

First Business Financial Services, Inc.

Form 10-Q

October 27, 2008

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the quarterly period ended September 30, 2008**

**OR**

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
Commission file number 000-51028  
FIRST BUSINESS FINANCIAL SERVICES, INC.**

(Exact name of registrant as specified in its charter)

**Wisconsin**

**39-1576570**

(State or jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

**401 Charmany Drive Madison, WI**

**53719**

(Address of Principal Executive Offices)

(Zip Code)

(608) 238-8008

Telephone number

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of shares outstanding of the registrant's sole class of common stock, par value \$0.01 per share, on October 21, 2008 was 2,545,546 shares.

**Table of Contents**

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**FIRST BUSINESS FINANCIAL SERVICES, INC.  
INDEX FORM 10-Q**

|  | <b>Page</b> |
|--|-------------|
| <b><u>PART I. FINANCIAL INFORMATION</u></b>  |             |
| <b><u>Item 1. Financial Statements (Unaudited)</u></b>   | 4           |
| <u>Consolidated Balance Sheets as of September 30, 2008 and December 31, 2007</u>  | 4           |
| <u>Consolidated Statements of Income for the Three Months and Nine Months Ended September 30, 2008 and 2007</u>                                  | 5           |
| <u>Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income for the Nine Months Ended September 30, 2008 and 2007</u> | 6           |
| <u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2008 and 2007</u>   | 7           |
| <u>Notes to Unaudited Consolidated Financial Statements</u>  | 8           |
| <b><u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>                                      | 18          |
| <b><u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u></b>   | 34          |
| <b><u>Item 4T. Controls and Procedures</u></b>   | 34          |
| <b><u>PART II. OTHER INFORMATION</u></b>   | 35          |
| <b><u>Item 1. Legal Proceedings</u></b>  | 35          |
| <b><u>Item 1A. Risk Factors</u></b>  | 35          |
| <b><u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u></b>  | 38          |
| <b><u>Item 3. Defaults upon Senior Securities</u></b>  | 39          |
| <b><u>Item 4. Submission of Matters to a Vote of Security Holders</u></b>  | 39          |
| <b><u>Item 5. Other information</u></b>  | 39          |
| <b><u>Item 6. Exhibits</u></b>   | 39          |
| <b><u>SIGNATURES</u></b>   | 40          |
| <u>EX-31.1</u>   |             |
| <u>EX-31.2</u>   |             |
| <u>EX-32</u>   |             |

**Table of Contents****PART I. Financial Information****Item 1. Financial Statements****First Business Financial Services, Inc.  
Consolidated Balance Sheets**

|  | (Unaudited)<br>September<br>30,<br>2008 | December<br>31,<br>2007 |
|--|---|-------------------------|
|  | (In Thousands, Except Share<br>Data)    |                         |
| <b>Assets</b>  |   |                         |
| Cash and due from banks  | \$ 23,494                               | \$ 17,421               |
| Short-term investments   | 2,159                                   | 203                     |
| Cash and cash equivalents  | 25,653                                  | 17,624                  |
| Securities available-for-sale, at fair value   | 107,446                                 | 97,378                  |
| Loans and leases receivable, net of allowance for loan and lease losses of \$10,816 and \$9,854, respectively  | 828,357                                 | 771,633                 |
| Leasehold improvements and equipment, net  | 1,551                                   | 1,546                   |
| Foreclosed properties  | 3,490                                   | 660                     |
| Cash surrender value of bank-owned life insurance  | 15,306                                  | 14,757                  |
| Investment in Federal Home Loan Bank stock, at cost  | 2,367                                   | 2,367                   |
| Goodwill and other intangibles   | 2,768                                   | 2,787                   |
| Accrued interest receivable and other assets   | 11,449                                  | 9,686                   |
| Total assets   | \$ 998,387                              | \$ 918,438              |
| <b>Liabilities and Stockholders Equity</b>   |   |                         |
| Deposits   | \$ 831,289                              | \$ 776,060              |
| Federal Home Loan Bank and other borrowings  | 89,829                                  | 81,986                  |
| Junior subordinated notes  | 10,315                                  |                         |
| Accrued interest payable and other liabilities   | 15,215                                  | 11,840                  |
| Total liabilities  | 946,648                                 | 869,886                 |
| Commitments and contingencies  |   |                         |
| Stockholders equity:   |   |                         |
| Preferred stock, \$10 par value, 10,000 Series A shares and 10,000 Series B shares authorized, none issued or outstanding  |   |                         |
| Common stock, \$0.01 par value, 8,000,000 shares authorized, 2,616,424 and 2,576,849 shares issued, 2,545,546 and 2,509,213 outstanding in 2008 and 2007, respectively | 26                                      | 26                      |
| Additional paid-in capital   | 23,912                                  | 23,462                  |
| Retained earnings  | 29,316                                  | 26,836                  |

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|   |            |            |
|---|------------|------------|
| Accumulated other comprehensive loss  | (90)       | (399)      |
| Treasury stock (70,878 and 67,636 shares in 2008 and 2007, respectively), at cost | (1,425)    | (1,373)    |
| Total stockholders' equity  | 51,739     | 48,552     |
| Total liabilities and stockholders' equity  | \$ 998,387 | \$ 918,438 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

4

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**Table of Contents****First Business Financial Services, Inc.  
Consolidated Statements of Income (Unaudited)**

|  | For the Three Months Ended<br>September 30, |           | For the Nine Months<br>Ended,<br>September 30, |           |
|--|---|-----------|--|-----------|
|  | 2008  | 2007      | 2008   | 2007      |
|  | (In Thousands, Except Share<br>Data)        |           |  |           |
| Interest income:   |   |           |  |           |
| Loans and leases   | \$ 13,518                                   | \$ 14,177 | \$ 41,100                                      | \$ 40,277 |
| Securities income, taxable                                       | 1,205                                       | 1,032     | 3,444  | 3,162     |
| Short-term investments   | 16  | 66        | 74   | 140       |
| Total interest income  | 14,739                                      | 15,275    | 44,618   | 43,579    |
| Interest expense:  |   |           |  |           |
| Deposits   | 7,245                                       | 8,464     | 22,474   | 23,962    |
| Notes payable and other borrowings                               | 965   | 949       | 2,901  | 2,736     |
| Junior subordinated notes  | 12  |           | 12   |           |
| Total interest expense   | 8,222                                       | 9,413     | 25,387   | 26,698    |
| Net interest income  | 6,517                                       | 5,862     | 19,231   | 16,881    |
| Provision for loan and lease losses                              | 17  | 596       | 1,314  | 1,873     |
| Net interest income after provision for loan and<br>lease losses | 6,500                                       | 5,266     | 17,917   | 15,008    |
| Non-interest income:   |   |           |  |           |
| Trust and investment services income                             | 489   | 524       | 1,510  | 1,415     |
| Service charges on deposits                                      | 282   | 175       | 742  | 522       |
| Increase in cash surrender value of bank-owned life<br>insurance | 192   | 175       | 549  | 515       |
| Loan fees  | 176   | 128       | 471  | 466       |
| Credit, merchant and debit card fees                             | 54  | 51        | 163  | 154       |
| Other  | 147   | 48        | 265  | 187       |
| Total non-interest income  | 1,340                                       | 1,101     | 3,700  | 3,259     |
| Non-interest expense:  |   |           |  |           |
| Compensation   | 3,137                                       | 3,171     | 9,721  | 9,136     |
| Occupancy  | 339   | 262       | 988  | 783       |
| Equipment  | 153   | 130       | 457  | 367       |
| Data processing  | 228   | 264       | 758  | 760       |

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|                                  |          |         |          |          |
|----------------------------------|----------|---------|----------|----------|
| Marketing                        | 251      | 260     | 727      | 788      |
| Professional fees                | 380      | 291     | 1,333    | 1,054    |
| Loss on foreclosed properties    | 626      |         | 631      |          |
| Other                            | 701      | 566     | 1,985    | 1,719    |
| Total non-interest expense       | 5,815    | 4,944   | 16,600   | 14,607   |
| Income before income tax expense | 2,025    | 1,423   | 5,017    | 3,660    |
| Income tax expense               | 853      | 538     | 2,007    | 1,318    |
| Net income                       | \$ 1,172 | \$ 885  | \$ 3,010 | \$ 2,342 |
| Earnings per share:              |          |         |          |          |
| Basic                            | \$ 0.48  | \$ 0.36 | \$ 1.24  | \$ 0.95  |
| Diluted                          | 0.48     | 0.36    | 1.24     | 0.95     |
| Dividends declared per share     | 0.07     | 0.065   | 0.21     | 0.195    |

See accompanying Notes to Unaudited Consolidated Financial Statements.

5



**Table of Contents****First Business Financial Services, Inc.****Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income (Unaudited)**

|  | Common<br>stock                   | Additional<br>paid-in<br>capital | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>loss | Treasury<br>stock | Total     |
|--|-----------------------------------|----------------------------------|----------------------|---|-------------------|-----------|
|  | (In Thousands, Except Share Data) |                                  |                      |   |                   |           |
| Balance at December 31, 2006                                   | \$ 25                             | \$ 23,029                        | \$ 24,237            | \$ (1,005)                                    | \$ (530)          | \$ 45,756 |
| Comprehensive income:  |                                   |                                  |                      |   |                   |           |
| Net income   |                                   |                                  | 2,342                |   |                   | 2,342     |
| Unrealized securities gains arising during the period          |                                   |                                  |                      | 875   |                   | 875       |
| Unrealized derivative losses arising during the period         |                                   |                                  |                      | (4)   |                   | (4)       |
| Reclassification adjustment for realized losses on derivatives |                                   |                                  |                      | 2   |                   | 2         |
| Income tax effect  |                                   |                                  |                      | (302)   |                   | (302)     |
| Comprehensive income   |                                   |                                  |                      |   |                   | 2,913     |
| Share-based compensation restricted shares                     | 1                                 | 270                              |                      |   |                   | 271       |
| Cash dividends (\$0.195 per share)                             |                                   |                                  | (491)                |   |                   | (491)     |
| Treasury stock purchased (1,021 shares)                        |                                   |                                  |                      |   | (21)              | (21)      |
| Stock options exercised (3,128 shares)                         |                                   | 37                               |                      |   |                   | 37        |
| Balance at September 30, 2007                                  | \$ 26                             | \$ 23,336                        | \$ 26,088            | \$ (434)                                      | \$ (551)          | \$ 48,465 |

|  | Common<br>stock                   | Additional<br>paid-in<br>capital | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>loss | Treasury<br>stock | Total     |
|--|-----------------------------------|----------------------------------|----------------------|---|-------------------|-----------|
|  | (In Thousands, Except Share Data) |                                  |                      |   |                   |           |
| Balance at December 31, 2007                                   | \$ 26                             | \$ 23,462                        | \$ 26,836            | \$ (399)                                      | \$ (1,373)        | \$ 48,552 |
| Comprehensive income:  |                                   |                                  |                      |   |                   |           |
| Net income   |                                   |                                  | 3,010                |   |                   | 3,010     |
| Unrealized securities gains arising during the period          |                                   |                                  |                      | 464   |                   | 464       |
| Unrealized derivative losses arising during the period         |                                   |                                  |                      | (4)   |                   | (4)       |
| Reclassification adjustment for realized losses on derivatives |                                   |                                  |                      | 9   |                   | 9         |
| Income tax effect  |                                   |                                  |                      | (160)   |                   | (160)     |
| Comprehensive income   |                                   |                                  |                      |   |                   | 3,319     |
| Share-based compensation restricted shares                     |                                   | 450                              |                      |   |                   | 450       |
| Cash dividends (\$0.21 per share)                              |                                   |                                  | (530)                |   |                   | (530)     |
|  |                                   |                                  |                      |   | (52)              | (52)      |

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Treasury stock purchased (3,242  
shares)

|                               |       |           |           |    |      |            |           |
|-------------------------------|-------|-----------|-----------|----|------|------------|-----------|
| Balance at September 30, 2008 | \$ 26 | \$ 23,912 | \$ 29,316 | \$ | (90) | \$ (1,425) | \$ 51,739 |
|-------------------------------|-------|-----------|-----------|----|------|------------|-----------|

See accompanying Notes to Unaudited Consolidated Financial Statements

6

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**Table of Contents****First Business Financial Services, Inc.  
Consolidated Statements of Cash Flows (Unaudited)**

|   | For the Nine Months Ended<br>September 30, |           |
|---|--|-----------|
|   | 2008                                       | 2007      |
|   | (In Thousands)                             |           |
| <b>Operating activities</b>   |  |           |
| Net income  | \$ 3,010                                   | \$ 2,342  |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |           |
| Deferred income taxes, net  | (612)                                      | (782)     |
| Provision for loan and lease losses   | 1,314                                      | 1,873     |
| Depreciation, amortization and accretion, net                                     | 391  | 354       |
| Share-based compensation  | 450  | 271       |
| Increase in cash surrender value of bank-owned life insurance                     | (549)                                      | (515)     |
| Origination of loans for sale   | (586)                                      | (1,340)   |
| Sale of loans originated for sale   | 588  | 1,346     |
| Gain on sale of loans originated for sale   | (2)  | (6)       |
| Loss on foreclosed properties   | 631  |           |
| Increase in accrued interest receivable and other assets                          | (1,247)                                    | (938)     |
| Increase in accrued interest payable and other liabilities                        | 3,362                                      | 3,071     |
| Net cash provided by operating activities   | 6,750                                      | 5,676     |
| <b>Investing activities</b>   |  |           |
| Proceeds from maturities of available-for-sale securities                         | 22,340                                     | 16,488    |
| Purchases of available-for-sale securities  | (31,947)                                   | (8,811)   |
| Proceeds from sale of foreclosed property   | 655  |           |
| Purchases of FHLB stock   |  | (343)     |
| Net increase in loans and leases  | (62,155)                                   | (110,569) |
| Purchases of leasehold improvements and equipment, net                            | (434)                                      | (319)     |
| Purchase of bank-owned life insurance   |  | (590)     |
| Net cash used in investing activities   | (71,541)                                   | (104,144) |
| <b>Financing activities</b>   |  |           |
| Net increase in deposits  | 55,229                                     | 109,648   |
| Net decrease in FHLB line of credit   |  | (17,048)  |
| Repayment of FHLB advances  | (41,007)                                   | (7)       |
| Proceeds from FHLB advances   | 50,000                                     | 15,000    |
| Net increase (decrease) in short-term borrowed funds                              | (9,150)                                    | (24,276)  |
| Proceeds from subordinated notes payable  | 39,000                                     | 10,000    |
| Repayment of subordinated notes payable   | (31,000)                                   |           |
| Proceeds from junior subordinated notes   | 10,315                                     |           |
| Exercise of stock options   |  | 37        |
| Cash dividends paid   | (515)                                      | (475)     |
| Purchase of treasury stock  | (52)                                       | (21)      |
| Net cash provided by financing activities   | 72,820                                     | 92,858    |

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|  |           |           |
|--|-----------|-----------|
| Net increase (decrease) in cash and cash equivalents     | 8,029     | (5,610)   |
| Cash and cash equivalents at the beginning of the period | 17,624    | 19,461    |
| Cash and cash equivalents at the end of the period       | \$ 25,653 | \$ 13,851 |

**Supplementary cash flow information**

|   |           |           |
|---|-----------|-----------|
| Interest paid on deposits and borrowings                              | \$ 23,260 | \$ 24,726 |
| Income taxes paid   | 896       | 1,885     |
| Transfer to foreclosed properties                                     | 4,117     | 660       |
| See accompanying Notes to Unaudited Consolidated Financial Statements |           |           |

7

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**Table of Contents**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 Principles of Consolidation**

The unaudited consolidated financial statements include the accounts and results of First Business Financial Services, Inc. (FBFS or the Corporation), and its wholly-owned subsidiaries, First Business Bank, and First Business Bank Milwaukee. All significant intercompany balances and transactions have been eliminated in consolidation.

