent is more than reasonable when compared to similarly situated banks and factoring in the bank's high volume of loan sales.
- The bank's overall lending efforts result in reasonable penetration among individuals of different income levels and farms and businesses of different sizes. This includes excellent penetration among businesses of different sizes and individuals of different income levels in the Sioux City metropolitan statistical area (MSA) assessment area (AA).
- The geographic distribution of commercial and consumer loans throughout the Sioux City MSA assessment area is poor overall.

Scope of Examination

Heritage Bank was evaluated under the small bank examination procedures that consist of a lending test. The lending test evaluated the bank's record of meeting the credit needs of its assessment areas through its lending activities. The lending test for Heritage Bank included all loans originated from January 1, 2010 to June 30, 2012. The bank's primary lending activities are consumer, residential real estate, agriculture, and commercial. Examiners sampled 20 loans for each primary product type in each assessment area to evaluate the bank's performance.

Description of Institution

Heritage Bank is a \$439 million commercial bank headquartered in Spicer, Minnesota, with 12 branches located in Willmar, Pennock, and Raymond, Minnesota and in Holstein, Aurelia, Lytton, Alta, Anthon, Cushing, Sioux City, and Storm Lake, Iowa.

Heritage Bank is wholly owned by Heritage Bancshares Group, Inc., a multi-state holding company headquartered in Willmar, Minnesota. In July 2011, the bank merged Heritage Bank, NA (Iowa) with Heritage Bank, NA (Minnesota). As of June 30, 2011, total assets for the banks were \$137 million and \$176 million, respectively.

The bank offers traditional community banking products including Internet, mobile banking, and bill pay services. These services provide customers with 24-hour access to deposit and loan account information and allow customers to make transfers between accounts. Applications for home loans and home equity loans are also available online. Heritage Bank owns four automated teller machines located within their AA. The Iowa branch locations have a primary focus on agricultural, commercial, and consumer loans. The Minnesota branch locations have a primary focus on residential real estate and consumer lending. According to the June 30, 2012 Call Report, the bank has the following outstanding loans by dollar volume: commercial

(36 percent), residential real estate (21 percent), agricultural (38 percent), and consumer (5 percent). Net loans equal 55 percent of total assets.

Heritage Bank has three assessment areas. Two are located in Iowa and one is located in Minnesota. The three assessment areas comply with regulatory requirements and do not arbitrarily exclude low- or moderate-income geographies. Based on information from two community contacts, examiners concluded that assessment area credit needs are being met. There are numerous other financial institutions located within the assessment areas that provide heavy competition. Individuals can refer to the bank's CRA Public File for a map outlining the bank's assessment areas.

Heritage Bank (Minnesota) received an "Outstanding" rating at its April 4, 2005 CRA examination. That Performance Evaluation assessed the bank's CRA activities from June 30, 1998 through December 31, 2004. Heritage Bank (Iowa) received an "Outstanding" rating at its October 10, 2006 CRA examination. That Performance Evaluation assessed the bank's CRA activities from January 1, 2004 through September 30, 2006. There are no financial, legal, or other factors that impede the bank's ability to meet the credit needs of its assessment areas.

Loan-to-Deposit Ratio

Heritage Bank's average lending level is more than reasonable. This is based on the bank's loan-to-deposit (LTD) ratio, size, financial condition, and the assessment area credit needs. The bank's quarterly average LTD ratio for the past 29 quarters ending June 30, 2012 was 94 percent, with a high of 108 percent and a low of 63 percent over this period. Heritage Bank's average LTD ratio compares favorably to the average LTD ratio of eleven similarly situated banks in the assessment areas. The eleven similarly situated banks have a 29-quarter average LTD ratio of 87 percent, and a range of 76 percent to 101 percent. Heritage Bank also originates and sells residential real estate loans, which would improve their LTD ratio if the loans were not sold on the secondary market.

Lending in Assessment Area

Heritage Bank originates a majority of its loans to borrowers within its defined assessment area. Examiners sampled 60 consumer, 20 residential real estate, 20 agriculture, and 20 commercial loans originated between January 1, 2010 and June 30, 2012 to determine the bank's lending performance within the assessment areas. Examiners found that 97 loans, or 81 percent of loans, were originated within the assessment areas. In addition, \$7.98 million, or 62 percent of loan volume, was originated within the assessment areas.

