

HERITAGE FINANCIAL CORP /WA/

Form 424B3

September 14, 2009

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Filed Pursuant to Rule 424(b)(3)

Registration No. 333-156271

The information in this preliminary prospectus supplement and the accompanying prospectus is not complete and may be changed. This preliminary prospectus supplement and the accompanying prospectus are not an offer to sell these securities and they are not soliciting an offer to buy these securities in any state or jurisdiction where the offer or sale is not permitted.

SUBJECT TO COMPLETION DATED SEPTEMBER 14, 2009

Preliminary Prospectus Supplement to Prospectus dated December 31, 2008

Shares

Common Stock

We are offering _____ shares of our common stock. Our common stock is listed on the Nasdaq Global Select Market under the symbol HFWA. On September 11, 2009, the closing sale price of our common stock on the Nasdaq Global Select Market was \$13.18 per share.

The shares of common stock are not savings accounts, deposits or other obligations of a bank or savings institution and are not insured by the Federal Deposit Insurance Corporation or any other government agency.

Investing in our common stock involves risks. See Risk Factors beginning on page S-13 of this prospectus supplement to read about factors you should consider before buying our common stock.

Neither the Securities and Exchange Commission nor any state securities regulator has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus supplement or the accompanying prospectus. Any representation to the contrary is a criminal offense.

	Per Share	Total
Public offering price	\$	\$ 35,000,000
Underwriting discounts and commissions	\$	\$

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Proceeds to Heritage Financial Corporation (before expenses)	\$	\$
The underwriters also may purchase up to an additional shares of our common stock within 30 days of the date of this prospectus supplement to cover over-allotments, if any.		

The underwriters expect to deliver the common stock in book-entry form only, through the facilities of The Depository Trust Company, against payment on or about September , 2009.

Keefe, Bruyette & Woods

D.A. Davidson & Co.

Prospectus supplement dated September , 2009.

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ABOUT THIS PROSPECTUS SUPPLEMENT

You should rely only on the information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus. We have not, and Keefe, Bruyette & Woods, Inc., and D.A. Davidson & Co., as underwriters, have not, authorized anyone to provide you with different information. You should assume that the information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus is accurate only as of their respective dates. Our business, financial condition, results of operations and prospects may have changed since such dates.

This prospectus supplement is a supplement to the accompanying prospectus that is also a part of this document. This prospectus supplement and the accompanying prospectus are part of a registration statement that we filed with the Securities and Exchange Commission (the "SEC"), using a shelf registration process. Under the shelf registration statement, we may offer and sell shares of our common stock described in the accompanying prospectus in one or more offerings. In this prospectus supplement, we provide you with specific information about the terms of this offering. Both this prospectus supplement and the accompanying prospectus include important information about us, our common stock and other information you should know before investing in our common stock. This prospectus supplement may also add, update and change information contained in the accompanying prospectus. To the extent that any statement that we make in this prospectus supplement is inconsistent with the statements made in the accompanying prospectus, the statements made in the accompanying prospectus are deemed modified or superseded by the statements made in this prospectus supplement. You should read this prospectus supplement and the accompanying prospectus as well as the documents incorporated herein by reference described under "Incorporation of Certain Documents by Reference" before investing in our common stock.

All references in this prospectus supplement to "Heritage," "we," "us," "our" or similar references mean Heritage Financial Corporation and its consolidated subsidiaries and all references in this prospectus supplement to "Heritage Financial Corporation" mean Heritage Financial Corporation excluding its subsidiaries, in each case unless otherwise expressly stated or the context otherwise requires.

WHERE YOU CAN FIND ADDITIONAL INFORMATION

We are subject to the information requirements of the Securities Exchange Act of 1934 (the "Exchange Act"), which means we are required to file annual, quarterly and special reports, proxy statements and other information with the SEC. Our SEC filings are available to the public over the Internet at the SEC's website at <http://www.sec.gov> and on the investor relations page of our website at www.HF-WA.com. Information on our website is not part of this prospectus supplement or the accompanying prospectus. You may also read and copy any document we file with the SEC at its Public Reference Room at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330.

We filed a registration statement on Form S-3 to register with the SEC the shares of common stock to be issued in this offering. This prospectus supplement and the accompanying prospectus do not contain all of the information you can find in the registration statement or the exhibits to the registration statement. You can obtain the full registration statement from the SEC as indicated above.

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INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE

The SEC allows us to incorporate by reference information into this prospectus supplement. This means that we can disclose important information to you by referring you to another document filed separately with the SEC. The information incorporated by reference is considered to be part of this prospectus supplement, except for any information that is superseded by subsequent incorporated documents or by information that is included directly in this prospectus supplement. We incorporate by reference the documents listed below and any future filings we make with the SEC after the date of this prospectus and until the termination of this offering under Sections 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934, or the Exchange Act:

our Annual Report on Form 10-K for the year ended December 31, 2008 (including the portions of our 2009 proxy material incorporated by reference into the Form 10-K);

our amendment to our Annual Report on Form 10-K/A for the year ended December 31, 2008;

our Current Report on Form 8-K filed on August 20, 2008;

our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2009 and June 30, 2009; and

the description of our common stock contained and incorporated into in our Registration Statement on Form 8-A filed on January 6, 1998.

Nothing in this prospectus supplement shall be deemed to incorporate information deemed furnished but not filed with the SEC.

