Zacks Small-Cap Research

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First Business Financial Services, Inc. (FBIZ-NASDAQ)

FBIZ: Common Stock Offering

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	11/01/2011
Current Price (12/19/12)	$22.95
Twelve- Month Target Price	**$25.50**

OUTLOOK

FBIZ recently completed a 1.1 million common share offering at $23.00 per share, raising gross proceeds of $25.3 million and net proceeds of $23.5 million, which are being used to pay off a like amount of subordinated debt. As a result, we are reducing our diluted EPS estimates and our target price to $25.50 from $28.00. For 2012, we have lowered our EPS estimate for the year to $3.30 from $3.40 and for 2013 to $3.00 from $3.75 previously. Because of the increased number of shares outstanding in 2013, our 2013 EPS estimate represents a 9% decline from our 2012 estimate. However, 2013 estimated net earnings are actually growing 25% year over year, largely the result of increased net interest income stemming from a higher net interest margin. In addition to the income statement impact, the sale of common stock has strengthened the balance sheet. Double leverage at the holding company has been significantly reduced and the Company's capital ratios have shown substantial improvement and meet Basel III requirements. Negatively, the return on equity has been reduced to an estimated 11% in 2013 from 12.5% estimated for 2012 and 12.8% actual in 2011, though ROE will remain well above the single-digit level of the 2006-2010 period.

SUMMARY DATA

52-Week High	**$24.74**
52-Week Low	**$15.88**
One-Year Return (%)	**40.65**
Beta	**0.04**
Average Daily Volume (sh)	**24,119**
Shares Outstanding (mil)	**3.8**
Market Capitalization ($mil)	**$87**
Short Interest Ratio (days)	**0.72**
Institutional Ownership (%)	**14**
Insider Ownership (%)	**19**
Annual Cash Dividend	**$0.28**
Dividend Yield (%)	**1.22**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**13.4**
Earnings Per Share (%)	**14.1**
Dividend (%)	**3.1**
P/E using TTM EPS	**6.9**
P/E using 2012 Estimate	**7.0**
P/E using 2013 Estimate	**7.7**
Zacks Rank	**3**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Midwest**
Zacks Rank in Industry	**27 of 39**

ZACKS ESTIMATES

Net Revenue

(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2010	9.5 A	9.4 A	9.8 A	10.0 A	38.7 A
2011	10.2 A	10.7 A	10.8 A	10.8 A	42.5 A
2012	10.8 A	11.5 A	12.2 A	12.1 E	46.6 E
2013					50.6 E

Earnings per Share

(EPS is operating earnings before nonrecurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2010	0.35 A	0.46 A	0.38 A	0.24 A	1.42 A
2011	0.52 A	0.68 A	0.83 A	0.90 A	2.94 A
2012	0.84 A	0.60 A	0.99 A	0.86 E	3.30 E
2013					3.00 E

Quarterly EPS may not add to total due to changes in shares outstanding.

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UPDATE

FBIZ recently completed a 1.1 million common share offering at $23.00 per share, raising gross proceeds of $25.3 million and net proceeds of $23.5 million, which are being used to pay off a like amount of subordinated debt. As a result, we are reducing our diluted EPS estimates and our target price to $25.50 from $28.00.

For 2012, we have lowered our EPS estimate for the year to $3.30 from $3.40 and for 2013 to $3.00 from $3.75 previously. Because of the increased number of shares outstanding in 2013, our 2013 EPS estimate represents a 9% decline from our 2012 estimate. However, 2013 estimated net earnings are actually growing 25% year over year, largely the result of increased net interest income stemming from a higher net interest margin.

We estimate that the net interest margin will rise about 15 basis points to 3.55% from our previous 3.40% estimate as the reduction in debt will cause interest expense to decline about $1.6 million per year. This compares to our 2012 estimate of 3.41% and 3.29% actual in 2011.

In addition to the income statement impact, the sale of common stock has significantly strengthened the balance sheet. Double leverage at the holding company has been reduced about 50 points to an estimated 129% at 2012 yearend from 179% at the yearend 2011.

Just as important, the Company's capital ratios have shown substantial improvement and meet Basel III requirements. The Tier 1 capital ratio jumps 245 basis points to 10.57% from 8.12% prior to the offering and the tangible equity ratio surges 197 basis points to 7.89% from 5.92%, both at September 30, 2012.

