



Continuously Improving  2005 Annual Report

NASDAQ: HFWA

HERITAGE FINANCIAL CORPORATION  
2005 ANNUAL REPORT

Continuously Improving 

## Heritage Financial Corporation

For years now, you have seen “Continuously Improving” on the cover of our annual report. It’s our motto and our measuring stick. It also happens to sum up our performance for 2005. Here’s what “continuously improving” meant for our shareholders, for our customers, and for us this year.

A professional portrait of Greg Patjens, an older man with white hair and glasses, smiling. He is wearing a dark suit jacket, a light blue shirt, and a patterned tie. The background is a blurred office interior with warm lighting.

**GREG PATJENS**  
Executive Vice President  
of Retail Banking  
Heritage Bank

“Continuously Improving ❖❖❖”

*With more than 34 years in banking—  
including seven with Heritage Bank—  
Greg knows something about making  
customers smile.*

### Return on Average Equity

2005		16.13%
2004		15.80%
2003		13.03%
2002		12.18%
2001		8.52%

### Net Income (in thousands)

2005		\$10,476
2004		\$ 9,585
2003		\$ 8,904
2002		\$ 9,424
2001		\$ 6,962

## means exceeding expectations.”

Building relationships is essential to our growth as an independent banking company. So every day, our banks look for ways to pleasantly surprise customers by meeting their needs in ways they may not expect. We might introduce them to an account that’s a better fit. Or we might simply remember them by name. We do whatever it takes to provide a level of satisfaction our customers may not have known they could get from a bank.

- In 2005, we:
- Finalized plans to increase Heritage Bank’s presence in Pierce County, Washington, with a new full-service branch in Sumner.
  - Introduced our Premier Relationship checking account for Heritage Bank customers.
  - Received a number of honors for both Heritage and Central Valley banks, including “Best Bank” from readers of *The Olympian*, “Best Bank in the Lower Valley” from Yakima Valley residents, and “Organization of the Year” from United Way of Thurston County.
  - Launched a new website with online banking services for customers of Central Valley Bank.








**BLAKE LINDSKOG  
(LEFT)**  
Senior Vice President of  
Business Banking  
Heritage Bank

**CHERIE CHALLAIN AND  
LARRY CHALLAIN**  
Batdorf and Bronson  
Premium Coffee Roasters  
Olympia, WA






“Continuously Improving ❖❖❖”

## Efficiency Ratio

2005		59.69%
2004		60.88%
2003		60.09%
2002		55.67%
2001		63.35%

*Batdorf and Bronson has built a thriving coffee business since 1986, thanks in part to our own “premium blend” of commercial banking products and services.*

## Total Assets (in thousands)

2005		\$ 751,152
2004		\$ 697,267
2003		\$ 640,920
2002		\$ 594,587
2001		\$ 609,643

means **growing** our business.”

Focusing on our commercial banking operations is a key part of our strategic plan. But helping local businesses and farmers succeed isn't just good for our bottom line—it's good for the economies of the areas we serve. The fact that we are an independent community banking company is a real strategic asset here. Because we know our customers and really understand their businesses, we're able to offer them solutions that they expect from a quality community bank.

- In 2005, we:
- ◆ Increased our commercial loan portfolio 7.0% over 2004.
  - ◆ Expanded commercial lending staff at both Heritage Bank and Central Valley Bank.
  - ◆ Introduced a business debit card, a powerful product for commercial customers.

# COMMERCIAL LENDING

**BRIAN L. VANCE (LEFT)**  
President & Chief Executive  
Officer, Heritage Bank and  
President, Heritage Financial  
Corporation

**D. MICHAEL BROADHEAD  
(RIGHT)**  
President,  
Central Valley Bank

“Continuously Improving ❖❖❖”



*Through our two banks, Heritage Financial Corporation serves two of the most vital economic regions in Washington State.*

#### Nonperforming Assets to Total Assets

2005		0.16%
2004		0.05%
2003		0.11%
2002		0.38%
2001		0.49%

#### Market Capitalization (in millions)

2005		\$152.71
2004		\$131.55
2003		\$133.34
2002		\$121.27
2001		\$ 89.88

means **delivering more** to our shareholders.”

Heritage Financial Corporation is the holding company for two banks: Heritage Bank, which serves the south Puget Sound area, and Central Valley Bank, based in central Washington’s Yakima Valley. They’re the “twin engines” that drive Heritage Financial’s performance and enable us to provide shareholders with a reliable return.

- In 2005, we:
- Negotiated the acquisition of Washington State Bank in Federal Way. We signed the official acquisition agreement in the early part of 2006. This acquisition marks Heritage Bank’s entry into South King County and is consistent with our strategy to expand in contiguous markets.
  - Posted total assets of \$110 million for Central Valley Bank, increased loans nearly 14.4% to \$82.0 million, and grew deposits 2.1% to \$100.2 million. In all, we marked Central Valley’s best year ever.
  - Paid shareholders the first stock dividend in our history.
  - Increased the total assets of Heritage Bank 8.6% to \$640.8 million. The bank’s total loans increased 8.0% to \$570.3 million, while deposits increased 9.6% to \$537.1 million.