You may obtain any of these incorporated documents from us without charge, excluding any exhibits to those documents unless the exhibit is specifically incorporated by reference in such document. You may obtain documents incorporated by reference in this prospectus supplement by requesting them from us in writing or by telephone at the following address:

Heritage Financial Corporation

201 Fifth Avenue, S.W.

Olympia, Washington 98501

(360) 943-1500

Attention: Corporate Secretary

In addition, we maintain a corporate website, www.HF-WA.com. We make available through our website our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. This reference to our website is for the convenience of investors as required by the SEC and shall not be deemed to incorporate any information on the website into this prospectus supplement.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus supplement, the accompanying prospectus and the documents incorporated by reference may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements often include the words believes, expects, anticipates, estimates, forecasts, intends, plans, targets, potentially, probably, projects, outlook or similar conditional verbs such as may, will, should, would and could. These forward-looking statements are subject to known and unknown risks

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uncertainties and other factors that could cause actual results to differ materially from the results anticipated, including:

the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets;

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changes in general economic conditions, either nationally or in our market areas;

changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources;

fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas;

results of examinations of us by the Board of Governors of the Federal Reserve System (the Federal Reserve Board) and of our bank subsidiaries by the Federal Deposit Insurance Corporation (the FDIC), the Washington State Department of Financial Institutions, Division of Banks (the Washington DFI) or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings;

legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, including the interpretation of regulatory capital or other rules;

our ability to control operating costs and expenses;

the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;

difficulties in reducing risk associated with the loans on our balance sheet;

staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;

computer systems on which we depend could fail or experience a security breach;

our ability to retain key members of our senior management team;

costs and effects of litigation, including settlements and judgments;

our ability to implement our branch expansion strategy;

our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto;

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changes in consumer spending, borrowing and savings habits;

the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions;

adverse changes in the securities markets;

inability of key third-party providers to perform their obligations to us;

changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods;

other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and the other risks described elsewhere in this prospectus supplement, the accompanying prospectus and the incorporated documents; and

future legislative changes in the TARP Capital Purchase Program.

Some of these and other factors are discussed in this prospectus supplement under the caption "Risk Factors" and elsewhere in this prospectus supplement and in the incorporated documents. Such developments could have an adverse impact on our financial position and our results of operations.

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Any forward-looking statements are based upon management's beliefs and assumptions at the time they are made. We undertake no obligation to publicly update or revise any forward-looking statements included or incorporated by reference in this prospectus supplement or the accompanying prospectus or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking statements discussed in this prospectus supplement or the accompanying prospectus or the incorporated documents might not occur, and you should not put undue reliance on any forward-looking statements.

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PROSPECTUS SUPPLEMENT SUMMARY

This summary highlights information contained elsewhere in, or incorporated by reference into, this prospectus supplement and the accompanying prospectus. As a result, it does not contain all of the information that may be important to you or that you should consider before investing in our common stock. You should read this entire prospectus supplement and accompanying prospectus, including the Risk Factors section, and the documents incorporated by reference, which are described under Incorporation of Certain Documents by Reference in this prospectus supplement. Unless otherwise expressly stated or the context otherwise requires, all information in this prospectus supplement assumes that the underwriters do not exercise their option to purchase additional shares of our common stock to cover over-allotments, if any.

Heritage Financial Corporation

Heritage Financial Corporation is a bank holding company incorporated in the State of Washington. We are primarily engaged in the business of planning, directing and coordinating the business activities of our wholly owned bank subsidiaries, Heritage Bank and Central Valley Bank. Heritage Bank is a Washington-chartered commercial bank that conducts business from its main office in Olympia, Washington and its 13 branch offices located in Thurston, Pierce, Mason and south King counties in Washington. Central Valley Bank is a Washington-chartered commercial bank that conducts business from its main office in Toppenish, Washington and its five branch offices located in Yakima and Kittitas counties in Washington. As a bank holding company, Heritage Financial Corporation is subject to regulation by the Federal Reserve Board. Heritage Bank and Central Valley Bank are subject to regulation by the Washington DFI and the FDIC. As of June 30, 2009, we had total consolidated assets of \$966.8 million, total net loans receivable of \$761.2 million, total deposits of \$842.1 million and total stockholders' equity of \$111.4 million.

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

Heritage Bank, the larger of our two bank subsidiaries, was established in 1927 and primarily serves the South Puget Sound region of Washington. Originally founded as a savings and loan, Heritage Bank implemented a growth strategy in 1994 to expand its offerings from traditional savings and loan products to a full range of products and services for both personal and business banking, which culminated in its conversion to a commercial bank charter in 2004. We acquired our other subsidiary bank, Central Valley Bank, in 1999. Central Valley Bank first opened for business in 1962 and serves the Yakima Valley region of Washington with a primary focus on small business and agricultural lending.

In addition to our acquisition of Central Valley Bank, we have completed two other acquisitions. In 1998, we acquired North Pacific Bank, a Washington-chartered commercial bank in Tacoma, Washington. In 2006, we acquired Western Washington Bancorp and its wholly owned subsidiary, Washington State Bank, N.A. located in Federal Way, Washington. Both banks were merged into Heritage Bank.

Our common stock is listed on the Nasdaq Global Select Market under the symbol HFWA. Our principal executive offices are located at 201 Fifth Avenue S.W., Olympia, Washington 98501. Our telephone number is (360) 943-1500.

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Our Strategies

Our primary objective is to be a well-capitalized, profitable community banking organization, with balanced growth while emphasizing lending and deposit relationships with small and medium size businesses along with their owners and the general public. We consider ourselves as an innovative team providing financial services focusing on the success of our customers. Our stated mission is: Continuously Improve Customer Satisfaction, Employee Empowerment and Shareholder Value. We will seek to achieve our objective through the following strategies:

Emphasize business relationships with a focus on commercial lending. We will continue to provide primarily commercial business, commercial real estate and residential construction loans with an emphasis on owner occupied commercial real estate and commercial business lending, and the deposit balances that accompany these relationships. We provide our business customers with an array of competitive deposit and cash management products through a variety of delivery channels with state of the art technologies. Our lending staff is well seasoned with extensive knowledge of our markets and adds value through a focused advisory role that we believe strengthens our customer relationships and loyalty. We currently have and will seek to maintain a diversified portfolio of lending relationships without concentrations in any industry.

Focus on Asset Quality. A strong credit culture is a high priority for us. We have a well-developed credit approval structure that has enabled us to maintain a standard of asset quality that we believe is conservative while maintaining our investment objectives. We will continue to focus on loan types and markets that we know well and have a historical record of success. We focus on loan relationships that are well diversified in both size and industry types. With respect to commercial business lending, which is our predominant lending activity, we view ourselves as cash-flow lenders obtaining additional support from realistic collateral values, personal guarantees and secondary sources of repayment. We have a problem loan resolution process that is focused on quick detection and solutions. We seek to maintain strong internal controls and subject our loans to periodic internal loan review as well as a third party loan review process.