Negatively, the return on equity has been reduced to an estimated 11% in 2013 from 12.5% estimated for 2012 and 12.8% actual in 2011, though ROE will remain well above the single-digit level of the 2006-2010 period.

Details of our projections are shown at the back of our report.

In other news, FBIZ 's asset-based lending company, First Business Capital Corp, has entered the factoring business with the hiring of a team of three experienced factoring professionals. The business will operate as First Business Factors in the Chicago area and has already secured its first client. This is a nice fit for FBIZ as high-growth, immature companies will start with First Business Factors, and then graduate to First Business Capital Corp., and ultimately to one of FBIZ's two banking subsidiaries.

OVERVIEW

First Business Financial Services, Inc. (FBIZ or the Company) is a bank holding company headquartered in Madison, Wisconsin, with $1.2 billion in total assets at September 30, 2012. FBIZ specializes in business lending for small-medium-sized companies with sales ranging from $2-50 million. As an adjunct to these services, FBIZ also offers banking services to business owners, executives, professionals, and high net worth individuals, though this is a less significant part of its business.

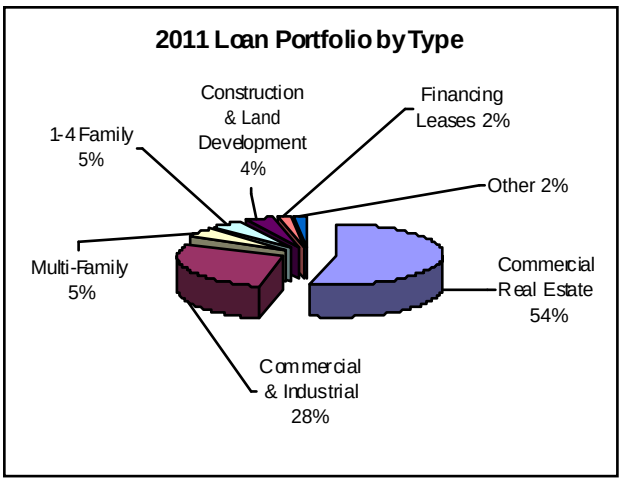
Banking operations are carried on through two banks, First Business Bank (FBB) located in Madison and First Business Bank-Milwaukee (FBB-Milwaukee), as well as First Business Trust & Investments (FBTI), a division of FBB that offers trust and investment services. FBB also has three loan production offices located in northeast Wisconsin in Appleton, Oshkosh, and Green Bay.

FBB owns two non-bank subsidiaries that engage in lending that is different than that typical for banks through six single-person business development offices, which are located in Minneapolis, Minnesota; Chicago, Illinois; St. Louis, Missouri; Detroit, Michigan; Cleveland, Ohio; and Denver, Colorado. These subsidiaries include: First Business Capital Corp. (FBCC, with net income of $3.3 million in 2011), which is an asset-based commercial lender that provides secured lines of credit and term loans on equipment and real estate assets, primarily to manufacturers and wholesale distribution companies located throughout the United States; and First Business Equipment Finance, LLC (FBEF, with net income of $569,000 in 2011), which is a commercial finance company that finances equipment for small and middle market companies.

In addition, the Company has three non-bank subsidiaries that help manage other aspects of its business. These include: First Business Real Estate LLC (FBBRE, owned by FBB and having a $94,000 net loss in 2011), and First Business Bank-Milwaukee Real Estate LCC (FBBMRE, owned by FBB-Milwaukee and posting a net loss of $297,000 in 2011), which are limited liability companies that dispose of real estate and other assets acquired through foreclosure; and First Madison Investment Corp. (FMIC, owned by FBB, earning net income of $4.1 million in 2011), which is located in the state of Nevada and manages a portion of the Bank's investment portfolio, though it no longer invests in commercial real estate loans as of October 1, 2011. First Madison Capital Corp Nevada Corp was dissolved on October 1, 2011 and its assets were transferred to FBCC.

Unlike other banks, FBIZ does not have a retail branch network. Instead, the Company typically provides custom-tailored banking services to its approximately 2,000 clients at client offices. This has a couple of important implications. First, FBIZ does not have the overhead and expense connected with owning a branch network. Second, FBIZ lacks the in-market deposit base typically associated with a retail bank and must fund a significant part of its operations through the wholesale-brokered deposit market.

