



---

2003 ANNUAL REPORT

*Continuously Improving*



WE ARE A BANK HOLDING COMPANY HEADQUARTERED IN OLYMPIA, WASHINGTON. WE OPERATE TWO COMMUNITY BANKS: HERITAGE BANK, SERVING PIERCE, THURSTON, AND MASON COUNTIES THROUGH 12 FULL-SERVICE BRANCHES IN THE SOUTH PUGET SOUND REGION, AND CENTRAL VALLEY BANK, WITH SIX FULL-SERVICE BRANCHES SERVING CENTRAL WASHINGTON'S YAKIMA AND KITTITAS COUNTIES.

## *A clear strategy for building value.*

*In 2002, we set out on a five-year mission to become a thriving commercial banking company delivering a 15 percent average return on equity to our shareholders. To help us get there, we developed a four-point strategy:*

- 1 . DIVERSIFY OUR BALANCE SHEET.*
- 2 . BUILD RELATIONSHIPS WITH CUSTOMERS.*
- 3 . MAINTAIN A HIGH STANDARD OF ASSET QUALITY.*
- 4 . GROW.*

*Three years later, our progress is strong. We're pleased to share our advances with you in the following pages.*

Our goal: **15%** ROE

*“We’re proud to keep earning the right to remain independent. We believe a healthy, longstanding community bank is an asset not only for shareholders, but for the communities we serve.”*



Chairman, President & Chief Executive Officer  
Heritage Financial Corporation

#### FELLOW SHAREHOLDERS

Three years ago, we established an overarching objective as part of our five-year plan to achieve a 15 percent return on average equity (ROAE) for our shareholders by the end of the 2005 fiscal year.

In 2003, Heritage Financial Corporation took another major stride toward that goal, achieving ROAE of 13.03 percent, up from 12.18 percent in 2002. Meanwhile, earnings per diluted share increased 4 percent over 2002, to \$1.322, and non-interest income for the year increased 15.9 percent to \$7.16 million.

In 2002, interest rates fell more rapidly on deposits than on loans, which produced extraordinary margins and unusually strong profits. In contrast, interest rates fell more rapidly on loans in 2003, which resulted in narrower margins and net profit of \$8.9 million—5.5 percent below the previous year. Still, when viewed over the six years since we became a public company, our earnings show steady growth. Our profitability remains strong, and we are confident of our ability to reach our 15 percent ROAE objective.

As we work to increase return on equity, we’re also working to decrease capital to normal levels. Our sixth stock-repurchasing program began in March 2003 with a target of repurchasing approximately 660,000 shares over 18 months. By year end, we had completed 87 percent of that objective and on February 17, 2004, we announced the completion of the sixth program.

We also continued to advance our plan for meeting our strategic goals. We are diversifying our balance sheet so that it reflects the successful commercial banking company we’ve become. Both subsidiary banks are maintaining high asset quality and leveraging technology to cultivate long-lasting relationships with our customers.

In short, we are continuously improving. We believe a healthy, long-standing community bank is a valuable asset not only for shareholders, but also for the communities we serve on both sides of the Cascades.

Details of our progress in 2003 can be found in the following pages. And I invite you to join me at our annual shareholders’ meeting on April 29, 2004, at the Phoenix Inn in Olympia, Washington.

In the meantime, I thank you for your interest and investment in our company.

Sincerely,

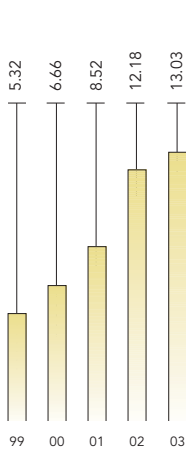
A handwritten signature in dark ink that reads "Donald V. Rhodes" with a long horizontal flourish extending to the right.

Donald V. Rhodes  
Chairman, President & Chief Executive Officer  
Heritage Financial Corporation

DIVERSIFY OUR BALANCE SHEET.