**Note 2 Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The Corporation has not changed its significant accounting and reporting policies from those disclosed in the Corporation's Form 10-K for the year ended December 31, 2007 with the exception of the partial adoption of Statement of Financial Accounting Standard (SFAS) No. 157, *Fair Value Measurements* (SFAS 157). Refer to **Note 3**

**Recent Accounting Pronouncements** for the impact of the adoption of this standard. There have been no significant changes in the methods or assumptions used in accounting policies requiring material estimates and assumptions. In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of the unaudited consolidated financial statements have been included in the consolidated financial statements. The results of operations for the three and nine month periods ended September 30, 2008 are not necessarily indicative of results that may be expected for any other interim period or the entire fiscal year ending December 31, 2008. Certain amounts in prior periods have been reclassified to conform to the current presentation.

**Note 3 Recent Accounting Pronouncements**

**Fair Value Disclosures.** Effective January 1, 2008, the Corporation partially adopted SFAS 157, which provides a framework for measuring fair value. Fair value is defined as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. The partial adoption of this standard only resulted in additional disclosure requirements and had no financial statement impact. Financial Accounting Standards Board (FASB) Staff Position No. FAS 157-2 permitted delayed application of this statement for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Corporation has not applied the provisions of SFAS 157 for goodwill and long-lived assets measured at fair value for impairment assessment under Statement 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, including foreclosed properties.

Refer to **Note 11 Fair Value Disclosure (SFAS 157 Disclosure)** of the unaudited consolidated financial statements for further information regarding the fair value of the Corporation's financial instruments.

**Fair Value Option for Financial Assets and Financial Liabilities.** Effective January 1, 2008, the Corporation adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Liabilities Including an Amendment of SFAS No. 115* (SFAS 159). This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. Most of the provisions in SFAS 159 are elective; however, the amendment to SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, applies to all entities with available-for-sale and trading securities.

The fair value option established by SFAS 159 permits the Corporation to choose to measure eligible items at fair value at specified election dates. The Corporation will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair

**Table of Contents**

value option: (a) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method; (b) is irrevocable (unless a new election date occurs); and (c) is applied only to entire instruments and not to portions of instruments. In connection with the adoption of this standard, the Corporation did not elect any additional financial instruments to be recorded at fair value.

**Derivative Instruments and Hedging Activities.** In March 2008, the Financial Accounting Standards Board issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an Amendment of Statement No. 133* (SFAS 161). SFAS 161 enhances disclosure requirements about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flows. This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Corporation is currently evaluating the impact of adoption of SFAS 161.

**Instruments Granted in Share-Based Payment Transactions as Participating Securities.** In June 2008, the FASB issued Staff Position (FSP) EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities*. This staff position addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the allocation in computing earnings per share under the two-class method described in SFAS 128, *Earnings Per Share*. The FASB concluded that all outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends participate in undistributed earnings with common shareholders. If awards are considered participating securities, the Corporation is required to apply the two-class method of computing basic and diluted earnings per share. FSP EITF 03-6-1 is effective for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. Early adoption is prohibited. The Corporation is currently evaluating the impact of adoption of this guidance.

**Note 4 Share-Based Compensation**

The Corporation adopted an equity incentive plan in 1993 as amended in 1995, an equity incentive plan in 2001 and the 2006 Equity Incentive Plan (the Plans). The Plans are administered by the Compensation Committee of the Board of Directors of FBFS and provide for the grant of equity ownership opportunities through incentive stock options, nonqualified stock options (stock options) and restricted shares. 116,694 shares are available for future grants under the Plans as of September 30, 2008. Shares covered by awards that expire, terminate or lapse will again be available for the grant of awards under the Plans. The Corporation may issue new shares and shares from treasury for shares delivered under the Plans.

**Stock Options**

The Corporation may grant stock options to senior executives and other employees under the Plans. Options generally have an exercise price that is equal to the fair value of the common shares on the date the option is granted. Options granted under the Plans are subject to graded vesting, generally ranging from four to eight years, and have a contractual term of 10 years. For any new awards issued, compensation expense is recognized over the requisite service period for the entire award on a straight-line basis. The Corporation has not granted any stock options since the Corporation met the definition of a public entity nor has it modified, repurchased or cancelled any stock options during that period. Therefore, no stock-based compensation was recognized in the consolidated statement of income for the three and nine months ended September 30, 2008 and 2007, except with respect to restricted share awards. The Corporation expects that a majority of the outstanding stock options will fully vest. Stock option activity for the nine months ended September 30, 2008 was as follows:

**Table of Contents**

|   | Options | Weighted<br>Average<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life<br>(Years) |
|---|---------|------------------------------|--|
| Outstanding at December 31, 2007          | 159,540 | \$ 22.10                     | 5.65   |
| Granted                                   |         |                              |  |
| Exercised                                 |         |                              |  |
| Forfeited                                 | (2,250) | 24.56                        |  |
| Outstanding at September 30, 2008         | 157,290 | 22.07                        | 4.92   |
| Options exercisable at September 30, 2008 | 142,415 |                              | 4.80   |

**Restricted Shares**

Under the 2001 and 2006 Equity Incentive Plans, the Corporation may grant restricted shares to plan participants, subject to forfeiture upon the occurrence of certain events until dates specified in the participant's award agreement. While the restricted shares are subject to forfeiture, the participant may exercise full voting rights and will receive all dividends and other distributions paid with respect to the restricted shares. The restricted shares granted under this plan are subject to graded vesting. Compensation expense is recognized over the requisite service period of four years for the entire award on a straight-line basis. Upon vesting of restricted share awards, the benefits of tax deductions in excess of recognized compensation expense is recognized as a financing cash flow activity. For the nine months ended September 30, 2008 and 2007, restricted share awards vested on a date at which the market price was lower than the market value on the date of grant; therefore, there is no excess tax benefit reflected in the consolidated statements of cash flows for the periods. Restricted share activity for the nine months ended September 30, 2008 was as follows:

|  | Number of<br>Restricted<br>Shares | Weighted<br>Average<br>Grant-Date<br>Fair Value |
|--|-----------------------------------|---|
| Nonvested balance as of December 31, 2007  | 91,379                            | \$21.16   |
| Granted                                    | 40,950                            | 16.00   |
| Vested                                     | (23,505)                          | 21.40   |
| Forfeited                                  | (1,375)                           | 20.59   |
| Nonvested balance as of September 30, 2008 | 107,449                           | 19.14   |

As of September 30, 2008, there was approximately \$1.8 million of deferred compensation expense included in additional paid-in capital in the consolidated balance sheet related to unvested restricted shares which the Corporation expects to recognize over four years. As of September 30, 2008, there were no restricted shares vested and not delivered. For the nine months ended September 30, 2008 and 2007, share-based compensation expense included in the consolidated statements of income totaled approximately \$450,000 and \$271,000, respectively.

**Note 5 Earnings Per Share.**

Basic earnings per share for the three and nine months ended September 30, 2008 and 2007 were determined by dividing net income for the respective periods by the weighted average number of shares of common stock outstanding. Diluted earnings per share were determined by dividing net income by the weighted average number of

common shares outstanding plus the effect of dilutive securities. The effects of dilutive securities were determined using the treasury stock method. For the three month periods ended



**Table of Contents**

September 30, 2008 and 2007, average anti-dilutive employee share-based awards totaled 237,158 and 183,941, respectively. For the nine month periods ended September 30, 2008 and 2007, average anti-dilutive employee share-based awards totaled 221,608 and 152,361, respectively.

|   | For the Three Months<br>Ended September 30, |            | For the Nine Months<br>Ended September 30, |              |
|---|---|------------|--|--------------|
|   | 2008  | 2007       | 2008                                       | 2007         |
| Income available to common stockholders | \$ 1,172,472                                | \$ 885,021 | \$ 3,009,891                               | \$ 2,342,185 |
| Basic average shares                    | 2,435,188                                   | 2,457,885  | 2,428,271                                  | 2,455,005    |
| Dilutive effect of share-based awards   | 1,050                                       | 2,970      | 1,402                                      | 6,004        |
| Dilutive average shares                 | 2,436,238                                   | 2,460,855  | 2,429,673                                  | 2,461,009    |
| Earnings per share:                     |   |            |  |              |
| Basic                                   | \$ 0.48                                     | \$ 0.36    | \$ 1.24                                    | \$ 0.95      |
| Diluted                                 | \$ 0.48                                     | \$ 0.36    | \$ 1.24                                    | \$ 0.95      |

**Note 6 Shareholder Rights Plan.**

On June 5, 2008, the Board of Directors declared a dividend of one common share purchase right for each outstanding share of common stock, \$0.01 par value per share (common shares) of the Company. The dividend was paid on July 15, 2008. Each right entitles the registered holder to purchase from the Company one-half of one common share, at a price of \$85.00 per full common share (equivalent to \$42.50 for each one-half of a common share), subject to adjustment. The rights will be exercisable only if a person or group acquires 15% or more of the Company's common stock, or announces a tender offer for such stock. Under conditions described in the Shareholder Rights Plan, holders of rights could acquire additional shares of the Company's common stock. The value of shares acquired under the plan would have a market value of two times the then current per share purchase price. The rights will expire on June 5, 2018.

**Note 7 Securities.**

The amortized cost and estimated fair values of securities available-for-sale were as follows:

|  | Amortized<br>cost | As of September 30, 2008                |  | Estimated<br>fair value |
|--|-------------------|---|--|-------------------------|
|  |                   | Gross<br>unrealized<br>holding<br>gains | Gross<br>unrealized<br>holding<br>losses |                         |
| Securities available-for-sale  |                   |   |  |                         |
| Collateralized mortgage obligations - government agencies              | \$ 78,137         | \$ 445                                  | \$ (456)                                 | \$ 78,126               |
| Collateralized mortgage obligations - government-sponsored enterprises | 29,438            | 25                                      | (143)                                    | 29,320                  |
|  | \$ 107,575        | \$ 470                                  | \$ (599)                                 | \$ 107,446              |

Collateralized mortgage obligations - government agencies represent securities issued by the Government National Mortgage Association. Collateralized mortgage obligations - government-sponsored enterprises include securities issued by the Federal Home Loan Mortgage Corporation, or Freddie Mac, and the Federal National Mortgage Association, or Fannie Mae.



**Table of Contents**

|  | Amortized<br>cost | As of December 31, 2007                 |  | Estimated<br>fair value |
|--|-------------------|---|--|-------------------------|
|  |                   | Gross<br>unrealized<br>holding<br>gains | Gross<br>unrealized<br>holding<br>losses |                         |
|  |                   | (In Thousands)                          |  |                         |
| U.S. Government corporations and agencies                              | \$ 1,500          | \$                                      | \$ (3)                                   | \$ 1,497                |
| Municipals   | 85                |   |  | 85                      |
| Collateralized mortgage obligations - government agencies              | 52,755            | 282                                     | (379)                                    | 52,658                  |
| Collateralized mortgage obligations - government-sponsored enterprises | 43,631            | 2                                       | (495)                                    | 43,138                  |
|  | \$ 97,971         | \$ 284                                  | \$ (877)                                 | \$ 97,378               |

The table below shows the Corporation's gross unrealized losses and fair value of investments, aggregated by investment category and length of time that individual investments have been in a continuous unrealized loss position at September 30, 2008 and December 31, 2007. At September 30, 2008 and December 31, 2007, the Corporation had 69 and 87 securities that were in an unrealized loss position, respectively. Such securities have declined in value due to current interest rate environments and have not experienced credit rating downgrades and do not presently represent realized losses. The Corporation has the ability to keep and anticipates that these securities, which have been in a continuous loss position but are not other-than-temporarily impaired, will be kept in the portfolio until the unrealized loss is recovered. If held until maturity, it is anticipated no loss will be realized with respect to such investments. If the Corporation determines that any of the securities are deemed other-than-temporarily impaired, the impairment loss will be recognized in the income statement.