The loan portfolio has a concentration in commercial real estate (about one-third of which is owner occupied), accounting for 54% of total loans at December 31, 2011. The rest of the lending book consists of commercial and industrial (accounting for 28% of total gross loans), 1-4 family (5%), multi-family (5%), construction and land development (4%), direct financing leases (2%), and consumer and other (2%). Almost all loans are secured, usually by real estate, inventory, accounts receivable, equipment, machinery, or corporate assets.



The liquidity portfolio, consisting of cash, short-term investments, and US agency mortgage obligations, represents 25% of total assets, while gross loans and leases accounts for 72%. Transaction and money market accounts accounted for 50% of total deposits at December 31, 2011, with certificates of deposit (CDs) at 8%, and brokered CDs at 42%.

In 2011, net interest income contributed 83% of net revenue. Other significant revenue sources include trust and investment services fee income (6% of net revenues), services charges on deposits (4%), loan fees (3 ½%), and increase in cash surrender value of bank-owned life insurance (1 ½%).

FBIZ's 2012 business plan includes: (1) improving asset quality of its loan portfolio, (2) generating organic growth in the loan portfolio, (3) increasing its market share of in-market core deposits, and (4) increasing fee income.

VALUATION

FBIZ stock has outperformed the industry in 2012, with a year-to-date price increase of 39.1% versus 33.4% for banks in the Zacks Small-Cap Index, as well as the S&P 500's gain of 12.4%. This follows a good year in 2011 when FBIZ's stock price rose 23.6%, compared to advances of 0.0% for the S&P 500 and of 0.0% for banks in the Zacks Small-Cap Index.

At its current price, FBIZ is trading at a discount to the industry median P/E of 34% in 2013, based upon our 2013 EPS estimate. This is slightly below the 36% P/E discount for FBIZ, based upon 5-year historical P/E averages.

Turning to Price/Tangible Book Value, FBIZ is valued at 0.92X versus the industry median of 0.91X. This represents a 1% premium, or about 24 points better than the FBIZ's average historical discount of 23% since the end of 2005.

We believe a higher valuation is justified for a few reasons: (1) the Company's earnings and profitability prospects are much improved, with its ROE significantly higher than the median for other banks in the Zacks small-cap index; (2) FBIZ has a superior dividend yield relative to the median for its small-cap peers; and (3) liquidity in the shares has increased following the addition of FBIZ shares to the Russell Microcap Index on June 24, 2011.

Applying the 0.92X ratio to our estimated book value for FBIZ one year out results in a price target of approximately $25.50. This compares to FBIZ's current stock price of $22.95. When combined with the Company's current dividend yield, our new target price for FBIZ represents a total return of 12%, above our expectations for broader U.S. equity market gains during this period. Therefore, we are maintaining our recommendation on FBIZ shares at Outperform.

Industry Comparables- Small-cap Banks

		Price / Earnings Ratios					Return on Equity		Return on Assets		
	Pr Chg YTD	TTM* EPS	2012E	2013E	5-Yr Avg	Price/ Tang Book	TTM*	5-Yr Avg	TTM*	5-Yr Avg	Div Yld
FIRST BUS FINL	**39.1**	**6.9**	**7.0**	**7.7**	**10.7**	**0.92**	**13.1**	**7.5**	**0.75**	**0.40**	**1.2**
S&P 500	12.4	14.4	13.9	13.0	17.0	3.6	42.5	-----	9.7	-----	2.1
Median	**33.4**	**11.8**	**11.4**	**11.6**	**16.6**	**0.91**	**7.4**	**3.9**	**0.70**	**0.33**	**0.3**
Average	38.8	14.8	14.2	12.8	25.0	0.9	5.7	1.8	0.6	0.3	1.1
High	147.9	55.0	42.5	45.9	103.7	2.0	19.0	14.2	1.7	2.1	5.4
Low	(12.2)	4.7	4.8	4.6	6.8	0.4	(30.5)	(73.5)	(2.1)	(2.2)	-----

*Trailing twelve months

First Business Financial Services, Inc.