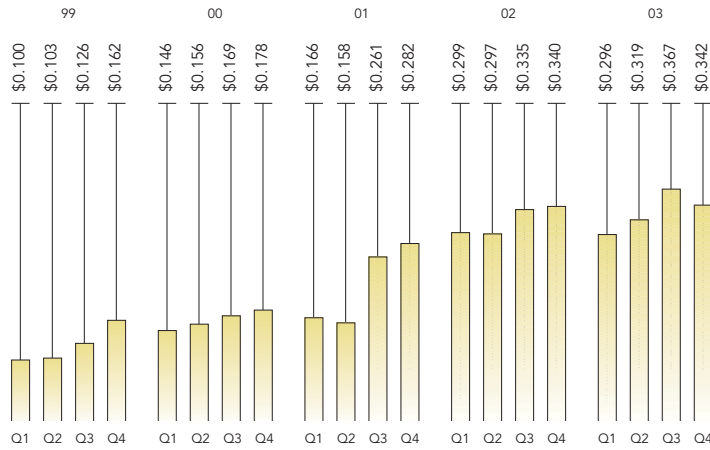
*We're not the same company we were three years ago. We're better.*

When we became a public company, we committed ourselves to transforming our profile from small-town thrift to commercial banking company. You can see the change in our balance sheet, which this year includes a 12.6 percent increase in net loans, a 4.8 increase in deposits, and a 7.8 percent increase in assets overall—the result of broadening our base of both business and consumer customers.



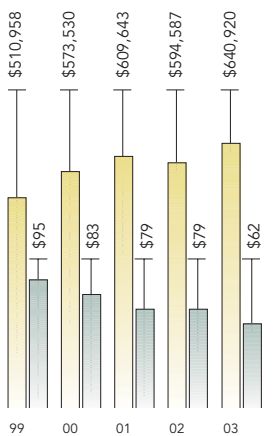
**Return on Average Equity**

(PERCENT)



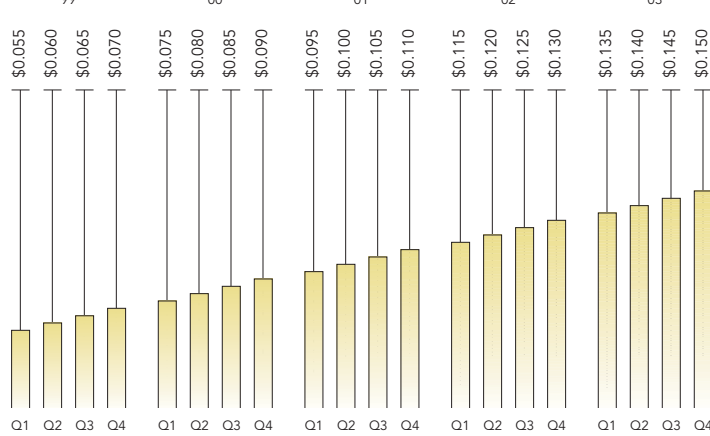
**Earnings per Diluted Share**

(DOLLARS)



**Capital to Total Assets**

■ TOTAL ASSETS  
■ TOTAL STOCKHOLDERS' EQUITY (IN THOUSANDS)



**Dividend Payout**

(DOLLARS)



**HERITAGE  
BANK**  
*the quality bank*

*“We expanded our loan base, maintained high asset quality, and met earnings expectations—all despite a weak economy.”*



President & Chief Executive Officer  
Heritage Bank

Executive Vice President  
Heritage Financial Corporation

#### DEAR SHAREHOLDERS

In 2003, Heritage Bank expanded its loan base, maintained high asset quality, and met earnings expectations—all despite a weak economy. It's a record of achievement we are proud of, and it represents continued progress toward fulfillment of the corporate vision articulated by our board of directors in 2001.

