

**“HERITAGE BANK IS
RANKED ONE OF THE
HEALTHIEST IN THE U.S.”**

—INSIDE BUSINESS, NOVEMBER 1, 2010

Always in your best interest.


HERITAGE
BANKSHARES, INC.

ANNUAL REPORT 2010

HERITAGE BANK LOCATIONS

NORFOLK BANKING CENTERS

- Financial District – 150 Granby Street
- Military Circle – 841 North Military Highway
- Colley – 4815 Colley Avenue
- Ocean View – 735 E. Ocean View Avenue

VIRGINIA BEACH BANKING CENTERS

- Lynnhaven – 601 Lynnhaven Parkway
- Hilltop – 1756 Laskin Road

“FOCUS ON SMALL BUSINESS KEY TO HERITAGE’S SUCCESS.”

—INSIDE BUSINESS, NOVEMBER 8, 2010

At Heritage Bank, we’ve made plenty of headlines over the past year. For good reasons, too.

As a bank that specializes in serving the needs of small and medium sized growing businesses, our creative deposit and lending approaches are unique. Our highly experienced management team provides individualized services and custom solutions to every customer we serve.

This approach has led to the growth and stability of our balance sheet as well as the companies we serve.

It’s the Heritage Bank way of building relationships...that are always in your best interest.

Always in your best interest.

PRESIDENT'S REPORT TO STOCKHOLDERS

In last year's President's Report to Stockholders, I asked a simple question, "Are we there yet?" I was, of course, referring to a recovery in our local economy. I was the first to admit that I did not know the answer to the question.

I stated that the Company had a strong tangible capital to total assets ratio of 13.4% at December 31, 2009. This would enable the Company to withstand any unexpected losses that might materialize from a further decline in the local economy during 2010. Our high capital level also gave the Company the financial strength to pursue lending opportunities more aggressively in the event the local economy were to stabilize and begin to improve in 2010. Either way, we were in a good position to deal with whatever unfolded during 2010.

Over the course of the year, we came to believe that our local economy was showing signs of stabilization, albeit at substantially lower levels than those prevailing during 2006 and 2007. We became more aggressive in our lending efforts and grew our loan portfolio from \$181.5 million at December 31, 2009 to \$214.3 million at December 31, 2010, an increase of \$32.8 million, or 18.1%.

In last year's President's Report, I also pointed out that, all other things being equal, any material increase in our loan portfolio should increase materially our net income. This proved to be the case. As noted above, our net loan portfolio increased by \$32.8 million, or 18.1%, in 2010. Correspondingly, the Company had net income of \$626,000 in the fourth quarter of 2010 compared to net income of \$463,000 in the fourth quarter of 2009, an increase of \$163,000, or 35.2%. We did what we said we were going to do and what happened was what we said would happen.

A quick look at our Company as of December 31, 2010 shows the continuing evolution of a strong and successful community bank.

- **Strong Capital Ratios:** At December 31, 2010, the Company had a tangible capital to total assets ratio of 14.1% compared to 13.4% at December 31, 2009.
- **Excellent Asset Quality:** We ended the year just as we began it. Our nonperforming assets to total assets ratio was 0.10% at December 31, 2010 compared to 0.11% at December 31, 2009. It is noteworthy that our sole nonperforming asset at December 31, 2010 was a branch site that the Company purchased in 2004 but no longer wishes to retain.
- **Earnings Growth:** The Company's net income for 2010 was \$2.086 million compared to net income of \$1.052 million for 2009, an increase of \$1.034 million, or 98.3%.

Of particular import, the Company earned \$1.274 million in the last six months of 2010.

- **Core Deposit Growth:** Our deposit focus remains growing our noninterest-bearing deposits. We increased our average noninterest-bearing deposits from \$65.0 million in 2009 to \$79.2 million in 2010, an increase of \$14.2 million, or 21.8%.

By now, our success in 2010 is ancient history. We have turned our attention to 2011 with three strategic objectives for the year.

Our first strategic objective is to reduce the outstanding balance of the preferred stock that the Company issued to the United States Treasury under the TARP Capital Purchase Program. To better understand this initiative, I need to reiterate what TARP has done for the Company.

First and foremost, the TARP capital quickly strengthened our balance sheet. This extra capital made a strong bank even stronger. The TARP capital supported our loan growth in 2010 by increasing substantially our loans to one borrower limit, allowing us to accommodate several larger credits.

Participation in TARP does place various restrictions on the Company. However, this has been true more in theory than in practice at our Company. We have had very little interaction with the United States Treasury and the TARP restrictions have had minimal impact on our operations. In fact, our Compensation Committee has found that their additional responsibilities and obligations under TARP have benefited the Company.