A summary of unrealized loss information for available-for-sale securities, categorized by security type follows:

|  | Less than 12 months |                      | As of September 30, 2008 |                      | Total         |                      |
|--|---------------------|----------------------|--------------------------|----------------------|---------------|----------------------|
|  | Fair<br>value       | Unrealized<br>losses | Fair<br>value            | Unrealized<br>losses | Fair<br>value | Unrealized<br>losses |
|  |                     |                      | (In Thousands)           |                      |               |                      |
| Collateralized mortgage obligations - government agencies              | \$ 32,992           | \$ 456               | \$                       | \$                   | \$ 32,992     | \$ 456               |
| Collateralized mortgage obligations - government-sponsored enterprises | 20,060              | 137                  | 655                      | 6                    | 20,715        | 143                  |
|  | \$ 53,052           | \$ 593               | \$ 655                   | \$ 6                 | \$ 53,707     | \$ 599               |

Table of Contents

|  | Less than 12 months |            | As of December 31, 2007<br>12 months or longer |            | Total     |            |
|--|---------------------|------------|--|------------|-----------|------------|
|  | Fair                | Unrealized | Fair   | Unrealized | Fair      | Unrealized |
|  | value               | losses     | value  | losses     | value     | losses     |
|  | (In Thousands)      |            |  |            |           |            |
| U.S. Government corporations and agencies                            | \$                  | \$         | \$ 1,497                                       | \$ 3       | \$ 1,497  | \$ 3       |
| Collateralized mortgage obligations government agencies              | 13,054              | 374        | 579  | 5          | 13,633    | 379        |
| Collateralized mortgage obligations government-sponsored enterprises | 6,463               | 66         | 35,317   | 429        | 41,780    | 495        |
|  | \$ 19,517           | \$ 440     | \$ 37,393                                      | \$ 437     | \$ 56,910 | \$ 877     |

The Corporation has not sold any available-for-sale securities during the three months or nine months ended September 30, 2008 and 2007 and has therefore not realized any gains or losses on such transactions.

At September 30, 2008 and December 31, 2007, securities with a fair value of approximately \$49.0 million and \$62.5 million, respectively, were pledged to secure public deposits and Federal Home Loan Bank (FHLB) advances.

**Note 8 Loans, Leases and Allowance for Loan and Lease Losses**

Loans and leases receivable consisted of the following:

|                                     | September<br>30,<br>2008 | December<br>31,<br>2007 |
|-------------------------------------|--------------------------|-------------------------|
|                                     | (In Thousands)           |                         |
| First mortgage loans:               |                          |                         |
| Commercial real estate              | \$ 381,220               | \$ 336,153              |
| Construction                        | 78,342                   | 90,545                  |
| Multi-family                        | 42,742                   | 41,821                  |
| 1-4 family                          | 49,050                   | 48,437                  |
|                                     | 551,354                  | 516,956                 |
| Commercial and industrial loans     | 238,868                  | 213,786                 |
| Direct financing leases, net        | 27,806                   | 29,383                  |
| Home equity loans                   | 7,626                    | 9,784                   |
| Credit card and other               | 13,969                   | 11,725                  |
|                                     | 839,623                  | 781,634                 |
| Less:                               |                          |                         |
| Allowance for loan and lease losses | 10,816                   | 9,854                   |
| Deferred loan fees                  | 450                      | 147                     |
| Loans and lease receivables, net    | \$ 828,357               | \$ 771,633              |



**Table of Contents**

An analysis of the allowance for loan and lease losses is presented below:

|   | Nine<br>Months<br>Ended<br>September<br>30,<br>2008 | Year Ended<br>December<br>31,<br>2007 |
|---|---|---------------------------------------|
|   | (In Thousands)                                      |                                       |
| Allowance at beginning of period          | \$ 9,854  | \$ 8,296                              |
| Charge-offs:                              |   |                                       |
| Commercial real estate and other mortgage | (417)   | (571)                                 |
| Commercial                                | (24)  | (778)                                 |
| Lease                                     |   | (25)                                  |
| Consumer                                  |   |                                       |
| Total charge-offs                         | (441)   | (1,374)                               |
| Recoveries:                               |   |                                       |
| Commercial real estate and other mortgage | 87  | 5                                     |
| Commercial                                | 2   | 23                                    |
| Lease                                     |   |                                       |
| Consumer                                  |   |                                       |
| Total recoveries                          | 89  | 28                                    |
| Net charge-offs                           | (352)   | (1,346)                               |
| Provision for loan and lease losses       | 1,314   | 2,904                                 |
| Allowance at end of period                | \$ 10,816   | \$ 9,854                              |
| Allowance to gross loans and leases       | 1.29%   | 1.26%                                 |

**Note 9 Deposits**

Deposits consisted of the following:

|   | September 30, 2008 |                             | December 31, 2007 |                             |
|---|--------------------|-----------------------------|-------------------|-----------------------------|
|   | Balance            | Weighted<br>average<br>rate | Balance           | Weighted<br>average<br>rate |
|   | (In Thousands)     |                             |                   |                             |
| Transaction accounts:                         |                    |                             |                   |                             |
| Demand deposits                               | \$ 57,995          | 0.00%                       | \$ 47,124         | 0.00%                       |
| Negotiable order of withdrawal (NOW) accounts | 58,993             | 1.81                        | 65,035            | 4.22                        |
|   | 116,988            |                             | 112,159           |                             |
| Money market accounts                         | 142,479            | 1.95                        | 162,585           | 4.49                        |
| Certificates of deposit                       | 571,822            | 4.64                        | 501,316           | 5.00                        |
|   | \$ 831,289         |                             | \$ 776,060        |                             |



**Table of Contents****Note 10 Borrowings**

Borrowings consisted of the following:

|   | September 30, 2008 |                                |                             | December 31, 2007 |                                |                             |
|---|--------------------|--------------------------------|-----------------------------|-------------------|--------------------------------|-----------------------------|
|   | Balance            | Weighted<br>average<br>balance | Weighted<br>average<br>rate | Balance           | Weighted<br>average<br>balance | Weighted<br>average<br>rate |
|   | (In Thousands)     |                                |                             |                   |                                |                             |
| Fed funds purchased and securities sold<br>under agreements to repurchase | \$ 7,300           | \$ 13,406                      | 2.75%                       | \$ 14,250         | \$ 10,394                      | 5.35%                       |
| FHLB advances   | 43,519             | 31,874                         | 4.71                        | 34,526            | 25,776                         | 4.87                        |
| Line of credit  | 10                 | 1,949                          | 4.86                        | 2,210             | 2,556                          | 7.20                        |
| Subordinated notes payable  | 39,000             | 33,905                         | 5.60                        | 31,000            | 23,630                         | 7.73                        |
| Junior subordinated notes   | 10,315             | 188                            | 10.64                       |                   |                                |                             |
| Other   |                    |                                |                             |                   | 25                             | 7.00                        |
|   | \$ 100,144         | \$ 81,322                      | 4.78                        | \$ 81,986         | \$ 62,381                      | 6.13                        |
| Short-term borrowings   | \$ 32,318          |                                |                             | \$ 32,470         |                                |                             |
| Long-term borrowings  | 67,826             |                                |                             | 49,516            |                                |                             |
|   | \$ 100,144         |                                |                             | \$ 81,986         |                                |                             |

At September 30, 2008 and December 31, 2007, there were no securities sold under agreements to repurchase. During March 2008, the Corporation increased its line of credit to \$10.5 million. The line of credit carries an interest rate of one month LIBOR plus 1.70% on the first \$7.5 million and one month LIBOR plus 1.75% on the remaining \$3.0 million. During June 2008, the Corporation obtained \$8.0 million of subordinated notes payable with a maturity of June 2015 which bears an interest rate of one month LIBOR plus 3.75%. In July 2008, we repaid \$31.0 million of subordinated notes payable and obtained additional \$31.0 million of subordinated notes payable with maturities of September 30, 2014 and interest rates of one month LIBOR plus 2.60% to 3.10%.

In September 2008, FBFS Statutory Trust II (the Trust), a Delaware business trust wholly owned by the Corporation, completed the sale of \$10.0 million of 10.5% fixed rate trust preferred securities (Preferred Securities). The Trust also issued common securities of \$315,000. The Trust used the proceeds from the offering to purchase \$10.3 million of 10.5% Junior Subordinated Notes (the Notes) of the Corporation. The Preferred Securities are mandatorily redeemable upon the maturity of the Notes on September 26, 2038. The Preferred Securities qualify under the risk-based capital guidelines as Tier 1 capital for regulatory purposes. The Corporation used the proceeds from the sale of the Notes for general corporate purposes including providing additional capital to its subsidiaries.

The Corporation has the right to redeem the Notes at any time on or after September 26, 2013. The Corporation also has the right to redeem the Notes, in whole but not in part, after the occurrence of a special event. Special events are limited to 1) a change in capital treatment resulting in the inability of the Corporation to include the Notes in Tier 1 Capital, 2) a change in laws or regulations that could require the Trust to register as an investment company under The Investment Company Act of 1940, as amended and 3) a change in laws or regulations that would a) require the Trust to pay income tax with respect to interest



**Table of Contents**

received on the Notes or b) prohibit the Corporation from deducting the interest payable by the Corporation on the Notes or c) result in greater than a de minimis amount of taxes for the Trust.

In accordance with the provisions of FIN 46R, the Trust, a wholly owned subsidiary of the Corporation, was not consolidated into the financial statements of the Corporation. Therefore, the Corporation presents in its consolidated financial statements junior subordinated notes as a liability and its investment in the Trust as a component of other assets.

**Note 11 Fair Value Disclosures (SFAS 157 Disclosure)**

Effective January 1, 2008, the Corporation determines the fair market values of its financial instruments based on the fair value hierarchy established in SFAS 157, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value. The Corporation carries its available-for-sale securities, and its interest rate swap that is designated as a cash flow hedge, and non-hedging interest rate swaps at fair value.

Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included with Level 1 that are observable for the asset or liability either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 3 inputs are inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Assets and liabilities measured at fair value on a recurring basis at September 30, 2008, segregated by fair value hierarchy level, are summarized below:

|                               | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total      |
|-------------------------------|---|---|--|------------|
|                               | (In Thousands)  |   |  |            |
| Assets:                       |   |   |  |            |
| Securities available for sale | \$  | \$ 107,446  | \$   | \$ 107,446 |
| Interest rate swaps non-hedge |   | 114   |  | 114        |
| Liabilities:                  |   |   |  |            |
| Interest rate swaps non-hedge | \$  | \$ 114  | \$   | \$ 114     |
| Interest rate swaps hedge     |   | 4   |  | 4          |
|                               | 16  |   |  |            |

**Table of Contents**

Assets and liabilities measured at fair value on a nonrecurring basis, segregated by fair value hierarchy, during the period ended September 30, 2008 are summarized below:

|                | Balance at<br>September<br>30,<br>2008 | Quoted<br>Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Gains<br>(Losses) |
|----------------|--|--|---|--|----------------------------|
| Impaired loans | \$4,381                                | \$   | \$ 945  | \$ 3,436   | \$                         |

Impaired loans that are collateral dependent were written down to their fair value of \$4.4 million through the establishment of specific reserves or by recording charge-offs when the carrying value exceeded the fair value. Valuation techniques consistent with the market approach, income approach, and/or cost approach were used to measure fair value and primarily included observable inputs for the individual impaired loans being evaluated such as recent sales of similar assets or observable market data for operational or carrying costs. In cases where such inputs were unobservable, the loan balance is reflected within Level 3 of the hierarchy.

**Note 12 Derivative Financial Instruments**

The Corporation enters into certain derivative financial instruments as part of its strategy to manage its exposure to interest rate risk. At September 30, 2008 and December 31, 2007, the fair value of the interest swap owned by the Corporation that is designated as a cash flow hedge represented a liability of \$4,000 and \$5,000, respectively. Beginning in the third quarter of 2008, the Corporation offers interest rate swap products directly to qualified commercial borrowers. The Corporation economically hedges client derivative transactions by entering into offsetting interest rate swap contracts executed with a third party. Derivative transactions executed as part of this program are not designated as SFAS 133 hedge relationships and are marked-to-market through earnings each period. The derivative contracts have mirror-image terms, which results in the positions' changes in fair value offsetting through earnings each period. At September 30, 2008, the aggregate amortizing notional value of interest rate swaps with various commercial borrowers was approximately \$5.5 million. The Corporation receives fixed rates and pays floating rates based upon LIBOR on the swaps with commercial borrowers. The aggregate amortizing notional value of interest rate swaps with dealer counterparties also was approximately \$5.5 million. The Corporation pays fixed rates and receives floating rates based upon LIBOR on the swaps with dealer counterparties. These interest rate swaps mature in 2018. The swaps were reported on the Corporation's balance sheet as a derivative asset of \$114,000, included in accrued interest receivable and other assets and a derivative liability of \$114,000, included in accrued interest and other liabilities.

**Table of Contents**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**General**

You should read the following discussion together with the Corporation's unaudited consolidated financial statements and related notes to unaudited consolidated financial statements, which are included elsewhere in this Report. The following discussion contains forward-looking statements that reflect plans, estimates and beliefs. When used in written documents or oral statements, the words anticipate, believe, estimate, expect, objective and similar expressions and verbs in the future tense are intended to identify forward-looking statements. The statements contained herein and such future statements involve or may involve certain assumptions, risks, and uncertainties, many of which are beyond the Corporation's control, which could cause actual results to differ materially from those discussed in the forward-looking statements. The forward-looking statements included in this Report are only made as of the date of its filing, and the Corporation undertakes no obligation to publicly update such forward-looking statements to reflect subsequent events or circumstances.

Forward-looking statements may also be made by the Corporation from time to time in other reports and documents as well as oral presentations. In addition to the assumptions and other factors referenced specifically in connection with such statements, the following factors could impact the business and financial prospects of the Corporation: general economic conditions; legislative and regulatory initiatives; increased competition and other effects of deregulation and consolidation of the financial services industry; monetary and fiscal policies of the federal government; deposit flows; disintermediation; the cost and availability of funds; general market rates of interest; interest rates or investment returns on competing investments; demand for loan products; demand for financial services; changes in accounting policies or guidelines; acts of terrorism and developments in the war on terrorism; and changes in the quality or composition of loan and investment portfolios. See also **Item 1A. Risk Factors** in Part II of this Form 10-Q regarding future operations discussed below.