Topping the list of our accomplishments is our significant expansion in Pierce County. We hired new commercial lenders who know the Pierce County market and bring with them valuable relationships with area businesses. We also consolidated our Pierce County commercial bankers in a new banking center at our downtown Tacoma branch. This expansion will allow us to capitalize on significant opportunities for serving small businesses. Indeed, much of the good news in our 2003 balance sheet is attributable to our penetration of Pierce County's commercial banking market.

We also expanded our product offerings for small business by adding to the range of services available through Business CashManager Online, our Internet banking system for commercial customers. In doing so, we continue to combine useful technical products with the irreplaceable, face-to-face relationships that are at the heart of a successful community bank.

Our commitment to building these relationships is reflected in the customer satisfaction statement we formally articulated in 2003: "Building successful relationships by exceeding your expectations." Exceeding expectations is the measure by which we evaluate service to both our internal and external customers.

Another factor in this successful year is our top-quality loan portfolio. With total assets at \$539.9 million—up from 7.8 percent over 2002—non-performing assets dropped from 0.38 percent in 2002 to 0.11 percent of total assets in 2003. When viewed in the context of Washington's soft economy, that's an accomplishment I'm especially pleased to report.

We owe our achievements this year, as always, to the smart, talented people who work at Heritage Bank. They know the marketplace, they have a keen understanding of banking, and they understand the value of relationships. They are the key to our success.

And speaking of our people, I'm proud to note that 2003 also brought Heritage Bank the honor of receiving the Leadership In Philanthropy Business of the Year Award in Thurston County for the time, energy, and resources we gave to a broad range of area organizations. Our continuing involvement in the community says a great deal about who we are and how our people do business.

Thank you for being part of the Heritage Bank team.

Sincerely,

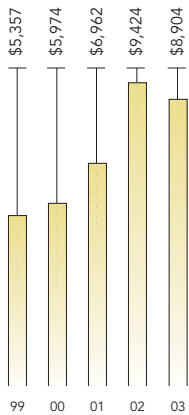
Brian Vance

President & Chief Executive Officer  
Heritage Bank

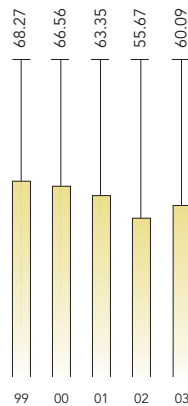
BUILD RELATIONSHIPS WITH CUSTOMERS.

*The most important faces in our business don't belong to Jackson, Grant, or Franklin.*

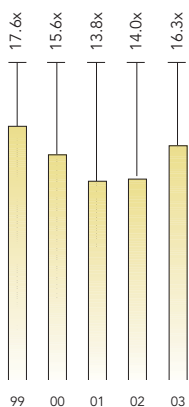
A successful bank is built on meaningful, long-lasting relationships. That's why our bankers and customer service representatives work hard to cultivate ongoing, face-to-face connections with the people we serve. It's also important that we continually develop new products to maintain ties with our customers and deliver service that exceeds expectations. Consider Positive Pay, part of our Business CashManager Online service. Positive Pay enables a business to see right away which checks are clearing its account each day.



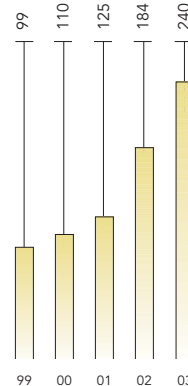
**Net Income**  
(IN THOUSANDS)



**Efficiency Ratio**  
(PERCENT)

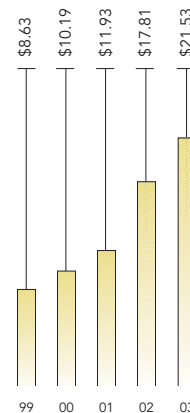


**Price/Earnings**



**Price/Tangible Book Value**

(PERCENT, AS OF 12/31)



**HFWA Closing Price**

(DECEMBER 31)

*“We understand something about sowing seeds now for future abundance. In 1990, our assets totaled just \$18 million. They’ve nearly doubled in the last five years alone.”*



President  
Central Valley Bank

#### DEAR SHAREHOLDERS

It is my pleasure to report that Central Valley Bank ended the year with record earnings and, for the first time in its 41-year history, with assets exceeding \$100 million. It's a fitting finish for the bank considered Central Washington's best performer and one of the top-ranked banks in the U.S.