Maintain Strong Balance Sheet. In addition to our focus on our underwriting, we believe that the strength of our balance sheet has thus far enabled us to endure the economic downturn afflicting the Pacific Northwest better than many of our competitors. While our non-performing loans have recently increased, our loan loss coverage ratios have remained strong. As of June 30, 2009, the ratio of our allowance for loan losses to total loans was 3.02% and the ratio of the allowance to non-performing loans was 104.1%. Our liquidity position is also strong, with \$82.5 million in cash and cash equivalents as of June 30, 2009. As of June 30, 2009, the regulatory capital ratios of our subsidiary banks were well in excess of the levels required for well-capitalized status, and our consolidated total risk-based capital, Tier 1 risk-based capital and leverage ratios were 14.0%, 12.7% and 10.3%, respectively.

Deposit Growth. Our strategic focus is to continuously grow deposits with emphasis on total relationship banking with our business and retail customers. We continue to seek to increase our market share in our communities by providing exceptional customer service, business development strategies and branch expansion. Our primary focus is to maintain a high level of non-maturity deposits to internally fund our loan growth with a low reliance on maturity (certificate) deposits. From June 30, 2008 to June 30, 2009, as a percentage of our total deposits, non-maturity deposits increased from 57.2% to 61.2%. We maintain state of the art technology-based products, such as on-line personal financial management, business cash management, and business remote deposit products that enable us to compete effectively with banks of all sizes. Our retail management team is well seasoned and has strong ties to the communities we serve with a strong focus on relationship building.

Recruit and retain highly competent personnel to execute our strategies. Our compensation and staff development programs are aligned with our strategies to grow our loans and core deposits while

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

Seek to expand geographically as opportunities present themselves. We believe that consolidation of community banks will continue to take place and further believe that, with our capital and liquidity positions and approach to credit management, we are well positioned to take advantage of acquisitions or other business opportunities in our market areas including FDIC-assisted transactions. In markets where we wish to enter or expand our business, we will also consider opening *de novo* offices. In the past, we have successfully integrated acquired institutions and opened *de novo* branches. We will continue to be disciplined and opportunistic as it pertains to future acquisitions and *de novo* branching focusing on the Pacific Northwest markets we know and understand.

Risk Factors

An investment in our common stock involves certain risks. You should carefully consider the risks described under **Risk Factors** beginning on page S-13 of this prospectus supplement and in the **Risk Factors** section included in our Annual Report on Form 10-K for the year ended December 31, 2008, as well as other information included or incorporated by reference into this prospectus supplement and the accompanying prospectus, including our financial statements and the notes thereto, before making an investment decision. See **Incorporation of Certain Documents by Reference**.

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The Offering

Common stock we are offering shares

Common stock to be outstanding after this offering shares(1)(2)

Use of proceeds Our estimated net proceeds from this offering are approximately \$ million, or approximately \$ million if the underwriters exercise their over-allotment option in full, after deducting underwriting discounts and commissions and other estimated expenses of this offering. We intend to use the net proceeds of this offering for general corporate purposes, which may include, without limitation, investments at the holding company level, providing capital to support the growth of our subsidiary banks and acquisitions or other business opportunities in our market areas, including FDIC-assisted transactions. We may also seek the approval of our regulators to utilize the proceeds of this offering and other cash available to us to repurchase all or a portion of the securities described below that we issued to the U.S. Department of the Treasury (the Treasury). See Use of Proceeds.

Dividends on common stock In the second quarter of 2009, our board of directors suspended our quarterly cash dividend in light of the current economic environment for financial institutions as well as our capital needs. See Price Range of Common Stock and Dividend Information.

Nasdaq Global Select Market Symbol HFWA

Settlement Date Delivery of shares of our common stock will be made against payment therefor on or about September , 2009.

(1) The number of our shares outstanding immediately after the closing of this offering is based on 6,707,094 shares of common stock outstanding as of August 31, 2009.

(2) Unless otherwise indicated, the number of shares of common stock presented in this prospectus supplement excludes shares issuable pursuant to the exercise of the underwriters' over-allotment option, excludes 545,068 shares of common stock issuable upon exercise of outstanding stock options as of August 31, 2009, with a weighted average exercise price of \$19.35 per share, 398,328 shares of common stock issuable pursuant to potential future awards under our equity compensation plans, and the Warrant (as defined below) for 276,074 shares of common stock held by the Treasury.

On November 21, 2008, we issued \$24.0 million of our Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Series A Preferred Stock) to the Treasury pursuant to the Troubled Asset Relief Program (TARP) Capital Purchase Program, together with a ten-year warrant to purchase up to 276,074 shares of our common stock at an initial exercise price of \$13.04 per share (the Warrant). If this offering and any other qualified equity offering that we may make prior to December 31, 2009 result in aggregate gross proceeds of at least \$24.0 million, the number of shares of our common stock underlying the Warrant will be reduced by 50% to 138,037 shares.

Table of Contents**Selected Historical Financial Information**

The following table sets forth selected consolidated financial information as of and for the years ended December 31, 2008, 2007, 2006, 2005 and 2004 (which has been derived from our audited consolidated financial statements), and as of and for the six months ended June 30, 2009 and 2008 (which is unaudited). The unaudited financial information as of and for the six months ended June 30, 2009 and 2008 has been prepared on the same basis as our audited financial statements and includes, in the opinion of management, all adjustments necessary to fairly present the data for such periods. The results of operations for the six months ended June 30, 2009 are not necessarily indicative of the results of operations to be expected for the full year or any future period. This information should be read in conjunction with our consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2008, as amended, and our Quarterly Report on Form 10-Q for the quarter ended June 30, 2009. See Incorporation of Certain Documents by Reference.