Unless otherwise indicated or unless the context requires otherwise, all references in this Report to First Business Financial Services, the Corporation, FBFS, we, us, our, or similar references mean First Business Financial Services, Inc. together with our subsidiaries. First Business Bank or First Business Bank Milwaukee or the Banks are used to refer to our subsidiaries, First Business Bank and First Business Bank Milwaukee, alone.

**Overview**

FBFS is a registered bank holding company incorporated under the laws of the State of Wisconsin and is engaged in the commercial banking business through its wholly-owned banking subsidiaries, First Business Bank and First Business Bank Milwaukee. All of the operations of FBFS are conducted through the Banks and certain subsidiaries of First Business Bank. The Corporation operates as a business bank focusing on delivering a full line of commercial banking products and services tailored to meet the specific needs of small and medium sized businesses, business owners, executives, professionals and high net worth individuals. The Corporation does not utilize its locations to attract retail customers.

**Results of Operations**

**General.** Net income for the three months ended September 30, 2008 was \$1.2 million, up 32.4% from \$885,000 for the same time period in 2007. The principal factors contributing to this increase included an increase in net interest income of \$655,000, primarily caused by volume increases associated with organic growth of our Banks and a \$579,000 decrease in provision for loan and lease losses. Offsetting factors include the recognition of a \$626,000 loss on one of our foreclosed properties and increases in FDIC insurance expense. Both basic and diluted earnings per share for the three months ended September 30, 2008 increased to \$0.48 from \$0.36 for the same period in 2007. The increase in basic and diluted earnings per share is mainly attributable to the increase in net income. The annualized returns on average assets and average equity were 0.48% and 9.14%, respectively, for the three month period ended September 30, 2008, compared to 0.41% and 7.45%, respectively, for the same time period of 2007.

**Table of Contents**

Net income for the nine months ended September 30, 2008 was \$3.0 million, up 28.5% from \$2.3 million for the same time period in 2007. The increase in net income for the nine month period is a result of increased net interest income due to the organic growth of the organization and a reduction of the provision for loan and lease losses related to changes of inherent and credit risks within the loan and lease portfolio. Offsetting factors to the overall increase in net income include increased non-interest expense of \$2.0 million primarily due to increases in compensation expense of \$585,000, professional fees of \$279,000, occupancy costs of \$205,000, and losses on foreclosed properties of \$631,000. Basic and diluted earnings per share increased to \$1.24 per share for the nine months ended September 30, 2008 from \$0.95 per share for the same time period in 2007. The annualized returns on average assets and average equity were 0.42% and 7.90%, respectively, for the nine month period ending September 30, 2008, compared to 0.38% and 6.65%, respectively, for the same time period of 2007.

**Top Line Revenue**

Top line revenue is comprised of net interest income and non-interest income. This measurement is also commonly referred to as operating revenue. We use this measurement to monitor our revenue growth and as one third of the performance measurements used for our non-equity incentive plans. The growth in top line revenue of 13.9% for the nine months ended September 30, 2008 exceeds our targeted growth of 10.0% over the prior year. The components of top line revenue were as follows:

|                        | For the Three Months Ended  |          |        | For the Nine Months Ended |           |        |
|------------------------|-----------------------------|----------|--------|---------------------------|-----------|--------|
|                        | 2008                        | 2007     | Change | 2008                      | 2007      | Change |
|                        | September 30, September 30, |          |        |                           |           |        |
|                        | (In Thousands)              |          |        |                           |           |        |
| Net interest income    | \$ 6,517                    | \$ 5,862 | 11.2%  | \$ 19,231                 | \$ 16,881 | 13.9%  |
| Non-interest income    | 1,340                       | 1,101    | 21.7   | 3,700                     | 3,259     | 13.5   |
| Total top line revenue | \$ 7,857                    | \$ 6,963 | 12.8   | \$ 22,931                 | \$ 20,140 | 13.9   |

**Adjusted Net Income**

Adjusted net income is comprised of our net income as presented under generally accepted accounting principles (GAAP) adjusted for the after tax effects of the provision for loan and lease losses and actual net charge-offs incurred during the year. We have experienced significant organic growth in our loan and lease portfolio. As a result of this organic growth and the need for an additional provision for loan and lease losses required to support the increased inherent risk associated with a growing portfolio, we adjust our GAAP net income for the after tax effects of the provision for loan and lease losses and related net charge-off activities to allow our management to better analyze the growth of our earnings, including a comparison to our benchmark peers. Institutions with different loan and lease growth rates may not have comparable provisions for loan and lease loss amounts and net charge-off activity. We also use this measurement as one of three performance measurements used for our non-equity incentive plans that covers substantially all our employees. Our targeted growth in adjusted net income is 10% over the prior year. Growth in our adjusted net income for the nine months ended September 30, 2008 was 2.8%. In our judgment, presenting net income excluding the after tax effects of the provision for loan and lease losses and actual net charge-offs allows investors to trend, analyze and benchmark our results of operations in a more meaningful manner. Adjusted net income is a non-GAAP financial measure that does not represent and should not be considered as an alternative to net income derived in accordance with GAAP.

**Table of Contents**

A reconciliation of net income to adjusted net income is as follows:

|  | For the Three Months Ended<br>September 30, |          |        | For the Nine Months Ended<br>September 30, |          |        |
|--|---|----------|--------|--|----------|--------|
|  | 2008  | 2007     | Change | 2008                                       | 2007     | Change |
|  | (In Thousands)                              |          |        |  |          |        |
| Net income, presented under<br>US GAAP         | \$ 1,172                                    | \$ 885   | 32.4%  | \$ 3,010                                   | \$ 2,342 | 28.5%  |
| Add back:                                      |   |          |        |  |          |        |
| Provision for loan and lease losses, after tax | 10  | 362      | (97.2) | 799  | 1,138    | (29.8) |
| Less:  |   |          |        |  |          |        |
| Net charge-offs (recoveries), after tax        | (46)  | (1)      | *      | 214  | (16)     | *      |
| Adjusted net income                            | \$ 1,228                                    | \$ 1,248 | (1.6)  | \$ 3,595                                   | \$ 3,496 | 2.8    |

\* Not meaningful

**Return on Equity**

We view return on equity to be an important measurement to monitor profitability and we are focused on improving our return on equity throughout 2008. To align our employees' focus on profitability with a meaningful measure used by our shareholders, beginning in 2008, return on equity is now one third of the performance measurements used for our non-equity incentive plans that covers substantially all our employees. Our target return on equity for the twelve months ending December 31, 2008 is 10.5%. Return on equity for the three months ended September 30, 2008 was 9.14%, compared to 7.45% for the three months ended September 30, 2007. Return on equity for the nine months ended September 30, 2008 was 7.90%, compared to 6.65% for the nine months ended September 30, 2007. The increase in return on equity from the comparable periods of the prior year is attributable to the increase in net income.

**Table of Contents**

**Net Interest Income.** Net interest income depends on the amounts of and yields on interest-earning assets as compared to the amounts of and rates on interest-bearing liabilities. Net interest income is sensitive to changes in market rates of interest and the asset/liability management procedures used by management in responding to such changes. The table below presents the change in net interest income resulting from change in the volume of interest-earning assets or interest-bearing liabilities and change in interest rates for the three and nine months ended September 30, 2008, compared to the same periods of 2007.

|   | For the three months ended September 30 |          |                 |            | For the nine months ended September 30 |          |                 |            |
|---|---|----------|-----------------|------------|--|----------|-----------------|------------|
|   | Rate                                    | Volume   | Rate/<br>Volume | Net        | Rate                                   | Volume   | Rate/<br>Volume | Net        |
|   | (In Thousands)                          |          |                 |            |  |          |                 |            |
| <b>Interest-Earning Assets</b>                              |   |          |                 |            |  |          |                 |            |
| Commercial real estate and other mortgage loans             | \$ (1,497)                              | \$ 969   | \$ (157)        | \$ (685)   | \$ (3,301)                             | \$ 4,105 | \$ (524)        | \$ 280     |
| Commercial loans  | (853)                                   | 634      | (121)           | (340)      | (2,251)                                | 2,140    | (366)           | (477)      |
| Leases  | 17                                      | 64       | 3               | 84         | (6)                                    | 241      | (1)             | 234        |
| Consumer loans  | (6)                                     | 330      | (42)            | 282        | (24)                                   | 961      | (151)           | 786        |
| Total loans and leases receivable                           | (2,339)                                 | 1,997    | (317)           | (659)      | (5,582)                                | 7,447    | (1,042)         | 823        |
| Mortgage-related securities                                 | 17                                      | 169      | 3               | 189        | 64                                     | 249      | 5               | 318        |
| Investment securities                                       |   | (16)     |                 | (16)       | 2                                      | (36)     | (2)             | (36)       |
| Other investments   | (16)                                    |          |                 | (16)       | (46)                                   | 4        | (4)             | (46)       |
| Fed funds sold and other                                    |   | (28)     |                 | (28)       | (17)                                   | 20       | (10)            | (7)        |
| Short-term investments                                      | (13)                                    | 19       | (12)            | (6)        | (31)                                   | 40       | (21)            | (12)       |
| Total net change in income on interest-earning assets       | \$ (2,351)                              | \$ 2,141 | \$ (326)        | \$ (536)   | \$ (5,610)                             | \$ 7,724 | \$ (1,075)      | \$ 1,039   |
| <b>Interest-Bearing Liabilities</b>                         |   |          |                 |            |  |          |                 |            |
| NOW accounts  | \$ (486)                                | \$ (57)  | \$ 39           | \$ (504)   | \$ (1,333)                             | \$ (71)  | \$ 42           | \$ (1,362) |
| Money market  | (1,299)                                 | (327)    | 217             | (1,409)    | (3,518)                                | (856)    | 499             | (3,875)    |
| Certificates regular  | (485)                                   | 1,384    | (131)           | 768        | (574)                                  | 4,131    | (169)           | 3,388      |
| Certificates large  | (244)                                   | 272      | (102)           | (74)       | (416)                                  | 1,035    | (258)           | 361        |
| Total deposits  | (2,514)                                 | 1,272    | 23              | (1,219)    | (5,841)                                | 4,239    | 114             | (1,488)    |
| FHLB advances   | (19)                                    | 58       | (4)             | 35         | (28)                                   | 331      | (11)            | 292        |
| Other borrowings  | (225)                                   | 334      | (116)           | (7)        | (591)                                  | 690      | (214)           | (115)      |
| Total net change in expense on interest-bearing liabilities | \$ (2,758)                              | \$ 1,664 | \$ (97)         | \$ (1,191) | \$ (6,460)                             | \$ 5,260 | \$ (111)        | \$ (1,311) |
| Net change in net interest income                           | \$ 407                                  | \$ 477   | \$ (229)        | \$ 655     | \$ 850                                 | \$ 2,464 | \$ (964)        | \$ 2,350   |

Net interest income was \$6.5 million for the three months ended September 30, 2008, an increase of 11.2% from the same period in 2007. The increase in net interest income was caused by a combination of increased volume in our loan and lease portfolio and favorable rate declines in our interest-bearing liability portfolio. The yield on earning assets

was 6.28% for the three months ended September 30, 2008, compared to 7.44% for the comparable period in 2007. The yield on interest-bearing liabilities was 3.77% and 5.01% for the three months ended September 30, 2008 and 2007, respectively.

Interest income decreased \$536,000, or 3.5%, to \$14.7 million for the three months ended September 30, 2008 compared to the same time period of the prior year. Our ability to generate new volume of business at an equivalent pace and price assisted in offsetting the effects of a volatile and declining interest rate environment. Average loans and leases receivable increased 14.5%, while the average yield on the loans and leases portfolio declined 131 basis points. The average balance of our commercial real estate and other mortgage loan portfolio was \$545.0 million with a weighted average yield of 6.31%, for the three months ended September 30, 2008, compared to an average balance of \$494.0 million with a weighted average yield of 7.51% for the same three months of the prior year. Yields on our commercial real estate and other mortgage loan portfolio decreased by 120 basis points. The majority of loans in this portfolio are fixed rate in nature and are minimally impacted during a volatile interest rate market; however, as the banking industry continues to endure a difficult environment, competition for the highest asset quality loans is putting pressure on the overall pricing of loans and leases

**Table of Contents**

and our ability to grow the loan portfolio at rates we experienced in recent years. The remaining loans have floating rates that are indexed to Prime or LIBOR. The decline in the yield is attributable to the significant decline in the average LIBOR and Prime rates over the comparative period.

The average balance of our commercial and industrial loan portfolio was \$232.2 million with a weighted average yield of 7.15% for the three months ended September 30, 2008, compared to an average balance of \$203.1 million with a weighted average yield of 8.84% for the same period of the prior year. The yields on our commercial and industrial loan portfolio decreased 169 basis points from the same period one year ago. As approximately 60% of this portfolio is variable rate; this basis point decline is attributable to the basis point decline in the average Prime and LIBOR rates for the comparative period, offset by increased asset-based loan fees included as part of yield.

Interest expense decreased \$1.2 million, or 12.6%, to \$8.2 million for the three months ended September 30, 2008, compared to the same time period of 2007. Yields on our interest-bearing liabilities decreased 124 basis points. The decrease in interest expense was caused by the significant declines in the rates paid on local deposits due to the falling interest rate environment, specifically the federal funds interest rate which we use as a guideline to price our money market and NOW accounts, offset by the increased interest expense associated with volume increases in our certificates of deposits. Rates on brokered certificates of deposits did not fall as sharply compared to related indices given the continued demand for liquidity within the financial institutions industry. Shortfalls in attracting local deposits were supplemented with brokered deposits. Average deposit balances, including brokered deposits, were approximately \$787.3 million at September 30, 2008 with a weighted average cost of 3.68%, compared to an average balance of \$690.9 million with a weighted average cost of funds of 4.90% for the same period of 2007.