These achievements are the fruition of years of work by a long-standing, cohesive management team and committed employees who believe deeply in our mission. Perhaps because we're an integral part of an agricultural economy, we understand something about sowing seeds now for future abundance. In 1990, our assets totaled just \$18 million. They've nearly doubled in just the last five years alone.

That growth is especially remarkable given the slow economic climate that has gripped the Yakima Valley for the last several years. Our bank is growing in an area that, by and large, is not. It's proof to me that our strategy is right on target: deliver exemplary service, ensure satisfaction for every customer, and build ongoing relationships.

In 2003, we focused mainly on building new customer relationships and strengthening existing ones. Last fall, we launched "Discover Excellence in Community Banking," an ad campaign featuring business customers and our loan officers. It's become

so popular that our clients are now asking to be part of it. Meanwhile, we continue to see great results from innovative products like our Silver Account, developed two years ago to build ties to the area's large senior population, which possesses about 85 percent of the region's wealth.

Finally, board, management, and staff continued to invest in the greater Yakima Valley in 2003. In addition to serving on various economic development boards, we donated time and financial resources to a wide range of projects and organizations. As business people and as residents, we want to encourage growth and cultural vitality in the valley.

In all, we are pleased with our performance in 2003, and we look forward to continued growth and the challenges that await us in 2004. In the meantime, I welcome your comments.

Sincerely,

A handwritten signature in black ink that reads "D. Michael Broadhead". The signature is written in a cursive style.

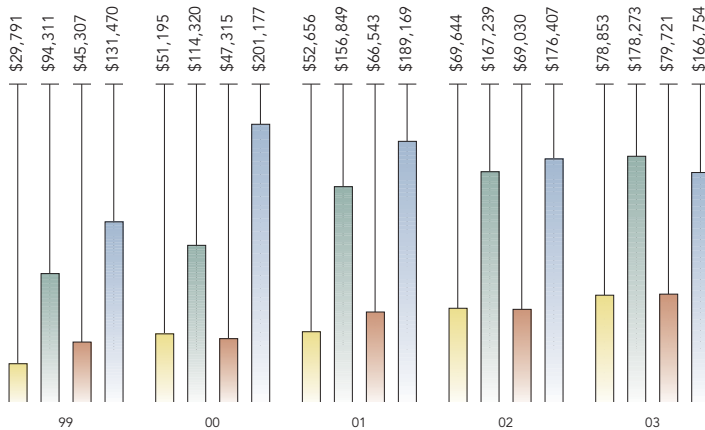
D. Michael Broadhead  
President  
Central Valley Bank

MAINTAIN A HIGH STANDARD OF ASSET QUALITY.

# You can judge a bank by the company it keeps.

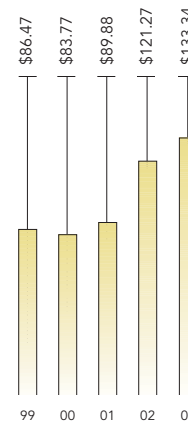
Nothing gets a bank into trouble faster than problem loans. That's why we're especially thorough in screening our applicants and making loans that make good business sense. Despite an uncertain economy, non-performing loans made up just 0.11 percent of our total assets in 2003.