Lending In and Out of the Assessment Areas										
Loan Type	Number of Loans					Dollars of Loans				
	Inside		Outside		Total	Inside		Outside		Total
	#	%	#	%		\$	%	\$	%	
Consumer	50	83%	10	17%	60	2,685,546	81%	612,601	19%	3,298,147
Residential RE	16	80%	4	20%	20	2,148,440	79%	560,395	21%	2,708,835
Agriculture	18	90%	2	10%	20	1,256,328	70%	540,351	30%	1,796,679
Commercial	13	65%	7	35%	20	1,894,677	37%	3,212,151	63%	5,106,828
Totals	97	81%	23	19%	120	7,984,991	62%	4,925,498	38%	12,910,489

Source: Loan sampling

Responses to Complaints

The Office of the Comptroller of the Currency and the bank have not received any complaints regarding the bank's CRA performance since the last CRA examination dated April 4, 2005.

Fair Lending or Other Illegal Credit Practices Review

Pursuant to 12 C.F.R. 25.28(c), in determining a national bank's CRA rating, the OCC considers evidence of discriminatory or other illegal credit practices in any geography by the bank, or in any assessment area by an affiliate whose loans have been considered as part of the bank's lending performance. We found no evidence of discriminatory or other illegal credit practices inconsistent with helping to meet community credit needs.

State Rating - Minnesota

CRA Rating for Minnesota: Satisfactory

The primary factor supporting this rating is borrower distribution reflects reasonable penetration among individuals of different income levels.

Description of Institution's Operations in Minnesota

Minnesota Non-MSA

Heritage Bank's Minnesota non-MSA assessment area consists of Kandiyohi and Chippewa Counties in Minnesota. The counties have a population of 54,291, and 24,270 housing units, respectively, according to the updated 2011 U.S. Census data. The updated Department of Housing and Urban Development (HUD) median family income is \$59,200. The assessment area contains 17 census tracts, 16 of which are middle-income, and one of which is upper-income. The updated 2011 U.S. Census estimates the median housing value to be \$87,810 and 66 percent of all housing units are owner-occupied.

The economic conditions in the area are good. The major employment sectors in the area are services and agriculture, which is reflective of major employers centered in health care, meat processing, and education. A majority of the businesses are considered small with 74 percent of

businesses reporting less than \$1 million in revenue. According to December 2011 U.S. Bureau of Labor Statistics, the assessment area unemployment rate is 2.8 percent. This is lower than the 2011 Minnesota unemployment rate of 5.7 percent and below the national unemployment rate of 7.9 percent.

Competition in the area is healthy. Heritage Bank is second in market share in the assessment area with 16 percent of deposits. The three institutions in the assessment area with the highest market share control approximately 48 percent of deposits.

Lending Test

The bank's performance under the lending test in Minnesota is rated "Satisfactory." Heritage Bank meets the standard for performance and borrower distribution reflects reasonable penetration among individuals of different income levels.

Lending to Borrowers of Different Incomes

Heritage Bank's distribution of residential real estate loans is reasonable. While the bank did not meet community demographic data for low-income families, it did approximate community demographics for moderate-income families. The bank originated just 5 percent of loans by number and 4 percent of loans by amount to low-income borrowers compared to demographic data of 16 percent. The distribution of loans to moderate-income borrowers was comparable to the demographic data of 19 percent.

BORROWER DISTRIBUTION OF RESIDENTIAL REAL ESTATE LOANS			
Borrower Income Level	% of Number	% of Amount	% of Families
Low	5%	4%	16%
Moderate	20%	16%	19%
Middle	20%	18%	26%
Upper	55%	62%	39%
Total	100%	100%	100%

Source: Loan sampling and 2000 U.S. Census data

Heritage Bank's distribution of consumer loans is reasonable. The bank originated 20 percent of loans by number and 15 percent of loans by amount to low-income borrowers compared to demographic data of 21 percent. The bank originated 30 percent of loans by number and 17 percent of loans by amount to moderate-income borrowers compared to demographic data of 18 percent.

BORROWER DISTRIBUTION OF CONSUMER LOANS			
Borrower Income Level	% of Number	% of Amount	% of Households
Low	20%	15%	21%
Moderate	30%	17%	18%
Middle	25%	28%	20%
Upper	25%	40%	41%
Total	100%	100%	100%

Source: Loan sampling and 2000 U.S. Census data

Geographic Distribution of Loans

All 17 census tracts within the assessment area are middle- or upper-income tracts. Therefore, specific analysis of geographic distribution is not meaningful.