Our summary consolidated financial information and other financial data contain information determined by methods other than in accordance with Generally Accepted Accounting Principles (GAAP). These measures include tangible book value per common share and tangible common equity to tangible assets. Tangible book value per common share may be important to investors interested in changes from period to period in book value per share exclusive of changes in intangible assets. Tangible common equity to tangible assets may be important to many investors interested in the equity to assets ratio exclusive of the effect of changes in intangible assets on equity and total assets. Reconciliations of the GAAP and the non-GAAP financial measures presented are contained within the summary consolidated financial information table.

	For the Six Months Ended June 30,		For the years ended December 31,				
	2009	2008	2008	2007	2006	2005	2004
	(Dollars in thousands, except per share data)						
Operations Data:							
Net interest income	\$ 20,413	\$ 18,453	\$ 38,342	\$ 36,621	\$ 35,772	\$ 33,881	\$ 31,727
Provision for loan losses	9,740	1,070	7,420	810	720	810	645
Noninterest income	4,309	4,520	8,824	8,572	7,954	6,630	6,498
Noninterest expense	15,906	15,256	30,419	28,288	27,082	24,183	23,270
Federal income tax (benefit) expense	(471)	2,183	2,976	5,387	5,377	5,042	4,725
Net income (loss)	(503)	4,464	6,351	10,708	10,547	10,476	9,585
Dividends accrued and discount accreted on preferred shares	659		143				
Net income (loss) applicable to common stockholders	(1,162)	4,464	6,208	10,708	10,547	10,476	9,585
Earnings (loss) per common share							
Basic	(0.18)	0.67	0.94	1.63	1.65	1.69	1.53
Diluted	(0.18)	0.67	0.93	1.61	1.60	1.65	1.49
Cash dividends per common share(1)	0.10	0.42	0.56	0.84	0.81	0.71	0.62
Performance Ratios:							
Net interest spread(2)	4.31%	3.98%	4.11%	3.86%	4.30%	4.75%	4.91%
Net interest margin(3)	4.64%	4.50%	4.59%	4.50%	4.83%	5.08%	5.13%
Efficiency ratio(4)	64.34%	66.41%	64.50%	62.59%	61.94%	59.69%	60.88%
Return on average assets(5)	(0.11)%	1.02%	0.71%	1.23%	1.33%	1.46%	1.44%
Return on average common equity(5)	(2.60)%	10.20%	6.98%	12.87%	14.18%	16.13%	15.80%
Ratios of Earnings to Fixed Charges and Preferred Stock Dividend Requirement(6)							
Including interest on deposits	0.86x	1.65x	1.50x	1.62x	1.82x	2.34x	2.98x
Excluding interest on deposits	(7)	38.77x	20.23x	11.46x	14.03x	17.28x	30.03x

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	As of June 30,		As of December 31,				
	2009	2008	2008	2007	2006	2005	2004
Balance Sheet Data:							
Total assets	\$ 966,763	\$ 901,481	\$ 946,145	\$ 886,055	\$ 852,893	\$ 751,152	\$ 697,267
Loans receivable, net	761,160	786,347	793,303	768,945	739,596	643,538	591,085
Loans held for sale	2,431	160	304	447		263	381
Deposits	842,103	800,989	824,480	776,280	725,921	636,504	587,278
Federal Home Loan Bank advances		5,605		14,990	37,167	39,900	40,900
Stockholders' equity	111,374	87,295	113,147	84,967	78,639	66,120	60,944
Less: goodwill	13,012	13,012	13,012	13,012	13,081	6,640	6,640
Less: other intangible assets	385	463	424	502	580		
Tangible equity	97,977	73,820	99,711	71,453	64,978	59,480	54,304
Less: preferred stock	23,426		23,367				
Tangible common equity	74,551	73,820	76,344	71,453	64,978	59,480	54,304
Book value per common share	13.11	13.05	13.40	12.79	11.99	10.57	9.76
Less: goodwill and other tangible assets per common share	2.00	2.02	2.00	2.03	2.08	1.06	1.06
Tangible book value per common share(8)	11.11	11.03	11.40	10.76	9.91	9.51	8.70
Equity to assets ratio	11.52%	9.68%	11.96%	9.59%	9.22%	8.80%	8.74%
Capital Ratios:							
Average equity to average assets	11.7%	10.0%	10.3%	9.5%	9.4%	9.1%	9.1%
Tangible common equity to tangible assets(9)	7.8%	8.3%	8.2%	8.2%	7.7%	8.0%	7.9%
Total risk-based capital ratio	14.0%	10.8%	13.7%	10.7%	10.4%	10.8%	10.8%
Tier 1 risk-based capital ratio	12.7%	9.5%	12.5%	9.5%	9.1%	9.5%	9.6%
Leverage ratio	10.3%	8.5%	11.0%	8.2%	8.0%	8.2%	8.0%
Asset Quality Ratios:							
Nonperforming loans to loans	2.90%	0.98%	0.42%	0.13%	0.37%	0.13%	0.05%
Allowance for loan losses to loans	3.02%	1.41%	1.91%	1.33%	1.35%	1.30%	1.38%
Allowance for loan losses to nonperforming loans	104.1%	144.3%	454.0%	1,016.1%	360.1%	1,016.3%	2,603.6%
Nonperforming assets to total assets	2.39%	0.94%	0.57%	0.13%	0.36%	0.16%	0.05%
Other Data:							
Number of banking offices	20	20	20	20	20	18	18
Number of full-time equivalent employees	225	230	217	224	233	211	196

- (1) Revised for stock dividends. During the first quarter of 2009 we suspended our cash dividends on our common stock to preserve our capital.
- (2) Net interest spread is the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities.
- (3) Net interest margin is net interest income divided by average interest earning assets.
- (4) The efficiency ratio is noninterest expense divided by the sum of net interest income and noninterest income.
- (5) Ratios for the six month periods are annualized.