Average borrowings were \$84.0 million with a weighted average yield of 4.65% for the three months ended September 30, 2008 compared to \$60.6 million with a weighted average yield of 6.26% for the three months ended September 30, 2007. The decline in this yield is primarily related to the overall lower LIBOR interest rates during the 2008 periods compared to the 2007 period as the majority of the average balance is related to our subordinated notes payable which are indexed to one month LIBOR. On September 26, 2008, we issued \$10.3 million of junior subordinated notes with a fixed rate of 10.5%. Given the timing of the issuance of this debt, there was minimal impact to the overall yield on borrowings for the three months ended September 30, 2008.

Net interest margin was 2.78% for the three months ended September 30, 2008 compared to 2.86% for the comparable time period of 2007. The decline in the net interest margin is primarily caused by the market rates associated with brokered certificates of deposits. As discussed above, the market rates associated with these deposits did not fall as quickly or sharply as other related indices which has put pressure on our margin. Brokered certificates of deposits were our primary funding source for our asset growth. We continue to manage the composition and duration of interest bearing liabilities to limit the exposure to changing interest rates.

For the nine months ended September 30, 2008, net interest income was \$19.2 million, up 13.9% from the same period in 2007. Net interest margin was 2.77% for nine months ended September 30, 2008 compared to 2.86% for the nine months ended September 30, 2007. The yield on earning assets was 6.43% and 7.38% for the nine months ended September 30, 2008 and 2007, respectively. The yield on interest-bearing liabilities was 3.96 % and 4.94% for the nine months ended September 30, 2008 and 2007, respectively.

Interest income increased \$1.0 million, or 2.3%, to \$44.6 million for the nine months ended September 30, 2008, compared to the same period of the prior year. The increase in interest income is primarily due to the continued growth of the loan and lease portfolio offset by the declining interest rate environment. Average loans and leases receivable increased 18.9% while the average yield on the loans and leases portfolio declined 111 basis points. The average balance of the commercial real estate and other mortgage loan portfolio was \$541.8 million with a weighted average yield of 6.43% for the nine months ended September 30, 2008, compared to an average balance of \$467.5 million with a weighted average yield of 7.37% for the same nine months of the prior year. Yields on our commercial real estate and other mortgage loan portfolio decreased by 94 basis points. The majority of loans in this portfolio are fixed rate in nature



**Table of Contents**

and are minimally impacted during a volatile interest rate market. The remaining loans have floating rates that are indexed to Prime or LIBOR. The decline in the yield is attributable to the significant decline in the average LIBOR and Prime rates over the comparative periods coupled with increased foregone interest associated with impaired loans. For the nine months ended September 30, 2008 and 2007, foregone interest was \$393,000 and \$250,000, respectively. The average balance of the commercial and industrial loan portfolio was \$226.1 million with a weighted average yield of 7.48% for the nine months ended September 30, 2008, compared to an average balance of \$194.4 million with a weighted average yield of 9.03% for the same period of the prior year. The yields on our commercial and industrial loan portfolio decreased 155 basis points from the same period in 2007. As this portfolio of loans primarily has floating rates, this basis point decline is attributable to the basis point decline in the average Prime and LIBOR rates for the comparative periods.

Interest expense decreased \$1.3 million to \$25.4 million for the nine months ended September 30, 2008 compared to \$26.7 million for the nine months ended September 30, 2007. The average yield on interest-bearing liabilities decreased 98 basis points. We experienced a significant decline of approximately 284 basis points in the average Federal Funds rate, which is utilized as a guideline to price our interest-bearing transaction deposit accounts thus causing the sharp decline in the overall rates paid on our money market and NOW accounts. The decrease in interest expense related to the falling rate environment was partially offset by the increase in interest expense associated with volume increases in our certificates of deposits. Shortfalls in attracting local deposits to fund our asset growth were offset by the purchase of brokered certificates of deposits. With the continued demand for liquidity amongst financial institutions, rates on brokered certificates of deposit did not fall as quickly or as sharply as related indices causing brokered certificates of deposit to be a higher than expected source of funds. We have also experienced a change in the overall mix of our deposit base, with total certificates of deposits representing 65.4% of total average interest-bearing liabilities for the nine months ended September 30, 2008 compared to 58.3% of total average interest-bearing liabilities for the nine months of the prior year.

Year-to-date average deposit balances, including brokered deposits, were approximately \$772.7 million at September 30, 2008 with a weighted average cost of funds of 3.88%, compared to an average balance of \$661.1 million with a weighted average cost of funds of 4.83% for the same time period of 2007. During the first quarter of 2008, we exercised our call provision on \$30 million of brokered certificates of deposit. These certificates had two years remaining before their scheduled maturity. At various points throughout the first quarter of 2008, we obtained newly issued brokered certificates of deposits with various maturities. The average cost of the newly issued certificates of deposits was 59 basis points lower than the average cost of the called certificates of deposits. As a result of calling these deposits, we expensed the remaining prepaid broker fee associated with these certificates and recorded approximately \$150,000 of additional interest expense during the first quarter of 2008. We expect to recoup the costs of the accelerated amortization with reduced interest expense by the end of 2008, and recognize the full benefit of the 59 basis point reduction on \$30 million of brokered certificates throughout 2009.

Our net interest margin declined by nine basis points to 2.77% for the nine months ended September 30, 2008 compared to 2.86% for the same time period in 2007. The decline in the net interest margin is caused by increased deposit base in more expensive deposit products, including brokered certificates of deposit, and increased non-accrual loans since September 2007 which continue to be included in the average balances for purposes of the yield calculations with no corresponding interest income recognized in our financial statements.

**Table of Contents**

**Average Interest-Earning Assets, Average Interest-Bearing Liabilities and Interest Rate Spread.** The table below shows our average balances, interest, average rates, net interest margin and the spread between the combined average rates earned on interest-earning assets and average cost of interest-bearing liabilities for the periods indicated. The average balances are derived from average daily balances.

|  | Average<br>balance | For the Three Months Ended September 30, |                | Average<br>balance | Interest | Average<br>yield/cost |
|--|--------------------|--|----------------|--------------------|----------|-----------------------|
|  |                    | 2008                                     | 2007           |                    |          |                       |
|  |                    | Average                                  | Average        |                    |          |                       |
|  |                    | Interest                                 | yield/cost     |                    |          |                       |
|  |                    |  | (In Thousands) |                    |          |                       |
| <b>Interest-Earning Assets</b>                                 |                    |  |                |                    |          |                       |
| Commercial real estate and other mortgage loans <sup>(1)</sup> | \$ 545,096         | \$ 8,594                                 | 6.31%          | \$ 493,953         | \$ 9,279 | 7.51%                 |
| Commercial and industrial loans <sup>(1)</sup>                 | 232,153            | 4,150                                    | 7.15           | 203,071            | 4,490    | 8.84                  |
| Leases   | 28,200             | 445                                      | 6.31           | 23,935             | 361      | 6.03                  |
| Consumer loans   | 23,626             | 329                                      | 5.57           | 2,949              | 47       | 6.38                  |
| Total loans and leases receivable <sup>(1)</sup>               | 829,075            | 13,518                                   | 6.52           | 723,908            | 14,177   | 7.83                  |
| Mortgage-related securities <sup>(2)</sup>                     | 103,869            | 1,205                                    | 4.64           | 89,048             | 1,016    | 4.56                  |
| Investment securities <sup>(2)</sup>                           |                    |  |                | 1,701              | 16       | 3.76                  |
| Federal Home Loan Bank stock                                   | 2,367              |  |                | 2,328              | 16       | 2.75                  |
| Fed funds sold and other                                       |                    |  |                | 2,104              | 28       | 5.32                  |
| Short-term investments   | 3,306              | 16                                       | 1.94           | 1,760              | 22       | 5.00                  |
| Total interest-earning assets                                  | 938,617            | 14,739                                   | 6.28           | 820,849            | 15,275   | 7.44                  |
| Non-interest-earning assets                                    | 38,261             |  |                | 32,947             |          |                       |
| Total assets   | \$ 976,878         |  |                | \$ 853,796         |          |                       |
| <b>Interest-Bearing Liabilities</b>                            |                    |  |                |                    |          |                       |
| NOW accounts   | \$ 60,585          | 213                                      | 1.41           | \$ 65,806          | 717      | 4.36%                 |
| Money market   | 141,808            | 551                                      | 1.55           | 170,170            | 1,960    | 4.61                  |
| Certificates regular   | 513,654            | 5,907                                    | 4.60           | 404,661            | 5,139    | 5.08                  |
| Certificates large   | 71,268             | 574                                      | 3.22           | 50,217             | 648      | 5.16                  |
| Total deposits   | 787,315            | 7,245                                    | 3.68           | 690,854            | 8,464    | 4.90                  |
| FHLB advances  | 29,203             | 335                                      | 4.59           | 24,471             | 300      | 4.90                  |
| Other borrowings   | 54,804             | 642                                      | 4.69           | 36,171             | 649      | 7.18                  |
| Total interest-bearing liabilities                             | 871,322            | 8,222                                    | 3.77           | 751,496            | 9,413    | 5.01                  |
| Non-interest-bearing liabilities                               | 54,206             |  |                | 54,757             |          |                       |

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|   |            |          |            |                |
|---|------------|----------|------------|----------------|
| Total liabilities   | 925,528    |          | 806,253    |                |
| Stockholders' equity  | 51,350     |          | 47,543     |                |
| Total liabilities and stockholders' equity                              | \$ 976,878 |          | \$ 853,796 |                |
| Net interest income/interest rate spread                                |            | \$ 6,517 | 2.51%      | \$ 5,862 2.43% |
| Net interest-earning assets   | \$ 67,295  |          | \$ 69,353  |                |
| Net interest margin   |            |          | 2.78%      | 2.86%          |
| Average interest-earning assets to average interest-bearing liabilities | 107.72%    |          | 109.23%    |                |
| Return on average assets  | 0.48       |          | 0.41       |                |
| Return on average equity  | 9.14       |          | 7.45       |                |
| Average equity to average assets  | 5.26       |          | 5.57       |                |
| Non-interest expense to average assets                                  | 2.38       |          | 2.32       |                |

(1) The average balances of loans and leases include non-performing loans and leases. Interest income related to non-performing loans and leases is recognized when collected.

(2) Includes amortized cost basis of assets available for sale.

**Table of Contents**

|   | For the Nine Months Ended September 30, |                  |   |                    |                  |                       |
|---|---|------------------|---|--------------------|------------------|-----------------------|
|   | Average<br>balance                      | 2008<br>Interest | Average<br>yield/cost<br>(In Thousands) | Average<br>balance | 2007<br>Interest | Average<br>yield/cost |
| <b>Interest-Earning Assets</b>                                    |   |                  |   |                    |                  |                       |
| Commercial real estate and<br>other mortgage loans <sup>(1)</sup> | \$ 541,809                              | \$ 26,125        | 6.43%                                   | \$ 467,544         | \$ 25,845        | 7.37%                 |
| Commercial loans <sup>(1)</sup>                                   | 226,051                                 | 12,687           | 7.48                                    | 194,431            | 13,164           | 9.03                  |
| Leases  | 28,455                                  | 1,352            | 6.34                                    | 23,434             | 1,118            | 6.36                  |
| Consumer loans  | 22,918                                  | 936              | 5.45                                    | 3,093              | 150              | 6.47                  |
| Total loans and leases<br>receivable <sup>(1)</sup>               | 819,233                                 | 41,100           | 6.69                                    | 688,502            | 40,277           | 7.80                  |
| Mortgage-related securities <sup>(2)</sup>                        | 99,736                                  | 3,434            | 4.59                                    | 92,350             | 3,116            | 4.50                  |
| Investment securities <sup>(2)</sup>                              | 348                                     | 10               | 3.83                                    | 1,661              | 46               | 3.69                  |
| Federal Home Loan Bank<br>stock                                   | 2,367                                   |                  |   | 2,184              | 46               | 2.81                  |
| Fed funds sold and other  | 1,387                                   | 29               | 2.79                                    | 895                | 36               | 5.36                  |
| Short-term investments  | 2,675                                   | 45               | 2.29                                    | 1,582              | 58               | 4.89                  |
| Total interest-earning assets                                     | 925,746                                 | 44,618           | 6.43                                    | 787,174            | 43,579           | 7.38                  |
| Non-interest-earning assets                                       | 33,873                                  |                  |   | 32,263             |                  |                       |
| Total assets  | \$ 959,619                              |                  |   | \$ 819,437         |                  |                       |
| <b>Interest-Bearing Liabilities</b>                               |   |                  |   |                    |                  |                       |
| NOW accounts  | \$ 66,109                               | 895              | 1.81                                    | \$ 68,250          | 2,257            | 4.41%                 |
| Money market  | 148,145                                 | 2,164            | 1.95                                    | 172,617            | 6,039            | 4.66                  |
| Certificates regular  | 487,980                                 | 17,388           | 4.75                                    | 376,800            | 14,000           | 4.95                  |
| Certificates large  | 70,466                                  | 2,027            | 3.84                                    | 43,466             | 1,666            | 5.11                  |
| Total deposits  | 772,700                                 | 22,474           | 3.88                                    | 661,133            | 23,962           | 4.83                  |
| FHLB advances   | 31,874                                  | 1,126            | 4.71                                    | 22,827             | 834              | 4.87                  |
| Other borrowings  | 49,448                                  | 1,787            | 4.82                                    | 36,290             | 1,902            | 6.99                  |
| Total interest-bearing<br>liabilities                             | 854,022                                 | 25,387           | 3.96                                    | 720,250            | 26,698           | 4.94                  |
| Non-interest-bearing liabilities                                  | 54,785                                  |                  |   | 52,260             |                  |                       |
| Total liabilities   | 908,807                                 |                  |   | 772,510            |                  |                       |
| Stockholders' equity  | 50,812                                  |                  |   | 46,927             |                  |                       |
| Total liabilities and<br>stockholders' equity                     | \$ 959,619                              |                  |   | \$ 819,437         |                  |                       |

|   |           |           |       |           |       |
|---|-----------|-----------|-------|-----------|-------|
| Net interest income/interest rate spread                                |           | \$ 19,231 | 2.47% | \$ 16,881 | 2.44% |
| Net interest-earning assets   | \$ 71,724 |           |       | \$ 66,924 |       |
| Net interest margin   |           |           | 2.77% |           | 2.86% |
| Average interest-earning assets to average interest-earning liabilities | 108.40%   |           |       | 109.29%   |       |
| Return on average assets  | 0.42      |           |       | 0.38      |       |
| Return on average equity  | 7.90      |           |       | 6.65      |       |
| Average equity to average assets  | 5.30      |           |       | 5.73      |       |
| Non-interest expense to average assets                                  | 2.31      |           |       | 2.38      |       |

(1) The average balances of loans and leases include non-performing loans and leases. Interest income related to non-performing loans and leases is recognized when collected.