Source: D.A. Davidson



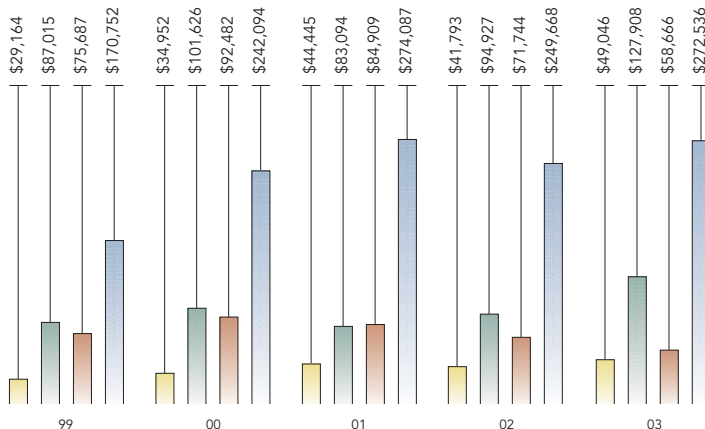
Deposit Mix Comparisons — Excludes public CD's

■ NONINTEREST BEARING TRANSACTION ACCOUNTS 
 ■ MONEY MARKET & SAVINGS  
■ INTEREST BEARING TRANSACTION ACCOUNTS 
 ■ CERTIFICATES OF DEPOSIT



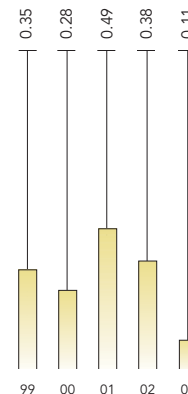
Market Capitalization

(IN MILLIONS)



Loan Mix Comparisons

■ CONSTRUCTION 
 ■ INCOME PROPERTY  
■ RESIDENTIAL MORTGAGES 
 ■ COMMERCIAL LOANS



Nonperforming Assets to Total Assets

(PERCENTAGE)





Board of Directors

*THE VISION BEGINS HERE.*

The Heritage Financial Corporation's board of directors continues to oversee the progress toward our objectives.

Our board draws on the insight and experience of its members, who represent a wide range of industries and interests in the communities we serve. Each member has a strong and continuing stake in the success of the corporation.

From Left to Right.

**Brian S. Charneski**  
President L&E Bottling Company

**James P. Senna**  
Retired, Former President & Chief Executive Officer  
Shee Atika, Inc.

**Daryl D. Jensen**  
Vice President, Administration  
Western Institutional Review Board  
Retired President Sunset Life Insurance Company

**Brian L. Vance**  
President, CEO Heritage Bank

**Donald V. Rhodes**  
Chairman, President & Chief Executive Officer  
Heritage Financial Corporation

**Melvin R. Lewis**  
President, Broker Terril, Lewis & Wilde Insurance, Inc.

**H. Edward Odegard**  
Retired, Former Co-Owner The Valley Athletic Club

**Philip S. Weigand**  
Real Estate Agent Virgil Adams Real Estate

**Peter N. Fluetsch**  
President & CEO Sunset Air Inc.

**John A. Clees**  
(Consultant to Board)  
Owner, RSM McGladrey

**Jeffrey S. Lyon**  
President & Chief Executive Officer, GVA Kidder Matthews

**Lynn M. Brunton**  
Community Volunteer

GROW.

*We're helping to green  
up the Evergreen State.*

From the Puget Sound area to the agriculture country of Central Washington, we're building value for our shareholders and helping to build prosperity for our communities. Through prudent acquisitions and facilities expansion, we're increasing our presence in key markets. This year, we bolstered our penetration of metropolitan Tacoma and surrounding Pierce County by expanding our team of commercial bankers and establishing a new banking center for them at our downtown Tacoma location.