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- (6) The ratio of earnings to fixed charges and preferred stock dividend requirement is computed by dividing (i) the sum of income before income taxes and total fixed charges by (ii) the sum of total fixed charges and preferred stock dividend requirement (pre-tax). The preferred stock dividend requirement (pre-tax) is computed as the amount of the preferred stock dividend divided by (1 minus the applicable effective income tax rate). Prior to the issuance of our Series A Preferred Stock in the fourth quarter of 2008, we had no shares of preferred stock outstanding. For purposes of computing these ratios, fixed charges excluding interest on deposits represents interest expense on Federal Home Loan Bank advances and other borrowed funds and fixed charges including interest on deposits represents all interest expense.
- (7) The earnings coverage for the period was inadequate to cover fixed charges. The coverage deficiency for the period was \$509,000.
- (8) Tangible book value per common share is defined as total shareholders' equity, less any outstanding preferred stock, reduced by recorded goodwill and other intangible assets divided by total common shares outstanding.
- (9) Tangible common equity to tangible assets is defined as total shareholders' equity, less any outstanding preferred stock, reduced by recorded goodwill and other intangible assets divided by total assets reduced by recorded goodwill and other intangible assets.

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RISK FACTORS

An investment in our common stock involves certain risks. Before you invest in our common stock, you should be aware that there are various risks, including those described below, which could affect the value of your investment in the future. The trading price of our common stock could decline due to any of these risks, and you may lose all or part of your investment. The risk factors described in this section, as well as any cautionary language in this prospectus supplement, provide examples of risks, uncertainties and events that could have a material adverse effect on our business, including our operating results and financial condition. This prospectus supplement also contains forward-looking statements that involve risks and uncertainties. These risks could cause our actual results to differ materially from the expectations that we describe in our forward-looking statements. You should carefully consider the risks described below and the risk factors included in our Annual Report on Form 10-K for the year ended December 31, 2008, as well as the other information included or incorporated by reference in this prospectus supplement and the accompanying prospectus, before making an investment decision.

Risks Associated with Our Business

The current economic recession in the market areas we serve may continue to adversely impact our earnings and could increase our credit risk associated with our loan portfolio.

Substantially all of our loans are to businesses and individuals in the state of Washington, and a continuing decline in the economies of our primary market areas of the south Puget Sound and Yakima Valley regions of Washington could have a material adverse effect on our business, financial condition, results of operations and prospects. In particular, the Puget Sound region has experienced substantial home price declines and increased foreclosures. A series of large Puget Sound-based businesses have implemented substantial employee layoffs and scaled back plans for future growth. Additionally, acquisitions and consolidations have resulted in substantial employee layoffs, along with a significant increase in office space vacancies in downtown Seattle. The Yakima Valley has likewise seen increased unemployment and a continued decline in housing prices.

A further deterioration in economic conditions in the market areas we serve could result in the following consequences, any of which could have a materially adverse impact on our business, financial condition and results of operations:

loan delinquencies, problem assets and foreclosures may increase;

demand for our products and services may decline;

collateral for loans made may decline further in value, in turn reducing customers' borrowing power, reducing the value of assets and collateral associated with existing loans; and

low cost or non-interest bearing deposits may decrease.

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

Repayment of our commercial business loans is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value. We offer different types of commercial loans to a variety of businesses with an emphasis on real estate related industries and businesses in agricultural, healthcare, legal, and other professions. The types of commercial loans offered are business lines of credit, term equipment financing and term real estate loans. We also originate loans that are guaranteed by the Small Business Administration (SBA) and are a preferred lender of the SBA. Commercial business lending involves risks that are different from those associated with real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial business loans are primarily made based on the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrowers' cash flow may be

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unpredictable, and collateral securing these loans may fluctuate in value. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable, or other business assets, the liquidation of collateral in the event of default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories may be obsolete or of limited use, among other things. Accordingly, the repayment of commercial business loans depends primarily on the cash flow and credit worthiness of the borrower and secondarily on the underlying collateral provided by the borrower. In addition, as part of our commercial business lending activities, we originate agricultural loans. Payments on agricultural loans are typically dependent on the profitable operation or management of the related farm property. The success of the farm may be affected by many factors outside the control of the borrower, including adverse weather conditions that prevent the planting of a crop or limit crop yields, declines in market prices for agricultural products and the impact of government regulations. In addition, many farms are dependent on a limited number of key individuals whose injury or death may significantly affect the successful operation of the farm. If the cash flow from a farming operation is diminished, the borrower's ability to repay the loan may be impaired.

As of June 30, 2009, our commercial business loans totaled \$436.6 million, or approximately 55.5% of our total loan portfolio.

Our income property loans, consisting of commercial and multi-family real estate loans, involve higher principal amounts than other loans and repayment of these loans may be dependent on factors outside our control or the control of our borrowers. We originate commercial and multi-family real estate loans for individuals and businesses for various purposes, which are secured by commercial properties. These loans typically involve higher principal amounts than other types of loans, and repayment is dependent upon income generated, or expected to be generated, by the property securing the loan in amounts sufficient to cover operating expenses and debt service, which may be adversely affected by changes in the economy or local market conditions. For example, if the cash flow from the borrower's project is reduced as a result of leases not being obtained or renewed, the borrower's ability to repay the loan may be impaired. Commercial and multifamily mortgage loans also expose a lender to greater credit risk than loans secured by residential real estate because the collateral securing these loans typically cannot be sold as easily as residential real estate. In addition, many of our commercial and multifamily real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment.

If we foreclose on a commercial and multi-family real estate loan, our holding period for the collateral typically is longer than for one-to-four family residential mortgage loans because there are fewer potential purchasers of the collateral. Additionally, commercial and multi-family real estate loans generally have relatively large balances to single borrowers or related groups of borrowers. Accordingly, if we make any errors in judgment in the collectability of our commercial and multi-family real estate loans, any resulting charge-offs may be larger on a per loan basis than those incurred with our residential or consumer loan portfolios.

As of June 30, 2009, our commercial and multi-family real estate loans totaled \$213.8 million, or 27.2% of our total loan portfolio.

Our construction loans are based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project's completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, our estimates with regards to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If our estimate of the value of a project at completion proves to be overstated, we may have inadequate security for repayment of the loan and we may incur a loss.

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As of June 30, 2009, construction loans totaled \$115.0 million, or approximately 14.5% of our total loan portfolio. Of these loans, \$62.9 million, or approximately 54.7%, were residential construction-related and \$52.1 million, or approximately 45.3%, were multi-family and commercial construction-related. Approximately \$16.1 million, or 14.0%, of our total construction loans were non-performing at June 30, 2009.