(2) Includes amortized cost basis of assets held and available for sale.

**Provision for Loan and Lease Losses.** The provision for loan and lease losses totaled \$17,000 and \$596,000 for the three months ended September 30, 2008 and 2007, respectively. The provision for loan and lease losses was \$1.3 million and \$1.9 million for the nine months ended September 30, 2008 and 2007. The provision for loan and lease loss recorded in the three and nine months ended September 30, 2008 and 2007 is related to the relative changes of inherent and credit risks within our portfolio. Our allowance for loan loss methodology prescribes our required provision for loan and lease losses based upon credit risk and other subjective factors. The provision for loan and lease losses is influenced by the

**Table of Contents**

magnitude of net charge-offs recorded in the period and by the required amount of reserves established for impaired loans that present potential collateral shortfall positions. Refer to **Asset Quality** for further information.

**Non-Interest Income.** Non-interest income, consisting primarily of fees earned for trust and investment services, service charges on deposits, income from bank-owned life insurance and loan fees, increased \$239,000, or 21.7%, to \$1.3 million for the three months ended September 30, 2008 from \$1.1 million for the same period in 2007. Trust and investment services fee income decreased \$35,000, or 6.7%, to \$489,000 for the three months ended September 30, 2008, compared to \$524,000 for the same period in 2007. Trust and investment services fee income is derived primarily from two sources, trust assets under management and brokerage services. Trust assets under management decreased approximately \$8.7 million to \$278.4 million at September 30, 2008 compared to \$287.1 million at September 30, 2007. Equity markets have continued to decline throughout the third quarter of 2008 which more than offset the overall growth in the cost basis of trust assets under management. Trust income is based upon a fee on the market values of assets under management. Trust income increased \$18,000 for the three months ended September 30, 2008 compared to the same period in 2007. Although market values have declined, the increase in trust fee income is attributable to successful sales efforts to grow the client base. At September 30, 2008, brokerage assets under administration decreased \$23.2 million, or 15.6%, to \$125.2 million compared to \$148.4 million at September 30, 2007. Investment service commission fee income decreased \$53,000 for the three months ended September 30, 2008 compared to the same period in 2007. Investment service fee income is driven by client activity and in part the timing of commissions received.

Service charges on deposits increased \$107,000, or 61.1%, to \$282,000 for the three months ended September 30, 2008 from \$175,000 for the same period in 2007. The increase in service charge income is in direct correlation to the declining interest rate environment. Our demand deposit clients receive an earnings credit based upon the federal funds rate and balances kept within our Banks. These earnings credits are utilized to reduce the service charges incurred on their deposit accounts. As the interest rate index utilized to calculate the earnings credit has substantially fallen, the majority of our clients do not have sufficient earnings credits to fully eliminate the service charges on their accounts, resulting in increased service charge income recognized within our consolidated financial statements. Beginning in the third quarter of 2008, we started offering interest rate swap products directly to our qualified commercial borrowers. We simultaneously economically hedged these client derivative transactions by entering into offsetting interest rate swap contracts with dealer counterparties. Derivative transactions executed as part of this program are not designated as SFAS 133 hedge relationships and are marked-to-market through earnings each period. We recognized in the consolidated income statements the initial fair value recognition for the swaps which for the nine months ended September 30, 2008 totaled \$54,000. Change in fair value of non-hedge derivative contracts is included in other income in the consolidated statements of income. The derivative contracts have mirror-image terms, which results in the positions changes in fair value offsetting through earnings each period.

Non-interest income for the nine months ended September 30, 2008 increased \$441,000, or 13.5%, to \$3.7 million from \$3.3 million for the comparable period of 2007. Similar to the explanation for the third quarter activity, non-interest income increases are primarily due to increased trust and investment services fee income. Trust and investment service fee income increased \$95,000, or 6.7%, to \$1.5 million for the nine months ended September 30, 2008 from \$1.4 for the nine months ended September 30, 2007. Although our trust assets under administration have declined, the decline in assets was associated with market value declines and not with loss of client relationships. Market value declines were most significant during the third quarter when the stock market experienced significant volatility. Service charges on deposits increased \$220,000, or 42.1%, to \$742,000 for the nine months ended September 30, 2008, compared to \$522,000 for the nine months ended September 30, 2007, due to the declining interest rate environment and the related impact to the earnings credit rate received by our clients as described above.

**Non-Interest Expense.** Non-interest expense increased \$871,000, or 17.6 %, to \$5.8 million for the three months ended September 30, 2008 from \$4.9 million for the comparable period of 2007, primarily due to an increase in loss on foreclosed properties of \$626,000. The loss on foreclosed properties was caused by

**Table of Contents**

an impairment write-down on a condominium development we own. Given further deterioration of market values of this condominium development, we have recorded further impairments to carry this asset at its best estimate of fair value. Occupancy expense has increased \$77,000, or 29.4%, to \$339,000 for the three months ended September 30, 2008 from \$262,000 for the comparable period of 2007. The increase in occupancy expense is associated with rental expense for new space obtained in late 2007 and early 2008. In December 2007, we occupied the new space completed for our loan production office in Appleton, Wisconsin. Also during the first quarter of 2008, we leased additional space in our corporate office building. Professional fees increased \$89,000, or 30.6%, to \$380,000 for the three months ended September 30, 2008 from \$291,000 for the three months ended September 30, 2007. The increase in professional fees is caused by additional contracts with third party vendors for various services and the related timing of the completion of those services. The increase in other expenses is associated with \$111,000 of additional FDIC insurance premiums caused by increased rates and the overall increase in our deposit base of our Banks to which the premium rate is applied. With the temporary change in FDIC insurance coverage from \$100,000 to \$250,000, we expect that the insurance premium we pay will continue to increase.

Non-interest expense increased \$2.0 million, or 13.6%, to \$16.6 million for the nine months ended September 30, 2008 from \$14.6 million for the comparable period of 2007. In general, non-interest expenses are influenced by the growth of operations, with additional employees to staff such growth. Compensation expense increased \$585,000, or 6.4%, to \$9.7 million for the nine months ended September 30, 2008 compared to \$9.1 million for the comparable period of 2007. The increase is due to more full-time equivalent employees, higher compensation levels from normal annual salary reviews and additional compensation expense associated with share-based compensation awards. Occupancy expense increased \$205,000, or 26.2%, to \$988,000 for the nine months ended September 30, 2008 compared to \$783,000 for the nine months ended September 30, 2007. Similar to the three month discussion, the increase in occupancy expense is associated with additional space we occupy. Professional fees increased \$279,000, or 26.5%, to \$1.3 million for the nine months ended September 30, 2008 from \$1.1 million for the comparable period of 2007. The increase in professional fees is related to additional contracts with third party vendors for various services and the related timing of completion coupled with the additional legal expenses incurred for the design and implantation of a shareholder rights plan. Other expense increased \$266,000, or 15.4%, to \$1.9 million for the nine months ended September 30, 2008 from \$1.7 million for the nine months ended September 30, 2007. The increase in other expenses is attributable to increased FDIC insurance premiums of approximately \$373,000, partially offset by income recognized on our investment in Aldine Capital. We account for investment in Aldine Capital under the equity method and we recognized \$41,000 of income related to the investment for the nine months ended September 30, 2008, compared to an expense of \$199,000 for the same time period in 2007.

**Income Taxes.** Income tax expense was \$853,000 for the three months ended September 30, 2008, with an effective rate of 42.1%, compared to \$538,000 with an effective rate of 37.8% for the three months ended September 30, 2007. Income tax expense was \$2.0 million for the nine months ended September 30, 2008, with an effective rate of 40.0%, compared to \$1.3 million with an effective rate 36.0% for the nine months ended September 30, 2007. The increase in the effective tax rate was primarily due to additional state tax amounts recognized related to uncertain tax liabilities coupled with a decline in the level of tax credits. In addition, during the third quarter of 2008, we recorded additional tax expense of approximately \$35,000 relating to the settlement of an IRS examination of the 2004 and 2005 tax years.

**Financial Condition**

**General.** The total assets of our Corporation increased \$79.9 million, or 8.7%, to \$998.4 million at September 30, 2008 from \$918.4 million at December 31, 2007, primarily due to increases in the loan and lease portfolio and securities available-for-sale portfolio. The allowance for loan and lease losses was 1.29% and 1.26% of gross loans and leases at September 30, 2008 and December 31, 2007, respectively. Asset growth was primarily funded by an increase of out-of-market deposits.

**Securities.** Securities available-for-sale increased \$10.1 million to \$107.4 million at September 30, 2008 from \$97.4 million at December 31, 2007, primarily due to additional purchases of government agency

**Table of Contents**

collateralized mortgage obligations to ensure our investment portfolio remains at approved investment levels to provide adequate liquidity to our organization. Our available-for-sale investment portfolio primarily consists of collateralized mortgage obligations and is used to provide a source of liquidity, including the ability to pledge securities, while maximizing the earnings potential of our assets. The estimated prepayment streams associated with this portfolio also allow us to better match our short-term liabilities. We purchase investment securities intended to protect our net interest margin while maintaining an acceptable risk profile. While collateralized mortgage obligations present prepayment risk and extension risk, we believe the overall credit risk associated with these investments is minimal as approximately 72.7% of the obligations we hold were issued by government agencies. The remaining 27.3% of the obligations we hold were issued by government-sponsored enterprises Fannie Mae and Freddie Mac. We do not hold any Fannie Mae or Freddie Mac preferred stock. In addition, our credit risk is further mitigated by the fact that the securities within our portfolio are not collateralized by subprime mortgages. We did not sell any available-for-sale securities during the three or nine months ended September 30, 2008 or 2007. During the nine months ended September 30, 2008, we recognized unrealized holding gains of approximately \$464,000 compared to unrealized holding gains of \$875,000 during the comparable period in 2007. Unrealized holding gains on available-for-sale securities are recognized in accumulated other comprehensive income. Our portfolio is sensitive to fluctuations in the interest rate environment and has limited sensitivity to credit risk due to the nature of the issuers of our securities as previously discussed. If interest rates decline and the credit quality of our securities remain positive, the market value of our debt securities will improve. If interest rates increase and the credit quality of securities remain positive, the market value of our debt securities will decline.

The average balance of our available-for-sale portfolio for the nine months ended September 30, 2008 was \$100.1 million, with an average yield of 4.59%, compared to an average balance of \$94.9 million, with an average yield of 4.44% for the same period last year.

**Loans and Leases Receivable.** Loans and leases receivable, net of allowance for loan and lease losses, increased \$56.7 million, or 7.3%, to \$828.4 million at September 30, 2008 from \$771.6 million at December 31, 2007. We principally originate commercial business loans and commercial real estate loans. The overall mix of the loan and lease portfolio at September 30, 2008 remained generally consistent with the mix at December 31, 2007 continuing with a concentration in commercial real estate mortgage loans at approximately 66% of our total loan portfolio. Growth in the loan and lease portfolio is attributable to organic growth by successful sales efforts of our expanded sales team to extend credit to established and new client relationships, including production from our loan production office located in the Northeast region of Wisconsin. Economic factors have deteriorated and the demand for new loans within our markets has declined. We are competing with our peers for fewer high quality loan opportunities which is putting pressure on our ability to grow our loan and lease portfolio at growth rates we experienced in recent years. We remain committed to our underwriting standards and continue to seek high quality assets to continue our growth plan. The allowance for loan and lease losses as a percentage of gross loans and leases was 1.29% and 1.26% as of September 30, 2008 and December 31, 2007, respectively. Non-accrual loans and leases as a percentage of total loans and leases has declined to 0.89% at September 30, 2008 compared to 1.13% at December 31, 2007. The primary factors impacting the decline in this ratio are the transfer of \$3.9 million into foreclosed properties and charge-offs of \$441,000 associated with non-accrual loans. The remaining difference is due to pay-offs or principal reductions of non-accrual loans due to cash collection. We believe the allowance for loan and lease losses was adequate at September 30, 2008. There were no charge-offs recognized through the nine months ended September 30, 2007. Recoveries of \$89,000 and \$27,000 were recognized through the nine months ended September 30, 2008 and 2007, respectively. During the quarter ended September 30, 2008, we recognized charge-offs in the amount of \$9,000 on four residential lots that were accepted by deed in lieu of foreclosure. There were no charge-offs during the three months ended September 30, 2007. Refer to the **Asset Quality** section for more information.

**Deposits.** As of September 30, 2008, deposits increased \$55.2 million to \$831.2 million from \$776.1 million at December 31, 2007. The increase was primarily attributable to an increase in brokered certificates of deposit. Brokered certificates of deposit represented \$495.6 million of total deposits at



**Table of Contents**

September 30, 2008, compared to \$429.2 million of total deposits at December 31, 2007. Our net loan and lease portfolio grew \$56.7 million, and we funded this growth with brokered deposits. Brokered deposits are generally a lower cost source of funds when compared to the interest rates on deposits with similar terms that would need to be offered in the local markets to generate an equivalent level of funds.

**Borrowings.** We had borrowings, including junior subordinated notes, of \$100.1 million as of September 30, 2008 compared to \$82.0 million as of December 31, 2007, an increase of \$18.2 million, or 22.1%. We use borrowings to offset variability of deposit flows and as an additional funding source for asset growth. In the second quarter of 2008, we obtained \$8.0 million of subordinated notes payable. In the third quarter, we refinanced \$31.0 million of our subordinated notes payable. Subordinated notes payable are included in Federal Home Loan Bank and other borrowings in our consolidated balance sheets. Subordinated notes payable qualify as Tier 2 capital for regulatory capital purposes.