Some have asked us whether there has been any adverse impact on our Company from the negative connotations of participating in TARP. This may be an issue with banks that focus on consumer customers. However, our primary emphasis is business banking, and our business customers find the extra capital from TARP to be comforting. This extra capital was a significant factor in FinStrata, a bank rating company, recognizing our Bank as one of the safest in the United States as of June 30, 2010.

Our original plan for redemption of the TARP preferred stock was to make partial redemptions over time from internal resources rather than through the issuance of common stock. We were pleased to be able to redeem \$2.6 million, or 25%, of our outstanding TARP preferred stock on March 16, 2011. The source of funds for this redemption was the existing financial resources of the Company and there was no dilution to our existing common stockholders.

We have no regrets about our participation in TARP. However, because there is now a better alternative, our second strategic objective is to replace TARP with participation in the Small Business Lending Fund (the "SBLF") for which, as of the date of this letter, we are awaiting regulatory approval. Like TARP, preferred stock issued to the United States Treasury under the SBLF will count as Tier One capital for all regulatory purposes. Participation in the SBLF has been designed to be less onerous than participation in TARP by eliminating the restrictions alluded to previously. Most importantly, participation in the SBLF would provide the Company with the opportunity to reduce its dividend rate on the preferred stock held by the United States Treasury to as low as 1%. This dividend reduction could be accomplished through relatively modest increases in small business lending by the Company, which is our primary lending focus anyway.

In 2010, the Company paid the United States Treasury \$587,000 in preferred stock dividends. Under the SBLF, the Company could conceivably pay only \$78,000 in annual preferred stock dividends to the United States Treasury in the years after the Company has attained the specified level of small business lending to qualify for the 1% dividend rate. This is a potential savings of approximately \$509,000 per year, as compared to our initial TARP dividends, for our common stockholders. This potential annual savings in income available to common stockholders would equate to an annual increase of approximately \$0.22 in earnings per share based on our weighted average diluted shares outstanding in the fourth quarter of 2010.

According to an analysis of trading multiples for bank stocks prepared for me by a regional brokerage firm, since 1995, banks have traded at an average multiple of approximately 15 times earnings per share for the trailing 12 months. Applying this average multiple to the approximate increase of \$0.22 in earnings per share that we expect would result from reducing the preferred stock dividend to 1% leads to a theoretical increase in the trading price of our stock of approximately \$3.30 per share over time.

Of course, I am in no way promising or predicting any increase in our stock price from participating in the SBLF. I am simply presenting for your information some illustrative math that we considered as part of our decision to apply to participate in the SBLF.

Our third strategic objective for 2011 relates to the basic function of growing our loans. In the past year, small business lending has become much more competitive as banks, both large and small, have shifted their attention to small business

lending. Quality small business loans are becoming more precious every day. The number of new business loans has been substantially reduced by the dismal economy, and the competition for these loans among banks has never been keener.

We have concluded that in order to compete effectively for small business loans, we need to augment our small business lending capabilities by recruiting additional lending personnel with the expertise and dedication to underwrite loans to our specifications. Recruiting is not an easy task for us in light of the requirements we have established for our lenders. But the importance of proper underwriting and documentation of small business loans should be quite apparent. Recently, Chairman Bernanke of the Federal Reserve Board bluntly told community bankers to "do the work" if they want relief from strict regulatory scrutiny of their small business loans. The work to which Mr. Bernanke was referring is thorough underwriting of the cash flow of the actual business and appropriate documentation of the loan rather than simple reliance on the appraised value of owner-occupied real estate. Just as Chairman Bernanke stated, our Company is looking for lenders with the capability and willingness to "do the work."

Once we have added these new lenders, we expect a material increase in our compensation expense that will likely have some negative impact on the net income we would otherwise anticipate in 2011. Just like many of the other initiatives that the Company has undertaken over the past five years, we will begin to incur the compensation expense before we enjoy any income from the incremental lending. However, we believe that this increase in compensation expense is necessary for continued growth in our small business loans and core deposits in such a competitive environment.

We have a simple plan for 2011. We want to lower the cost of our capital and improve our capability to grow small business loans and core deposits in a very competitive environment. It is a simple plan for a simple business. A successful community bank makes prudent loans and funds them with stable core deposits. It is not rocket science to run a safe and sound community bank. We just have to "do the work."



Michael S. Ives
President and Chief Executive Officer
April 21, 2011

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STOCK TRADING

Heritage Bankshares, Inc. common stock is currently quoted on the OTCBB and Pink Sheets over-the-counter markets under the symbol “HBKS.”

FINANCIAL INFORMATION

To obtain financial information on Heritage Bankshares, Inc., contact:

John O. Guthrie, Executive Vice President
& Chief Financial Officer
Heritage Bankshares, Inc.
150 Granby Street
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