At June 30, 2009, our largest lending relationship to one borrower was classified as potential problem loans. The loans are to a builder/developer of single-family homes/lots in Pierce County, Washington and are secured by several homes under construction as well as approximately 200 completed single-family lots ready for sale. Pierce County has had a significant slowdown in homes sales and this slowdown has affected the borrower's ability to sell lots and repay the loans as originally planned. At June 30, 2009, these loans had an approximate balance of \$17 million. Since June 30, 2009, updated appraisals were obtained on all collateral, which justified current carrying values. It is becoming more likely these loans will become non-accrual loans in the future. While at this time we do not anticipate the need for additional reserves in the event these loans are placed on non-accrual status, no assurance can be given in this regard. These loans were a contributing factor to the increase in the provision for loan losses for the quarter ended June 30, 2009.

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

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

cash flow of the borrower and/or the project being financed;

the changes and uncertainties as to the future value of the collateral, in the case of a collateralized loan;

the credit history of a particular borrower;

changes in economic and industry conditions; and

the duration of the loan.

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

our general reserve, based on our historical default and loss experience;

our specific reserve, based on our evaluation of non-performing loans and their underlying collateral; and

current macroeconomic factors.

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for loan losses, we will need additional provisions to increase the allowance for loan losses. Any increases in the allowance for loan losses will result in a decrease in net income and, possibly, capital, and may have a material adverse effect on our financial condition and results

of operations.

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If our allowance for loan losses is not adequate, we may be required to make further increases in our provisions for loan losses and to charge off additional loans, which could adversely affect our results of operations and our capital.

For the quarter ended June 30, 2009 we recorded a provision for loan losses of \$4.5 million compared to \$710,000 for the quarter ended June 30, 2008, an increase of \$3.8 million. We also recorded net loan charge-offs of \$988,000 for the quarter ended June 30, 2009 compared to \$156,000 for the quarter ended June 30, 2008. For the six months ended June 30, 2009, we recorded a provision for loan losses of \$9.8 million compared to \$1.1 million for the six months ended June 30, 2008, an increase of \$8.7 million. We also recorded net loan charge-offs of \$1.5 million for the six months ended June 30, 2009 compared to \$200,000 for the six months ended June 30, 2008. For the year ended December 31, 2008 we recorded a provision for loan losses of \$7.4 million compared to \$810,000 for the year ended December 31, 2007, an increase of \$6.6 million. We also recorded net loan charge-offs of \$2.4 million for the year ended December 31, 2008 compared to \$541,000 for the year ended December 31, 2007. We are experiencing increasing loan delinquencies and credit losses. Generally, our non-performing loans and assets reflect operating difficulties of individual borrowers resulting from weakness in the local economy; however, more recently the deterioration in the general economy has become a significant contributing factor to the increased levels of delinquencies and non-performing loans. Slower sales and excess inventory in the housing market has been the primary cause of the increase in delinquencies and foreclosures for residential construction and land development loans, which represent 69.7% of our nonperforming assets at June 30, 2009. In addition, slowing housing sales have been a contributing factor to the increase in non-performing loans as well as the increase in delinquencies. At June 30, 2009 our total non-performing loans had increased to \$22.8 million or 2.9% of total loans compared to \$3.4 million or 0.4% of total loans at December 31, 2008. If current trends in the housing and real estate markets continue, we expect that we will continue to experience higher than normal delinquencies and credit losses. Moreover, if a prolonged recession occurs, we expect that it could severely impact economic conditions in our market areas and that we could experience significantly higher delinquencies and credit losses. As a result, we may be required to make further increases in our provision for loan losses and to charge off additional loans in the future, which could adversely affect our financial condition and results of operations, perhaps materially.

We cannot accurately predict the effect of the national economic recession on our future results of operations or market price of our stock.

The national economy and the financial services sector in particular are currently facing challenges of a scope unprecedented in recent history. We cannot accurately predict the severity or duration of the current economic recession, which has adversely impacted the markets we serve. Any further deterioration in the economies of the nation as a whole or in our local markets would have an adverse effect, which could be material, on our business, financial condition, results of operations and prospects, and could also cause the market price of our stock to decline. While it is impossible to predict how long these recessionary conditions may exist, the economic downturn could continue to present risks for some time for our industry and our company.

Further economic downturns may adversely affect our investment securities portfolio.

The deterioration in the credit markets created market volatility and illiquidity, resulting in significant declines in the market values of a broad range of investment products. We continue to monitor our investment portfolio for deteriorating collateral values and other-than-temporary impairments. Any other than temporary impairments would adversely affect our operating results.

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

Accounting standards require that we account for acquisitions using the purchase method of accounting. Under purchase accounting, if the purchase price of an acquired company exceeds the fair value of its net assets, the excess is carried on the acquirer's balance sheet as goodwill. In accordance with generally accepted accounting principles, our goodwill is evaluated for impairment on an annual basis or more frequently if events

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or circumstances indicate that a potential impairment exists. Such evaluation is based on a variety of factors, including the quoted price of our common stock, market prices of common stock of other banking organizations, common stock trading multiples, discounted cash flows, and data from comparable acquisitions.

During the quarters ended March 31, 2009 and June 30, 2009, due to poor overall economic conditions and declines in our stock price, we determined that a triggering event requiring an interim goodwill impairment analysis had occurred and conducted an interim impairment test of goodwill. Even though, based on these tests, it was determined that there was no goodwill impairment during the quarters ended March 31, 2009 and June 30, 2009, continued declines in our stock price or additional adverse changes in the operating environment of the financial services industry may result in a future impairment charge. Any such impairment charge could have a material adverse affect on our operating results and capital.

Fluctuating interest rates can adversely affect our profitability.

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

The FDIC has increased deposit insurance premiums to restore and maintain the federal deposit insurance fund, which has increased our costs.