In September 2008, FBFS Statutory Trust II (the Trust), a Delaware business trust wholly owned by the Corporation, completed the sale of \$10.0 million of 10.5% fixed rated trust preferred securities (Preferred Securities). The trust also issued common securities of \$315,000. The Trust used the proceeds from the offering to purchase \$10.3 million of 10.5% Junior Subordinated Notes (the Notes) issued by us. The Preferred Securities are mandatorily redeemable upon the maturity of the Notes on September 26, 2038. The Preferred Securities qualify under the risk-based capital guidelines as Tier 1 capital for regulatory purposes. We used the proceeds from the sale of the Notes for general corporate purposes including providing capital to our subsidiaries. We have the right to redeem the Notes at any time on or after September 26, 2013, or earlier after the occurrence of a special event, as defined.

**Asset Quality**

**Non-performing Assets.** Non-performing assets consisted of non-accrual loans and leases and foreclosed properties of \$10.9 million as of September 30, 2008. This represented approximately 1.09% of total assets as of September 30, 2008, compared to \$9.5 million, or 1.04% of total assets, as of December 31, 2007. The increase in non-performing assets is a function of further deterioration in certain construction and land development loans partially offset by the sale of a foreclosed property in March 2008, which resulted in a \$5,000 loss, an impairment charge of \$626,000 on one of our foreclosed properties, charge-offs of \$441,000 relating to two large condominium construction projects and one land development project, and pay-offs and cash collections of other non-performing assets.

For the nine months ended September 30, 2008, we recorded net charge-offs of approximately \$352,000. These charge-offs were directly related to continued deteriorations of market valuations on a condominium construction project, a land development project and unsold developed residential lots. Based upon complications with each project and further market decline, we concluded that we would not recover our entire principal on these loans and as a result recorded related partial charge-offs. We continue to proactively monitor our loan and lease portfolio for further deterioration and apply our prescribed allowance for loan and lease loss reserve methodology. However, given complexities with legal actions on certain of our large impaired loans and continued decline in economic conditions, we continue to evaluate the best information available to us to determine the amount of the loans that is collectible. We believe the loans were recorded at the appropriate value at September 30, 2008; however, further charge-offs could be recorded if additional facts and circumstances lead us to a different conclusion.

**Table of Contents**

Our non-accrual loans and leases consisted of the following at September 30, 2008 and December 31, 2007, respectively.

|  | September<br>30,<br>2008   | December<br>31,<br>2007                                    |
|--|--|--|
|  | (In Thousands)   |  |
| Non-accrual loans  | \$ 7,439   | \$ 8,805   |
| Non-accrual leases   |  | 59   |
| Total non-accrual loans and leases                                   | 7,439  | 8,864  |
| Foreclosed properties  | 3,490  | 660  |
| Total non-performing assets  | \$ 10,929  | \$ 9,524   |
| Performing troubled debt restructurings                              | \$   | \$   |
| Total non-accrual loans and leases to total loans and leases         | 0.89%  | 1.13%  |
| Total non-performing assets to total assets                          | 1.09   | 1.04   |
| Allowance for loan and lease losses to total loans and leases        | 1.29   | 1.26   |
| Allowance for loan and lease losses to non-accrual loans and leases  | 145.40   | 111.17   |
| The following represents information regarding our impaired loans:   |  |  |
|  | As of<br>and for<br>the<br>Nine<br>Months<br>Ended<br>September<br>30,<br>2008 | As of and for<br>the Year<br>Ended<br>December 31,<br>2007 |
|  | (In Thousands)   |  |
| Impaired loans and leases with no impairment reserves required       | \$ 3,569   | \$ 6,500   |
| Impaired loans and leases with impairment reserves required          | 3,870  | 2,617  |
| Total impaired loans and leases                                      | 7,439  | 9,117  |
| Less:  |  |  |
| Impairment reserve (included in allowance for loan and lease losses) | 695  | 834  |
| Net impaired loans and leases  | \$ 6,744   | \$ 8,283   |
| Average impaired loans and leases                                    | \$ 7,565   | \$ 3,439   |
| Foregone interest income attributable to impaired loans and leases   | \$ 442   | \$ 365   |
| Interest income recognized on impaired loans and leases              | (49)   | (41)   |

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|   |        |        |
|---|--------|--------|
| Net foregone interest income on impaired loans and leases | \$ 393 | \$ 324 |
|---|--------|--------|

Net foregone interest income on impaired loans and leases for the nine months ended September 30, 2007 was \$250,000.

**Table of Contents**

A summary of the activity in the allowance for loan and lease losses follows:

|                                       | For the Three Months<br>Ended<br>September 30,<br>2008 |           | For the Nine Months<br>Ended<br>September 30,<br>2008 |           |
|---------------------------------------|--|-----------|---|-----------|
|                                       | 2007   | 2007      | 2007  | 2007      |
|                                       | (In Thousands)   |           |   |           |
| Allowance at beginning of period      | \$ 10,723  | \$ 9,598  | \$ 9,854  | \$ 8,296  |
| Charge-offs:                          |  |           |   |           |
| Mortgage                              | (9)  |           | (417)   |           |
| Commercial                            |  |           | (24)  |           |
| Lease                                 |  |           |   |           |
| Consumer                              |  |           |   |           |
| Total charge-offs                     | (9)  |           | (441)   |           |
| Recoveries:                           |  |           |   |           |
| Mortgage                              | 84   | 2         | 87  | 4         |
| Commercial                            | 1  |           | 2   | 23        |
| Lease                                 |  |           |   |           |
| Consumer                              |  |           |   |           |
| Total recoveries                      | 85   | 2         | 89  | 27        |
| Net (charge-offs) recoveries          | 76   | 2         | (352)   | 27        |
| Provision for loan and lease losses   | 17   | 596       | 1,314   | 1,873     |
| Allowance at end of period            | \$ 10,816  | \$ 10,196 | \$ 10,816   | \$ 10,196 |
| Allowance to average loans and leases | 1.30%  | 1.41%     | 1.32%   | 1.48%     |

**Liquidity and Capital Resources**

During the nine months ended September 30, 2008 and the year ended December 31, 2007, the Banks did not make dividend payments to the Corporation. The Banks are subject to certain regulatory limitations regarding their ability to pay dividends to the Corporation. Management believes that the Corporation will not be adversely affected by these dividend limitations. The Corporation's principal liquidity requirements at September 30, 2008 are the repayment of interest payments due on subordinated and junior subordinated notes. The Corporation expects to meet its liquidity needs through existing cash flow sources, its line of credit in the amount of \$10.5 million of which \$10,000 is outstanding on September 30, 2008 and through any future dividends received from the Banks. The Corporation and its subsidiaries continue to have a strong capital base and the Corporation's regulatory capital ratios continue to be above the defined minimum regulatory ratios. During the second quarter of 2008, we obtained an additional \$8.0 million of subordinated notes payable. Subordinated notes payable are considered allowable Tier 2 capital for purposes of regulatory capital. A portion of the proceeds from the issuance of the subordinated debt was contributed to the capital of the Banks to ensure the Banks remain well-capitalized for their future growth. During the third quarter of 2008, we issued \$10.3 million of 10.5% fixed rate junior subordinated notes that were purchased by FBFS Statutory Trust II. In September 2008, the Trust issued \$10.0 million of trust preferred securities. The trust preferred securities qualify as Tier 1 capital for regulatory purposes.

We manage our liquidity to ensure that funds are available to each of our Banks to satisfy the cash flow requirements of depositors and borrowers and to ensure the Corporation's own cash requirements are met. The Banks maintain liquidity by obtaining funds from several sources.

The Banks' primary sources of funds are principal and interest payments on loans receivable and mortgage-related securities, deposits and other borrowings such as federal funds and Federal Home Loan Bank advances. The scheduled payments of loans and mortgage-related securities are generally a predictable source of funds. Deposit flows and loan prepayments, however, are greatly influenced by general interest rates, economic conditions and competition.

**Table of Contents**

Brokered deposits are used by the Banks, which allows them to gather funds across a larger geographic base at price levels considered attractive. Access to such deposits allows us the flexibility to not pursue single service deposit relationships in markets that have experienced some unfavorable pricing levels. We had \$495.6 million of outstanding brokered deposits at September 30, 2008, compared to \$429.2 million of brokered deposits as of December 31, 2007. In addition, the administrative costs associated with brokered deposits are considerably less than the administrative costs that would be incurred to administer a similar level of local deposits. Although local market deposits are expected to increase as new client relationships are established and as marketing efforts are made to increase the balances in existing clients' deposit accounts, we will likely continue to use brokered deposits. In order to provide for ongoing liquidity and funding, all of the brokered deposits are certificates of deposit that do not allow for withdrawal, at the option of the depositor, before the stated maturity. In the event that there is a disruption in the availability of brokered deposits at maturity, the Banks have managed the maturity structure so that at least 90 days of maturities would be funded through other means, including but not limited to advances from the Federal Home Loan Bank, replacement with higher cost local market deposits or cash flow from borrower repayments and security maturities. The Banks are required by federal regulation to maintain sufficient liquidity to ensure safe and sound operations. Management believes that the Banks have an acceptable liquidity percentage to match the balance of net withdrawable deposits and short-term borrowings in light of present economic conditions and deposit flows. Under Federal law and regulation, the Corporation and the Banks are required to meet certain Tier 1 and risk-based capital requirements. Tier 1 capital generally consists of stockholders' equity plus certain qualifying debentures and other specified items less intangible assets such as goodwill. Risk-based capital requirements presently address credit risk related to both recorded and off-balance sheet commitments and obligations. As of September 30, 2008, the most recent notification from the Federal Deposit Insurance Corporation and the State of Wisconsin Department of Financial Institutions categorized the Banks as well capitalized under the regulatory framework for prompt corrective action. In addition, the Banks exceeded the minimum net worth requirement of 6.0% required by the State of Wisconsin at December 31, 2007.

**Table of Contents**

The following table summarizes the Corporation's and Banks' capital ratios and the ratios required by their federal regulators at September 30, 2008 and December 31, 2007, respectively:

|  | Actual     |        | Minimum Required for Capital Adequacy Purposes |       | Minimum Required to be Well Capitalized Under Prompt Corrective Action Requirements |        |
|--|------------|--------|--|-------|---|--------|
|  | Amount     | Ratio  | Amount   | Ratio | Amount  | Ratio  |
| As of September 30, 2008                 |            |        |  |       |   |        |
| Total capital (to risk-weighted assets)  |            |        |  |       |   |        |
| Consolidated                             | \$ 108,876 | 12.03% | \$ 72,419                                      | 8.00% | N/A   | N/A    |
| First Business Bank                      | 88,965     | 11.02  | 64,582   | 8.00  | \$ 80,728   | 10.00% |
| First Business Bank Milwaukee            | 12,461     | 12.74  | 7,825  | 8.00  | 9,781   | 10.00  |
| Tier 1 capital (to risk-weighted assets) |            |        |  |       |   |        |
| Consolidated                             | \$ 59,060  | 6.52%  | \$ 36,209                                      | 4.00% | N/A   | N/A    |
| First Business Bank                      | 79,958     | 9.90   | 32,291   | 4.00  | \$ 48,437   | 6.00%  |
| First Business Bank Milwaukee            | 11,216     | 11.47  | 3,912  | 4.00  | 5,868   | 6.00   |
| Tier 1 capital (to average assets)       |            |        |  |       |   |        |
| Consolidated                             | \$ 59,060  | 6.06%  | \$ 38,967                                      | 4.00% | N/A   | N/A    |
| First Business Bank                      | 79,958     | 9.37   | 34,149   | 4.00  | \$ 42,686   | 5.00%  |
| First Business Bank Milwaukee            | 11,216     | 9.33   | 4,810  | 4.00  | 6,013   | 5.00   |
| As of December 31, 2007                  |            |        |  |       |   |        |
| Total capital (to risk-weighted assets)  |            |        |  |       |   |        |
| Consolidated                             | \$ 87,018  | 10.22% | \$ 68,119                                      | 8.00% | N/A   | N/A    |
| First Business Bank                      | 79,072     | 10.45  | 60,528   | 8.00  | \$ 75,660   | 10.00% |
| First Business Bank Milwaukee            | 9,847      | 10.26  | 7,679  | 8.00  | 9,599   | 10.00  |

First Business Bank  
Milwaukee

Tier 1 capital  
(to risk-weighted assets)

|                                  |          |       |           |       |           |       |
|----------------------------------|----------|-------|-----------|-------|-----------|-------|
| Consolidated                     | \$46,164 | 5.42% | \$ 34,060 | 4.00% | N/A       | N/A   |
| First Business Bank              | 71,097   | 9.40  | 30,264    | 4.00  | \$ 45,396 | 6.00% |
| First Business Bank<br>Milwaukee | 8,639    | 9.00  | 3,840     | 4.00  | 5,759     | 6.00  |

Tier 1 capital  
(to average assets)

|                                  |          |       |           |       |           |       |
|----------------------------------|----------|-------|-----------|-------|-----------|-------|
| Consolidated                     | \$46,164 | 5.12% | \$ 36,065 | 4.00% | N/A       | N/A   |
| First Business Bank              | 71,097   | 9.04  | 31,459    | 4.00  | \$ 39,324 | 5.00% |
| First Business Bank<br>Milwaukee | 8,639    | 7.39  | 4,678     | 4.00  | 5,848     | 5.00  |



**Table of Contents**

**Contractual Obligations and Off-balance Sheet Arrangements**

There have been no significant changes to the Corporation's contractual obligations and off-balance arrangements disclosed in our Form 10-K at December 31, 2007. Management continues to believe there is adequate capital and liquidity available from various sources to fund projected contractual obligations and commitments.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Interest rate risk, or market risk, arises from exposure of our financial position to changes in interest rates. It is our strategy to reduce the impact of interest rate risk on net interest margin by maintaining a favorable match between the maturities and repricing dates of interest-earning assets and interest-bearing liabilities. This strategy is monitored by the Banks' respective Asset/Liability Management Committees, in accordance with policies approved by the Banks' respective Board of Directors. These committees meet regularly to review the sensitivity of each Bank's assets and liabilities to changes in interest rates, liquidity needs and sources, and pricing and funding strategies.