State Rating - Iowa

CRA Rating for Iowa: Satisfactory

The primary factors supporting this rating are:

- Borrower distribution in the non-MSA assessment area reflects reasonable penetration among farms of different sizes and individuals of different income levels.
- Borrower distribution in the Sioux City MSA assessment area reflects excellent penetration among businesses of different sizes and individuals of different income levels.
- The geographic distribution of commercial and consumer loans throughout the Sioux City MSA assessment area is poor overall.

Description of Institution's Operations in Iowa

Iowa non-MSA

Heritage Bank's Iowa non-MSA assessment area consists of 18 census tracts in Buena Vista, Sac, Ida, Calhoun, and Cherokee Counties in Iowa. The counties have a population of 57,004, and 25,056 housing units according to the updated 2011 U.S. Census data. The updated 2011 U.S. Census estimates the median housing value to be \$61,252 and 66 percent of all housing units are owner-occupied. The updated HUD median family income is \$58,500. All of the 18 census tracts in the assessment area are considered middle-income.

The economic conditions in the area are good. The major employment sectors in the area are agriculture and services establishments. A majority of the businesses are considered small with 76 percent of businesses reporting less than \$1 million in revenue per updated 2011 U.S. Census data. According to December 2011 U.S. Bureau of Labor Statistics, the assessment area

unemployment rate is 2.3 percent. This is lower than the 2011 Iowa unemployment rate of 5.6 percent and below the national unemployment rate of 7.9 percent.

There is a fair amount of competition in the rural assessment area with 27 institutions in the area. Heritage Bank has the sixth highest market share in the Iowa non-MSA assessment area with five percent of deposits.

Sioux City MSA

Heritage Bank's Sioux City MSA assessment area includes 30 census tracts in Woodbury County, Iowa and in Dakota County, Nebraska. Woodbury and Dakota Counties have a population of 124,130, and 48,922 housing units, respectively, according to the updated 2011 U.S. Census data. The updated 2011 U.S. Census estimates the median housing value to be \$75,332 and 65 percent of all housing units are owner-occupied. The HUD 2011 updated median family income is \$58,800. Of the 30 census tracts in the assessment area, one is low income, seven are moderate-income, sixteen are middle-income, and six are upper-income.

The economic conditions in the area are stable. The major employment sectors in the area are services, retail, and non-classifiable establishments. Major employers in the meat packing industry struggled with job layoffs due to adverse media attention; however, this appears to have subsided. According to December 2011 U.S. Bureau of Labor Statistics, the assessment area unemployment rate is 2.8 percent. This is lower than the 2011 Iowa unemployment rate of 5.6 percent and below the national unemployment rate of 7.9 percent. A majority of the businesses are considered small with 69 percent of businesses reporting less than \$1 million in revenue.

Bank competition in the Sioux City assessment area is strong. There are 27 financial institutions with a presence in the bank's assessment area, some of which are branches of regional and national banks situated in the metro area. Heritage Bank has the sixteenth highest market share in the assessment area with two percent of deposits.

Lending Test

The bank's performance under the lending test in Iowa is rated "Satisfactory." Heritage Bank meets the standard for performance. Borrower distribution in the non-MSA assessment area reflects reasonable penetration among farms of different sizes and individuals of different income levels. Borrower distribution in the Sioux City MSA assessment area reflects excellent penetration among businesses of different sizes and individuals of different income levels. The geographic distribution of commercial and consumer loans throughout the Sioux City MSA assessment area is poor overall.

Lending to Borrowers of Different Incomes and to Businesses and Farms of Different Sizes

Borrower distribution in the non-MSA assessment area reflects reasonable penetration among farms of different sizes and individuals of different income levels. Borrower distribution in the Sioux City MSA assessment area reflects excellent penetration among businesses of different sizes and individuals of different income levels.

Performance in the Non-MSA Assessment Area

Distribution of agriculture loans to farms of different sizes is reasonable. Examiners reviewed a sample of 20 agriculture loans. Nine loans within the sample, that contained revenue information, were to farms with gross annual revenues less than \$1 million. While 11 loan files, or 55 percent of the sample, did not contain gross revenue information, eight of these files contained cash flow projections. Seven of the eight cash flows projected total annual revenue less than \$1 million. This compares reasonably to the census data of 99 percent of assessment area farms with gross annual revenues less than \$1 million.