During the second quarter of 2009, the FDIC increased deposit insurance assessment rates generally and imposed a special assessment of five basis points on each insured institution's total assets less Tier 1 capital. This special assessment will be calculated based on the insured institution's assets at June 30, 2009, and collected on September 30, 2009. Based on the assets of our subsidiary banks as of June 30, 2009 subject to the FDIC assessment, the special assessments on our subsidiary banks totaled approximately \$437,000. This special assessment is in addition to the regular quarterly risk-based assessment. The FDIC has announced that an additional special assessment in 2009 of up to five basis points is probable.

The FDIC deposit insurance fund may suffer additional losses in the future due to bank failures. There can be no assurance that there will not be additional significant deposit insurance premium increases in order to restore the insurance fund's reserve ratio.

We may grow through future acquisitions, which could, in some circumstances, adversely affect our profitability measures.

We may engage in selected acquisitions of financial institutions in the future, which may involve the issuance of additional common stock, including FDIC-assisted transactions. Any such acquisitions and related issuances of stock may have dilutive effect on earnings per share and the percentage ownership of current shareholders. There are risks associated with our acquisition strategy that could adversely impact our profitability. These risks include, among others, incorrectly assessing the asset quality of a particular institution being acquired, encountering greater than anticipated costs of incorporating acquired businesses into our company, and being unable to profitably deploy funds acquired in an acquisition. Furthermore, we cannot provide any assurance as to the extent to which we can continue to grow through acquisitions.

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

We originate and sell mortgage loans as well as broker mortgage loans. Changes in interest rates affect demand for our loan products and the revenue realized on the sale of loans. A decrease in the volume of loans sold/brokered can decrease our revenues and net income.

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The tightening of available liquidity could limit our ability to replace deposits and fund loan demand, which could adversely affect our earnings and capital levels.

A tightening of the credit markets and the inability to obtain adequate funding to replace deposits and fund continued loan growth may negatively affect asset growth and, consequently, our earnings capability and capital levels. In addition to any deposit growth, maturity of investment securities and loan payments, we rely from time to time on advances from the Federal Home Loan Bank of Seattle and certain other wholesale funding sources to fund loans and replace deposits. In the event of a further downturn in the economy, these additional funding sources could be negatively affected which could limit the funds available to us. Our liquidity position could be significantly constrained if we were unable to access funds from the Federal Home Loan Bank of Seattle or other wholesale funding sources.

Our growth or future losses may require us to raise additional capital in the future, but that capital may not be available when it is needed or the cost of that capital may be very high.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. With the proceeds of the offering made by this prospectus supplement, we anticipate that our capital resources will satisfy our capital requirements for the foreseeable future. We may at some point need to raise additional capital to support continued growth, both internally and through acquisitions.

Our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial condition and performance. Accordingly, we cannot make assurances of our ability to raise additional capital if needed, or if the terms will be acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth and acquisitions could be materially impaired and our financial condition and liquidity could be materially and adversely affected.

We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations, including rules and policies applicable to participants in the TARP Capital Purchase Program.

We are subject to extensive regulation, supervision and examination by federal and state banking authorities. Any change in applicable regulations or laws could have a substantial impact on us and our operations. Additional legislation and regulations that could significantly affect our powers, authority and operations may be enacted or adopted in the future, which could have a material adverse effect on our financial condition and results of operations. The rules and policies applicable to recipients of capital under the TARP Capital Purchase Program have been significantly revised and supplemented since the inception of that program, and continue to evolve. Further, our regulators have significant discretion and authority to prevent or remedy unsafe or unsound practices or violations of laws by financial institutions and holding companies in the performance of their supervisory and enforcement duties. The exercise of regulatory authority generally may have a negative impact, which may be material, on our results of operations and financial condition.

Risks Relating to the Offering and our Common Stock

The price of our common stock may fluctuate significantly, and this may make it difficult for you to resell our common stock when you want or at prices you find attractive.

We cannot predict how our common stock will trade in the future. The market value of our common stock will likely continue to fluctuate in response to a number of factors including the following, most of which are beyond our control, as well as the other factors described in this Risk Factors section:

actual or anticipated quarterly fluctuations in our operating and financial results;

developments related to investigations, proceedings or litigation that involve us;

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changes in financial estimates and recommendations by financial analysts;

dispositions, acquisitions and financings;

actions of our current shareholders, including sales of common stock by existing shareholders and our directors and executive officers;

fluctuations in the stock prices and operating results of our competitors;

regulatory developments; and

other developments related to the financial services industry.

The market value of our common stock may also be affected by conditions affecting the financial markets in general, including price and trading fluctuations. These conditions may result in (i) volatility in the level of, and fluctuations in, the market prices of stocks generally and, in turn, our common stock and (ii) sales of substantial amounts of our common stock in the market, in each case that could be unrelated or disproportionate to changes in our operating performance. These broad market fluctuations may adversely affect the market value of our common stock.

There may be future sales of additional common stock or other dilution of our equity, which may adversely affect the market price of our common stock.

Except as described under "Underwriting," we are not restricted from issuing additional common stock or preferred stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, common stock or preferred stock or any substantially similar securities. The market price of our common stock could decline as a result of sales by us of a large number of shares of common stock or preferred stock or similar securities in the market after this offering or from the perception that such sales could occur.

Our board of directors is authorized generally to cause us to issue additional common stock, as well as series of preferred stock, without any action on the part of our shareholders except as may be required under the listing requirements of the Nasdaq Stock Market. In addition, the board has the power, without shareholder approval, to set the terms of any such series of preferred stock that may be issued, including voting rights, dividend rights and preferences over the common stock with respect to dividends or upon the liquidation, dissolution or winding-up of our business and other terms. If we issue preferred stock in the future that has a preference over the common stock with respect to the payment of dividends or upon liquidation, dissolution or winding-up, or if we issue preferred stock with voting rights that dilute the voting power of the common stock, the rights of holders of the common stock or the market price of the common stock could be adversely affected.

We will retain broad discretion in using the net proceeds from this offering, and may not use the proceeds effectively.