**DONALD V. RHODES**  
Chairman & Chief Executive Officer,  
Heritage Financial Corporation

## → To Our Shareholders

An annual report can give the impression that at the end of each year, all of us at Heritage Financial Corporation push our chairs away from our desks, stretch, and start over with a clean slate for the next 12 months.

Of course, things are never that cut-and-dried. As 2005 closed, we were taking steps toward achieving our goals of increasing net income to \$14 million by 2009 and increasing assets to \$1 billion. While economic conditions and other circumstances beyond our control can impact actual results, we will continue to work hard to meet these objectives.

During 2005, we completed a careful analysis of possible locations for new Heritage Bank branches. In early 2006, we opened a branch in Sumner, Washington, strengthening our presence in Pierce County. And in late 2005, we entered into negotiations with Western Washington Bancorp, the parent company of Washington State Bank in Federal Way, Washington. Early in 2006, we agreed to acquire that company, marking Heritage Bank's entrance into South King County. Both initiatives are aligned with our strategy for expanding in contiguous markets. We expect to close on the acquisition of Western Washington Bancorp in the second quarter of 2006, pending required regulatory approval. With that acquisition, our assets will total approximately \$800 million, and Heritage Bank will operate 14 offices across Thurston, Mason, Pierce, and King counties. Central Valley Bank will continue operating its six branches in Yakima and Kittitas counties.

## Price/Tangible Book Value

2005		257%
2004		242%
2003		240%
2002		184%
2001		125%

## HFWA Closing Price

2005		\$ 24.41
2004		\$ 21.07
2003		\$ 20.50
2002		\$ 16.96
2001		\$ 11.36

## Price/Earnings Ratio

2005		14.83x
2004		14.13x
2003		16.26x
2002		14.01x
2001		13.94x

While our work doesn't come to a sudden halt on December 31, the end of the year does provide an opportunity to reflect on our overall performance over the last 12 months. I'm pleased to report good news there as well. Our net income for the year was up 9.3% to \$10,476,000. Loan growth at both our banks was strong, up 8.9% to \$643.5 million. Our Return on Average Equity was 16.13%, up from 15.80% in 2004. Diluted earnings per share were \$1.646, up from \$1.490 last year. And as you know by now, we continued to deliver increasing cash dividends along with a 5% stock dividend—the first in our history.

“Continuously improving” means keeping our focus on our long-term objectives and then, when we've realized those, setting the bar even higher. It is a never-ending process that drives our work, no matter what time of year it is.

On behalf of directors and all employees of Heritage Financial Corporation, I thank you for your investment and your interest in our company.

Sincerely,

**DONALD V. RHODES**

Chairman & Chief Executive Officer  
Heritage Financial Corporation

# 2005 Financial Performance

## Loan Mix Comparisons (in thousands)

2005		
Construction		\$ 63,600
Income Property		\$164,544
Residential Mortgages		\$ 48,018
Commercial Loans		\$359,808

2004		
Construction		\$ 40,386
Income Property		\$152,679
Residential Mortgages		\$ 55,205
Commercial Loans		\$336,219

2003		
Construction		\$ 49,046
Income Property		\$127,908
Residential Mortgages		\$ 58,666
Commercial Loans		\$272,536

2002		
Construction		\$ 41,793
Income Property		\$ 94,927
Residential Mortgages		\$ 71,744
Commercial Loans		\$249,668

2001		
Construction		\$ 44,445
Income Property		\$ 83,094
Residential Mortgages		\$ 84,909
Commercial Loans		\$274,087

## Deposit Mix Comparisons (excludes public CDs) (in thousands)

2005		
Noninterest-Bearing Transaction Accounts		\$ 88,105
Interest-Bearing Transaction Accounts		\$ 96,538
Money Market & Savings Accounts		\$168,600
Certificates of Deposit		\$233,226

2004		
Noninterest-Bearing Transaction Accounts		\$ 82,076
Interest-Bearing Transaction Accounts		\$ 90,570
Money Market & Savings Accounts		\$178,958
Certificates of Deposit		\$186,840

2003		
Noninterest-Bearing Transaction Accounts		\$ 78,853
Interest-Bearing Transaction Accounts		\$ 79,721
Money Market & Savings Accounts		\$178,273
Certificates of Deposit		\$166,754

2002		
Noninterest-Bearing Transaction Accounts		\$ 73,860
Interest-Bearing Transaction Accounts		\$ 64,881
Money Market & Savings Accounts		\$167,455
Certificates of Deposit		\$176,190

2001		
Noninterest-Bearing Transaction Accounts		\$ 51,298
Interest-Bearing Transaction Accounts		\$ 47,315
Money Market & Savings Accounts		\$114,620
Certificates of Deposit		\$188,952