BORROWER DISTRIBUTION OF AGRICULTURE LOANS			
Gross Annual Revenue	% of Number	% of Amount	% of Farms
<= \$1 million	45%	47%	99%
>\$1 million	0%	0%	0%
Revenue Unavailable	55%	53%	1%
Total	100%	100%	100%

Source: Loan sampling and 2011 U.S. Census agriculture demographic data

Distribution of consumer loans to low- and moderate-income households is reasonable. We reviewed a sample of 20 consumer loans to determine lending to households of different income levels. While Heritage Bank did not meet community demographic data for moderate-income households, the bank exceeded community demographics for low-income families based on both the number and amount of loans.

BORROWER DISTRIBUTION OF CONSUMER LOANS			
Borrower Income Level	% of Number	% of Amount	% of Households
Low	35%	25%	23%
Moderate	15%	7%	19%
Middle	40%	60%	22%
Upper	10%	8%	36%
Total	100%	100%	100%

Source: Loan sampling and 2000 U.S. Census data

Performance in the MSA Assessment Area

Heritage Bank has an excellent record of lending to commercial borrowers of different sizes. We reviewed a sample of 20 commercial loans to determine the bank's lending to businesses of different sizes. The bank originated 85 percent of commercial loans by number to business operations with gross annual revenues less than \$1 million. Heritage Bank's lending compares favorably to census data, which shows 67 percent of assessment area businesses with gross annual revenues less than \$1 million.

BORROWER DISTRIBUTION OF COMMERCIAL LOANS			
Business Revenues (or Sales)	MSA Assessment Area		
	% of Number	% of Amount	% of Businesses
<= \$1 million	85%	51%	67%
>\$1 million	10%	48%	4%
Revenue Unavailable	5%	1%	29%
Total	100%	100%	100%

Source: Loan sampling and 2011 U.S. Census business demographic data

Distribution of consumer loans to low- and moderate-income households is excellent. Heritage Bank originated 25 percent of loans by number and 24 percent of loans by amount to low-income borrowers. This penetration compares favorably to the demographic data of 21 percent. Heritage Bank also exceeded the demographic data on loans to moderate-income borrowers with 25 percent by number compared to demographic data of 18 percent.

BORROWER DISTRIBUTION OF CONSUMER LOANS			
Borrower Income Level	% of Number	% of Amount	% of Households
Low	25%	24%	21%
Moderate	25%	10%	18%
Middle	20%	9%	21%
Upper	30%	57%	40%
Total	100%	100%	100%

Source: Loan sampling and 2000 U.S. Census data

Geographic Distribution of Loans

Heritage Bank's overall record of lending to businesses and individuals in different income tracts is poor. Geographic distribution in the Sioux City MSA is reasonable for commercial loans and poor for consumer loans. Geographic distribution is not meaningful in the non-MSA assessment area as it only contains middle-income tracts.

Performance in the MSA Assessment Area

Geographic distribution of commercial loans in the Sioux City MSA reflects reasonable dispersion throughout the census tracts of different income levels. The bank exceeded the demographic comparators for low-income census tracts by number at 5 percent compared to 2 percent. The bank did not meet the demographic data of 24 percent for moderate-income census tracts with just 15 percent of loans by number and 12 percent of loans by amount.

GEOGRAPHIC DISTRIBUTION OF BUSINESS LOANS			
Census Income Tract Level	MSA Assessment Area		
	% of Number	% of Amount	% of Businesses
Low	5%	1%	2%
Moderate	15%	12%	24%
Middle	45%	13%	47%
Upper	35%	74%	27%
Total	100%	100%	100%

Source: Loan sampling and 2011 U.S. Census business demographic data

Geographic distribution of consumer loans in the Sioux City MSA reflects poor dispersion throughout the census tracts of different income levels. An expanded sample of 60 consumer loans originated in the Sioux City MSA found just four loans to borrowers in the MSA's seven moderate-income census tracts and no loans to borrowers in the MSA's one low-income census tract. This low penetration is partially explained by the relatively few households in the low- and moderate-income census tracts.

GEOGRAPHIC DISTRIBUTION OF CONSUMER			
Census Income Tract Level	MSA Assessment Area		
	% of Number	% of Amount	% of Households
Low	0%	0%	1%
Moderate	7%	5%	20%
Middle	65%	75%	56%
Upper	28%	20%	23%
Total	100%	100%	100%

Source: Loan sampling and 2000 U.S. Census data