We intend to use the net proceeds of this offering for general corporate purposes, which may include, without limitation, investments at the holding company level, providing capital to support the growth of our subsidiary banks and acquisitions or other business opportunities. We may also seek the approval of our regulators to utilize the proceeds of this offering and other cash available to us to repurchase all or a portion of the Series A Preferred Stock and the Warrant we issued to the Treasury pursuant to the TARP Capital Purchase Program. We have not determined if, or when, we will seek the approval of our regulators to repurchase the Series A Preferred Stock and the Warrant, and no assurance can be given that such approval will be granted if requested.

We have not designated the amount of net proceeds we will use for any particular purpose. Accordingly, our management will retain broad discretion to allocate the net proceeds of this offering. The net proceeds may be applied in ways with which you and other investors in the offering may not agree. Moreover, our management may use the proceeds for corporate purposes that may not increase our market value or make us more profitable.

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In addition, it may take us some time to effectively deploy the proceeds from this offering. Until the proceeds are effectively deployed, our return on equity and earnings per share may be negatively impacted. Management's failure to use the net proceeds of this offering effectively could have an adverse effect on our business, financial condition and results of operations.

Regulatory and contractual restrictions may limit or prevent us from paying dividends on our common stock.

Heritage Financial Corporation is an entity separate and distinct from its bank subsidiaries, and derives substantially all of its revenue in the form of dividends from those subsidiaries. Accordingly, Heritage Financial Corporation is and will be dependent upon dividends from its subsidiary banks to pay the principal of and interest on its indebtedness, to satisfy its other cash needs and to pay dividends on its common and preferred stock. The banks' abilities to pay dividends are subject to their ability to earn net income and to meet certain regulatory requirements. In the event the banks were unable to pay dividends to Heritage Financial Corporation, Heritage Financial Corporation may not be able to pay dividends on its common or preferred stock. Also, Heritage Financial Corporation's right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors.

The securities purchase agreement between us and the Treasury we entered into in connection with the TARP Capital Purchase Program provides that prior to the earlier of (i) November 21, 2011 and (ii) the date on which all of the shares of the Series A Preferred Stock we issued to the Treasury have been redeemed by us or transferred by the Treasury to third parties, we may not, without the consent of the Treasury, (a) increase the cash dividend on our common stock to more than \$0.14 per share or (b) subject to limited exceptions, redeem, repurchase or otherwise acquire shares of our common stock or preferred stock (other than the Series A Preferred Stock) or any trust preferred securities then outstanding. We also are unable to pay any dividends on our common stock unless we are current in our dividend payments on the Series A Preferred Stock. These restrictions, together with the potentially dilutive impact of the Warrant we issued to the Treasury described below, could have a negative effect on the value of our common stock. Moreover, holders of our common stock are entitled to receive dividends only when, as and if declared by our board of directors. Our board of directors recently determined to suspend the payment of cash dividends on our common stock to preserve capital in the current environment. No assurance can be given as to when or whether our board will resume the payment of a cash dividend on our common stock.

Our common stock constitutes equity and is subordinate to our existing and future indebtedness and our Series A Preferred Stock, and effectively subordinated to all the indebtedness and other non-common equity claims against our subsidiaries.

The shares of our common stock represent equity interests in us and do not constitute indebtedness. Accordingly, the shares of our common stock will rank junior to all of our indebtedness and to other non-equity claims on Heritage Financial Corporation with respect to assets available to satisfy claims on Heritage Financial Corporation. Additionally, holders of our common stock are subject to the prior dividend and liquidation rights of the holder(s) of our Series A Preferred Stock. The Series A Preferred Stock has an aggregate liquidation preference of \$24.0 million. As noted above, the terms of the Series A Preferred Stock prohibit us from paying dividends with respect to our common stock unless all accrued and unpaid dividends for all completed dividend periods with respect to the Series A Preferred Stock have been paid.

In addition, our right to participate in any distribution of assets of any of our subsidiaries upon the subsidiary's liquidation or otherwise, and thus your ability as a holder of our common stock to benefit indirectly from such distribution, will be subject to the prior claims of creditors of that subsidiary, except to the extent that any of our claims as a creditor of such subsidiary may be recognized. As a result, holders of our common stock will be effectively subordinated to all existing and future liabilities and obligations of our subsidiaries. At June 30, 2009, our subsidiaries total deposits and borrowings were approximately \$859.6 million.

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Our Series A Preferred Stock impacts net income available to our common shareholders and earnings per common share, and the Warrant we issued to Treasury may be dilutive to holders of our common stock.

The dividends declared on our Series A Preferred Stock reduce the net income available to common shareholders and our earnings per common share. The Series A Preferred Stock will also receive preferential treatment in the event of liquidation, dissolution or winding up of Heritage Financial Corporation. Additionally, the ownership interest of the existing holders of our common stock will be diluted to the extent the Warrant we issued to the Treasury in conjunction with the sale to the Treasury of the Series A Preferred Stock is exercised. The 276,074 shares of common stock underlying the Warrant represent approximately 4.0% of the shares of our common stock outstanding as of June 30, 2009 (including the shares issuable upon exercise of the Warrant in total shares outstanding). The number of shares underlying the Warrant will be reduced to 138,037 shares if we receive gross proceeds of at least \$24.0 million in one or more qualified equity offerings completed prior to December 31, 2009. This offering constitutes a qualified equity offering. Although the Treasury has agreed not to vote any of the shares of common stock it receives upon exercise of the Warrant, a transferee of any portion of the Warrant or of any shares of common stock acquired upon exercise of the Warrant is not bound by this restriction.

If we are unable to redeem our Series A Preferred Stock after five years, the cost of this capital to us will increase substantially.

If we are unable to redeem our Series A Preferred Stock prior to February 15, 2014, the cost of this capital to us will increase substantially on that date, from 5.0% per annum (approximately \$1.2 million annually) to 9.0% per annum (approximately \$2.2 million annually). Depending on our financial condition at the time, this increase in the annual dividend rate on the Series A Preferred Stock could have a material negative effect on our liquidity.

Our directors and executive officers could have the ability to influence shareholder actions in a manner that may be adverse to your personal investment objectives.

As of June 30, 2009, our directors and executive officers as a group beneficially owned 1,307,302 shares of our common stock (including 156,562 shares issuable under exercisable stock options), which represented approximately 19.4% of our outstanding shares as of that