## Dividends Declared

2005	
Q4	\$0.190
Q3	\$0.185
Q2	\$0.171
Q1	\$0.167
<b>Total</b>	<b>\$0.713</b>

2004	
Q4	\$0.162
Q3	\$0.157
Q2	\$0.152
Q1	\$0.148
<b>Total</b>	<b>\$0.619</b>

2003	
Q4	\$0.143
Q3	\$0.138
Q2	\$0.133
Q1	\$0.129
<b>Total</b>	<b>\$0.543</b>

2002	
Q4	\$0.124
Q3	\$0.119
Q2	\$0.114
Q1	\$0.110
<b>Total</b>	<b>\$0.467</b>

2001	
Q4	\$0.105
Q3	\$0.100
Q2	\$0.095
Q1	\$0.090
<b>Total</b>	<b>\$0.390</b>

## Earnings Per Share

Basic Diluted

2005		
Q4	\$0.436	\$0.421
Q3	\$0.440	\$0.429
Q2	\$0.403	\$0.393
Q1	\$0.413	\$0.403
<b>Total</b>	<b>\$1.692</b>	<b>\$1.646</b>

2004		
Q4	\$0.426	\$0.414
Q3	\$0.397	\$0.386
Q2	\$0.368	\$0.357
Q1	\$0.344	\$0.333
<b>Total</b>	<b>\$1.534</b>	<b>\$1.490</b>

2003		
Q4	\$0.338	\$0.326
Q3	\$0.363	\$0.350
Q2	\$0.316	\$0.304
Q1	\$0.291	\$0.282
<b>Total</b>	<b>\$1.309</b>	<b>\$1.261</b>

2002		
Q4	\$0.335	\$0.324
Q3	\$0.330	\$0.319
Q2	\$0.291	\$0.283
Q1	\$0.291	\$0.285
<b>Total</b>	<b>\$1.248</b>	<b>\$1.210</b>

2001		
Q4	\$0.273	\$0.267
Q3	\$0.252	\$0.247
Q2	\$0.150	\$0.148
Q1	\$0.157	\$0.154
<b>Total</b>	<b>\$0.832</b>	<b>\$0.815</b>



→ 2005

## Board of Directors

*Standing from left to right:*

**Lynn M. Brunton**  
Community Volunteer

**John A. Clees**  
Owner, RSM McGladrey

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

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

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

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

*Seated from left to right:*

**Peter N. Fluetsch**  
Chief Executive Officer,  
Sunset Air Inc.

**Gary B. Christensen**  
Owner, RE Powell Distributing

**Brian L. Vance**  
President, Heritage Financial  
Corporation  
President & Chief Executive Officer,  
Heritage Bank

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

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

## Corporate Officers

HERITAGE FINANCIAL  
CORPORATION

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

**Brian L. Vance**  
President

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

**Lisa A. Welander**  
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

**Brian L. Vance**  
Vice Chairman

**D. Michael Broadhead**  
President

**Bruce Lyman**  
Senior Vice President &  
Senior Credit Officer

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

→ Form 10-K 2005

**Heritage Bank**  
[www.HeritageBankWa.com](http://www.HeritageBankWa.com)

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

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

**Both and Pacific**  
8002 Pacific Ave  
Tacoma, WA 98408  
253 473 4945

**56th and South Tacoma Way**  
5448 S Tacoma Way  
Tacoma, WA 98409  
253 472 3333

**88th and South Tacoma Way**  
8801 S Tacoma Way  
Lakewood, WA 98499  
253 584 8600

**Downtown Tacoma**  
1119 Pacific Ave  
Tacoma, WA 98402  
253 572 5772

**Sumner**  
612 Harrison St, Ste 200  
Sumner, WA 98390  
253 826 0944

**Central Valley Bank**  
[www.CVBankWa.com](http://www.CVBankWa.com)

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

**Nob Hill**  
3919 W Nob Hill Blvd  
Yakima, WA 98907  
509 972 9510

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 Second Ave, Ste 900  
Seattle, WA 98104  
206 913 4000

STOCK LISTING

NASDAQ® Stock Market  
Symbol: HFWA  
Common Stock

WEBSITE

[www.HF-WA.com](http://www.HF-WA.com)

STOCKHOLDER/  
INVESTOR INFORMATION

The annual meeting will be held  
Thursday, April 27, 2006, 10:30 a.m.  
at the Phoenix Inn, 417 Capitol Way N,  
Olympia, WA. All shareholders are  
invited to attend.

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

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

Heritage Financial Corporation  
PO Box 1578  
Olympia, WA 98507  
360 705 9172

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

All charts contained in this annual  
report pertain to Heritage Financial  
Corporation.



HERITAGE FINANCIAL CORPORATION  
201 5th Ave SW  
Olympia, WA 98501

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