We use two techniques to measure interest rate risk. The first is simulation of earnings. The balance sheet is modeled as an ongoing entity whereby future growth, pricing, and funding assumptions are implemented. These assumptions are modeled under different rate scenarios.

The second measurement technique used is static gap analysis. Gap analysis involves measurement of the difference in asset and liability repricing on a cumulative basis within a specified time frame. A positive gap indicates that more interest-earning assets than interest-bearing liabilities reprice/mature in a time frame and a negative gap indicates the opposite. In addition to the gap position, other determinants of net interest income are the shape of the yield curve, general rate levels, reinvestment spreads, balance sheet growth and mix, and interest rate spreads. We manage the structure of interest-earning assets and interest-bearing liabilities by adjusting their mix, yield, maturity and/or repricing characteristics based on market conditions.

The process of asset and liability management requires management to make a number of assumptions as to when an asset or liability will reprice or mature. Management believes that its assumptions approximate actual experience and considers them reasonable, although the actual amortization and repayment of assets and liabilities may vary substantially. Our economic sensitivity to change in rates at September 30, 2008 has not changed materially since December 31, 2007.

**Item 4T. Controls and Procedures**

The Corporation's management, with the participation of the Corporation's chief executive officer and chief financial officer, has evaluated the Corporation's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation, the Corporation's chief executive officer and chief financial officer have concluded that the Corporation's disclosure controls and procedures were effective as of September 30, 2008.

There was no change in the Corporation's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended September 30, 2008 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

**Table of Contents**

**Part II. Other Information**

**Item 1. Legal Proceedings**

From time to time, the Corporation and its subsidiaries are engaged in legal proceedings in the ordinary course of their respective businesses. Management believes that any liability arising from any such proceedings currently existing or threatened will not have a material adverse effect on the Corporation's financial position, results of operations, or cash flows.

**Item 1A. Risk Factors**

You should carefully read and consider the following risks and uncertainties because they could materially and adversely affect our business, financial condition, results of operations and prospects.

***Adverse changes in economic conditions, particularly a continuing or worsening slowdown in Dane, Waukesha and Outagamie counties where our business is concentrated, could harm our business.***

Our success depends on the economic conditions in the U.S. and general economic conditions in the specific local markets in which we operate, principally in the Dane County, Wisconsin area and to a lesser extent, Waukesha County, Wisconsin, and Outagamie County, Wisconsin. We invest in collateralized mortgage obligations as a part of our asset portfolio due to the liquidity, favorable returns and flexibility with these instruments. In recent months, structured investments, such as collateralized mortgage obligations, have been subject to significant market volatility due to the uncertainty of their credit ratings, deterioration in credit quality occurring within certain types of residential mortgages, changes in prepayments of the underlying collateral and the lack of transparency related to the credit quality of the underlying collateral. A decline in the U.S. economy or an extended disruption in the credit markets could have an adverse effect on the pricing, terms, liquidity and/or availability of these instruments.

The origination of loans secured by real estate and business assets of those businesses are our primary business and our principal source of profits. Most of our loans are to businesses located in or adjacent to Dane, Waukesha and Outagamie Counties in Wisconsin. Client demand for loans could be reduced by a weaker economy, an increase in unemployment, a decrease in real estate values, or an increase in interest rates in these areas. Any general adverse change in the economic conditions, including real estate values, prevailing in these areas could reduce our growth rate, impair our ability to collect loans or attract deposits, cause loans to become inadequately collateralized and generally have an adverse impact on our results of operations and financial condition. If this region experienced adverse economic, political or business conditions, we would likely experience higher rates of loss and delinquency on our loans than if our loans were geographically more diverse.

***Our commercial 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.***

Commercial real estate lending typically involves higher loan principal amounts, and the repayment of these loans generally is dependent on sufficient income from the properties securing the loans to cover operating expenses and debt service. Because payments on loans secured by commercial real estate are often dependent upon the successful operation and management of the properties, repayment of these loans may be affected by factors outside the borrower's control, including adverse conditions in the real estate market or the economy. If the cash flow from the property is reduced, the borrower's ability to repay the loan could be impacted. The market value of real estate can fluctuate significantly in a short period of time as a result of market conditions within our geographic areas. Adverse developments affecting real estate values in one or more of our markets could impact the collateral coverage associated with our commercial real estate loan portfolio. The deterioration of one or a few of these loans could cause a significant increase in our percentage of non-performing loans. An increase in non-performing loans could result in a loss of earnings from these loans, an increase in the provision for loan and lease loss and in increase in charge-offs, all of which could have a material adverse impact on our net income.

**Table of Contents**

***Our loan and lease loss allowance may not be adequate to cover actual losses.***

We are exposed to the risk that our loan and lease clients may not repay their loans and leases according to their terms and that the collateral securing the payment of these loans and leases may be insufficient to assure repayment. We may experience significant loan and lease losses which could have a material adverse impact on operating results. There is a risk that various assumptions and judgments about the collectibility of the loan and lease portfolios made by us could be formed from inaccurately assessed conditions leading to and related to such judgments and assumptions. Those assumptions and judgments are based, in part, on assessment of the following conditions:

Current economic conditions and their estimated effects on specific borrowers and collateral values;

An evaluation of the existing relationships among loans and leases, probable loan and lease losses and the present level of the allowance for loan and lease losses;

Results of examinations of our loan and lease portfolios by regulatory agencies; and

Management's internal review of the loan and lease portfolios.

We maintain an allowance for loan and lease losses to cover probable losses inherent in the loan and lease portfolios. Additional loan and lease losses will likely occur in the future and may occur at a rate greater than that experienced to date. An analysis of the loan and lease portfolios, historical loss experience and an evaluation of general economic conditions are all utilized in determining the size of the allowance. Additional adjustments may be necessary to allow for unexpected volatility or deterioration in the local or national economy. If significant additions are made to the allowance for loan and leases losses, this would materially decrease net income. Additionally, regulators periodically review our allowance for loan and lease losses or identify further loan or lease charge-offs to be recognized based on judgments different from ours. Any increase in the loan or lease allowance or loan or lease charge-offs as required by regulatory agencies could have a material adverse impact on net income.

***Our continued pace of growth may require us to raise additional capital in the future, but that capital may not be available or may not be on terms acceptable to us when it is needed.***

We are required by federal regulatory authorities to maintain adequate levels of capital to support our operations. We may decide to raise additional capital to support continued growth, either internally or through acquisitions. In addition, the use of brokered deposits without regulatory approval is limited to banks that are well capitalized according to regulation. If our Banks are unable to maintain our capital levels at well capitalized minimums, we could lose a significant source of funding, which would force us to utilize additional wholesale funding or potentially sell loans at a time when loan sales pricing is unfavorable. 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 performance.

Accordingly, we cannot be certain of our ability to raise additional capital in the future if needed or on terms acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth, deposit gathering and acquisitions could be materially impacted.

***We rely, in part, on external financing to fund our operations and the lack of availability of such funds in the future could adversely affect our growth strategy.***

Our ability to implement our business strategy will depend on our ability to obtain funding for loan originations, working capital and other general corporate purposes. If our core banking and commercial deposits are not sufficient to meet our funding needs, we may increase our utilization of brokered deposits, Federal Home Loan Bank advances and other wholesale funding sources necessary to continue our growth strategy. Because these funds generally are more sensitive to rates than our core deposits, they are more likely to move to the highest rate available. To the extent we are not successful in obtaining such funding, we will be unable to implement our strategy as planned, which would have a material adverse effect on our financial condition, results of operations and cash flows.

**Table of Contents**

***Competition from other financial institutions could adversely affect our growth or profitability.***

We encounter strong competition in attracting commercial loan, equipment finance and deposit clients as well as trust and investment clients. We believe the principal factors that are used to attract core deposit accounts and that distinguish one financial institution from another include rates of return, types of accounts, service fees, convenience of office locations and hours and quality of service to the depositors. We believe the primary factors in competing for commercial loans are interest rates, loan fee charges, loan structure and timeliness and quality of service to the borrower.

Our competition includes banks, savings institutions, mortgage banking companies, credit unions, finance companies, equipment finance companies, mutual funds, insurance companies, brokerage firms and investment banking firms. Our market areas include branches of several commercial banks that are substantially larger in terms of loans and deposits. Furthermore, tax exempt credit unions operate in most of our market areas and aggressively price their products and services to a large portion of the market. We also compete with regional and national financial institutions, many of which have greater liquidity, higher lending limits, greater access to capital, more established market recognition and more resources and collective experience than us. Our profitability depends, in part, upon our continued ability to successfully maintain and increase market share.

***We rely on our management, and the loss of one or more of those managers may harm our business.***

Our success has been and will be greatly influenced by our continuing ability to retain the services of our existing senior management and, as it expands, to attract and retain additional qualified senior and middle management. If we unexpectedly lose any of the key management personnel, or we are unable to recruit and retain qualified personnel in the future, that could have an adverse effect on our business and financial results.

***Variations in interest rates may harm our financial results.***

We are subject to interest rate risk. Changes in the interest rate environment, whether as a result of changes in monetary policies of the Federal Reserve Board or otherwise, may reduce our profits. Net interest spreads are affected by the difference between the maturities and repricing characteristics of interest-earning assets and interest-bearing liabilities. They are also affected by the proportion of interest-earning assets that are funded by interest-bearing liabilities. Loan volume and yield are affected by market interest rates on loans, and increasing interest rates are generally associated with a lower volume of loan originations. There is no assurance that we can minimize our interest rate risk. In addition, an increase in the general level of interest rates may adversely affect the ability of certain borrowers to pay their obligations if the reason for that increase in rates is not a result of a general expansion of the economy. Accordingly, changes in levels of market interest rates could materially and adversely affect our net interest spread, asset quality, loan origination volume and overall profitability.

***We are subject to extensive regulation, and changes in banking laws and regulations could adversely affect our business.***

Our businesses are subject to extensive state and federal government supervision, regulation, and control. Existing state and federal banking laws subject us to substantial limitations with respect to loans, purchases of securities, payment of dividends and many other aspects of our businesses. There can be no assurance that future legislation or government policy will not adversely affect the banking industry and our operations by further restricting activities or increasing the cost of compliance.

***Our trust operations subject us to financial and reputational risks.***

We are subject to trust operations risk related to performance of fiduciary responsibilities. Clients may make claims and take legal action pertaining to our performance of our fiduciary responsibilities. Whether client claims and legal action related to our performance of our fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to us, they may result in significant financial liability and/or adversely affect the market perception of us and our products and services, as well as impact client demand for those products and services. Any financial liability or

**Table of Contents**

reputation damage could have a material adverse affect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

***If we are unable to keep pace with technological advances in our industry, our ability to attract and retain clients could be adversely affected.***

The banking industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to better serving clients, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend in part on our ability to address the needs of our clients by using technology to provide products and services that will satisfy client demands for convenience as well as create additional efficiencies in our operations. A number of our competitors have substantially greater resources to invest in technological improvements, as well as significant economies of scale. There can be no assurance that we will be able to implement new technology-driven products and services to our clients. If we fail to do so, our ability to attract and retain clients may be adversely affected.

***Our business continuity plans or data security systems could prove to be inadequate, resulting in a material interruption in, or disruption to, our business and a negative impact on the results of operations.***

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems, whether due to severe weather, natural disasters, acts of war or terrorism, criminal activity or other factors, could result in failures or disruptions in general ledger, deposit, loan, customer relationship management and other systems. While we have a business continuity plan and other policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of clients, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our results of operations.

***We are exposed to risks of environmental liabilities with respect to secured properties or properties for which we take title.***

We encounter certain environmental risks in our lending activities. Under federal and state law, we may become liable for costs of cleaning up hazardous materials found on properties on which we have taken title. Certain states may also impose liens with higher priorities than first mortgages on properties to recover funds used in such efforts. We attempt to control our exposure to environmental risks with respect to loans secured by larger properties by monitoring available information on hazardous waste disposal sites and occasionally requiring environmental inspections of such properties prior to closing a loan, as warranted. No assurance can be given, however, that the value of properties securing loans in our portfolio will not be adversely affected by the presence of hazardous materials, increasing the risks of borrower default, or that future changes in federal or state laws will not increase our exposure to liability for environmental cleanup, which, in either case, may adversely affect our profitability.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

- (a) On September 26, 2008 FBFS Statutory Trust II, a financing subsidiary of the Corporation, issued and sold capital securities of the trust in the aggregate principal amount of \$10 million, in a private placement, and issued \$315,000 in common securities to the Corporation. On the same date, the trust used the proceeds from the sale of all such securities to purchase \$10.3 million of the Corporation's Junior Subordinated Notes due September 26, 2038. The Corporation also issued a guarantee of the various obligations associated with the trust preferred securities. The trust preferred securities were offered and sold to accredited investors in private placement exempt from registration pursuant to Regulation D under the Securities Act.

**Table of Contents**

(b) None.

(c) Issuer Purchases of Equity Securities

| Period               | Total Number of Shares Purchased | Average Price Paid | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs |
|----------------------|----------------------------------|--------------------|--|--|
| July 1 31, 2008      | 1,844                            | \$ 15.52           |  | \$ 177,150   |
| August 1 31, 2008    | 166                              | 15.25              |  | 177,150  |
| September 1 30, 2008 | 427                              | 17.00              |  | 177,150  |

For the three months ended September 30, 2008, 2,437 shares purchased as part of settling restricted share obligations.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

(31.1) Certification of the Chief Executive Officer.

(31.2) Certification of the Chief Financial Officer.

(32) Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. paragraph 1350.

**Table of Contents**

**Signatures**

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**FIRST BUSINESS FINANCIAL  
SERVICES, INC.**

/s/ Corey A. Chambas

Corey A. Chambas  
Chief Executive Officer

October 27, 2008

40