*CORPORATE OFFICERS*

*Heritage Financial Corporation*

**Donald V. Rhodes**  
Chairman, President & Chief Executive Officer

**Brian L. Vance**  
Executive Vice President

**Edward D. Cameron**  
Senior Vice President  
Corporate Secretary & Treasurer

**Lisa A. Welander**  
Senior Vice President & Chief Information Officer

*Heritage Bank*

**Donald V. Rhodes**  
Chairman

**Brian L. Vance**  
President & Chief Executive Officer

**Gregory D. Patjens**  
Executive Vice President

**Edward D. Cameron**  
Senior Vice President & Treasurer

**Ronald H. Goodwin**  
Senior Vice President & Senior Credit Officer

**Lisa A. Welander**  
Senior Vice President & Chief Information Officer

*Central Valley Bank*

**Donald V. Rhodes**  
Chairman & Chief Executive Officer

**D. Michael Broadhead**  
President

**Dale Loveland**  
Senior Vice President & Senior Credit Officer

**Janet St. Clair**  
Senior Vice President & Cashier

HERITAGE FINANCIAL CORPORATION

**2003**

*Form 10-k*

---

## HERITAGE BANK

---

### THURSTON COUNTY

#### Olympia Main Office

201 5th Ave. SW  
Olympia, WA 98501  
360 943 1500

#### Lacey

4400 Pacific Ave. SE  
Lacey, WA 98503  
360 491 4350

#### Tumwater

5301 Capitol Blvd. S  
Tumwater, WA 98501  
360 943 5100

#### West Olympia

900 Cooper Point Rd. SW  
Olympia, WA 98502  
360 705 3500

#### Indian Summer

5800 Rainier Lp. SE  
Lacey, WA 98513  
360 438 2000

### MASON COUNTY

#### Shelton

301 E. Wallace Kneeland Blvd.  
Shelton, WA 98584  
360 426 4431

## CENTRAL VALLEY BANK

---

### YAKIMA COUNTY

#### Toppenish

537 W. Second Ave.  
Toppenish, WA 98948  
509 865 2511

#### Wapato

507 W. First St.  
Wapato, WA 98951  
509 877 6161

#### Union Gap

2205 S. First St.  
Yakima, WA 98909  
509 576 0424

#### Downtown Yakima

301 W. Yakima Ave.  
Yakima, WA 98901  
509 453 1172

### PIERCE COUNTY

#### Spanaway

15211 Pacific Ave. W  
Tacoma, WA 98444  
253 531 4360

#### Lakewood

9802 Gravelly Lake Dr. SW  
Lakewood, WA 98499  
253 588 9866

#### 80th and Pacific

8002 Pacific Ave.  
Tacoma, WA 98408  
253 473 4945

#### 56th and South Tacoma Way

5448 South Tacoma Way  
Tacoma, WA 98499  
253 472 3333

#### 88th and South Tacoma Way

8801 South Tacoma Way  
Lakewood, WA 98499  
253 584 8600

#### Downtown Tacoma

1201 Pacific Ave.  
Tacoma, WA 98402  
253 572 5772

[www.HeritageBankWA.com](http://www.HeritageBankWA.com)

### KITTITAS COUNTY

#### Ellensburg

100 N. Main  
Ellensburg, WA 98926  
509 925 5444

## CORPORATE INFORMATION

### TRANSFER AGENT & REGISTRAR

U.S. Stock Transfer Corporation  
1745 Gardena Ave.  
Glendale, CA 91204  
818 502 1404

### INDEPENDENT AUDITOR

KPMG LLP  
801 2nd Ave, Suite 900  
Seattle, WA 98104  
206 913 4000

### STOCK LISTING

NASDAQ<sup>®</sup> Stock Market  
Symbol: HFWA  
Common Stock

### WEBSITE

[www.HFWA.com](http://www.HFWA.com)

### STOCKHOLDER/ INVESTOR INFORMATION

The annual meeting will be held Thursday, April, 29, 2004 at 10:30 a.m. at Phoenix Inn in Olympia, 417 Capitol Way N. All shareholders are invited to attend.

Shareholders and investors interested in additional information about Heritage Financial Corporation or receiving a copy of the Company's Annual report the the Securities and Exchange Commission on Form 10-K may contact:

Edward D. Cameron  
Senior Vice President,  
Corporate Secretary & Treasurer  
Heritage Financial Corporation  
P.O. Box 1578  
Olympia, WA 98507  
360 705 9172

email: [HFWA@HeritageBankWA.com](mailto:HFWA@HeritageBankWA.com)



NASDAQ: HFWA • [WWW.HF-WA.COM](http://WWW.HF-WA.COM)