Income Statement and Balance Sheet

(Dollars in millions, except per share data)

Summary Financial Data	12/07	12/08	12/09	12/10	12/11	12/12 E	12/13 E
Net interest income	23.2	26.3	28.1	32.0	35.5	38.6	42.5
Non-interest income	4.4	5.1	6.4	6.7	7.1	8.0	8.1
Total net revenue	27.6	31.4	34.5	38.7	42.6	46.6	50.6
Loan loss provision	2.9	4.3	8.2	7.0	4.3	4.0	3.0
Non-interest expense	19.7	21.9	24.5	25.7	26.4	28.7	30.2
Income taxes & other	1.7	2.1	0.8	2.4	4.2	4.9	6.2
Zacks adjusted income before NRI	3.3	3.1	1.0	3.6	7.7	9.0	11.2
GAAP net income	3.3	3.1	1.0	0.9	8.4	9.0	11.2
Diluted EPS before NRI	1.32	1.28	0.41	1.42	2.94	3.30	3.00
Reported EPS	1.32	1.28	0.41	0.37	3.23	3.30	3.00
Dividends per share	0.26	0.28	0.28	0.28	0.28	0.28	0.28
Liquid assets	114.9	132.8	235.0	204.2	297.6	281.0	283.8
Loans & leases, gross	781.6	852.8	854.5	878.0	851.5	892.0	936.5
Total assets	918.4	1,010.8	1,117.4	1,107.1	1,177.2	1,201.7	1,259.9
Core deposits	703.6	746.4	942.2	949.1	997.3	1,019.8	1,071.8
Purchased funds	105.0	129.5	58.2	41.2	54.8	55.0	55.0
Long-term debt	49.5	67.8	51.8	49.8	49.8	25.5	25.5
Shareholders' equity	48.6	53.0	54.4	55.3	64.2	96.4	106.6
Profitability							
Return on avg assets	0.39%	0.32%	0.10%	0.33%	0.68%	0.76%	0.91%
Return on avg equity	6.86%	6.11%	1.90%	6.46%	12.83%	12.53%	11.05%
Net interest margin	2.87%	2.81%	2.77%	3.04%	3.29%	3.41%	3.55%
Loan loss provision % avg assets	0.35%	0.44%	0.78%	0.64%	0.38%	0.34%	0.24%
Noninterest income % avg assets	0.53%	0.53%	0.61%	0.61%	0.63%	0.67%	0.66%
Noninterest expense % avg assets	2.34%	2.26%	2.33%	2.33%	2.34%	2.43%	2.45%
Preprovision pretax income % avg assets	0.95%	0.98%	0.95%	1.18%	1.43%	1.52%	1.66%
Tangible efficiency ratio	71%	70%	72%	66%	62%	62%	60%
Payout ratio	20%	22%	66%	75%	9%	8%	9%
Asset Quality							
Net charge-offs % avg loans	0.19%	0.28%	0.69%	0.57%	0.74%	0.45%	0.31%
Allowance % loans	1.26%	1.39%	1.65%	1.85%	1.66%	1.61%	1.55%
NPAs % loans & related assets	1.22%	2.25%	3.45%	4.56%	2.81%	1.64%	1.45%
Allowance % NPAs	103%	61%	48%	41%	59%	98%	107%
Liquidity & Funding							
Liquid assets % purchased funds	109%	103%	404%	496%	543%	511%	516%
Core deposits % loans	90%	88%	110%	108%	117%	114%	114%
Liquid assets % assets	13%	13%	21%	18%	25%	23%	23%
Loans % assets	85%	84%	76%	79%	72%	74%	74%
Capital Adequacy							
Total equity % assets	5.29%	5.24%	4.87%	5.00%	5.45%	8.03%	8.46%
Tangible equity % assets	5.00%	4.98%	4.63%	5.00%	5.45%	8.03%	8.46%
Tier 1 capital ratio	5.42%	6.48%	6.61%	6.65%	7.91%		
Total capital ratio	10.22%	12.00%	12.15%	11.23%	13.11%		
Parent Company Statistics							
Interest coverage	(1.1)X	(0.9)X	0.3X	0.2X	(0.0)X	0.3X	0.7X
Interest & dividend coverage	(0.9)X	(0.7)X	0.2X	0.2X	(0.0)X	0.3X	0.2X
Short-term debt coverage	16.9X	Lge	Lge	Lge	N/A	N/A	N/A
Total debt coverage	1.1X	0.9X	1.0X	1.0X	N/A	N/A	N/A
Double leverage	169.1%	185.6%	187.0%	189.5%	179.7%	129.0%	127.1%

First Business Financial Services, Inc.

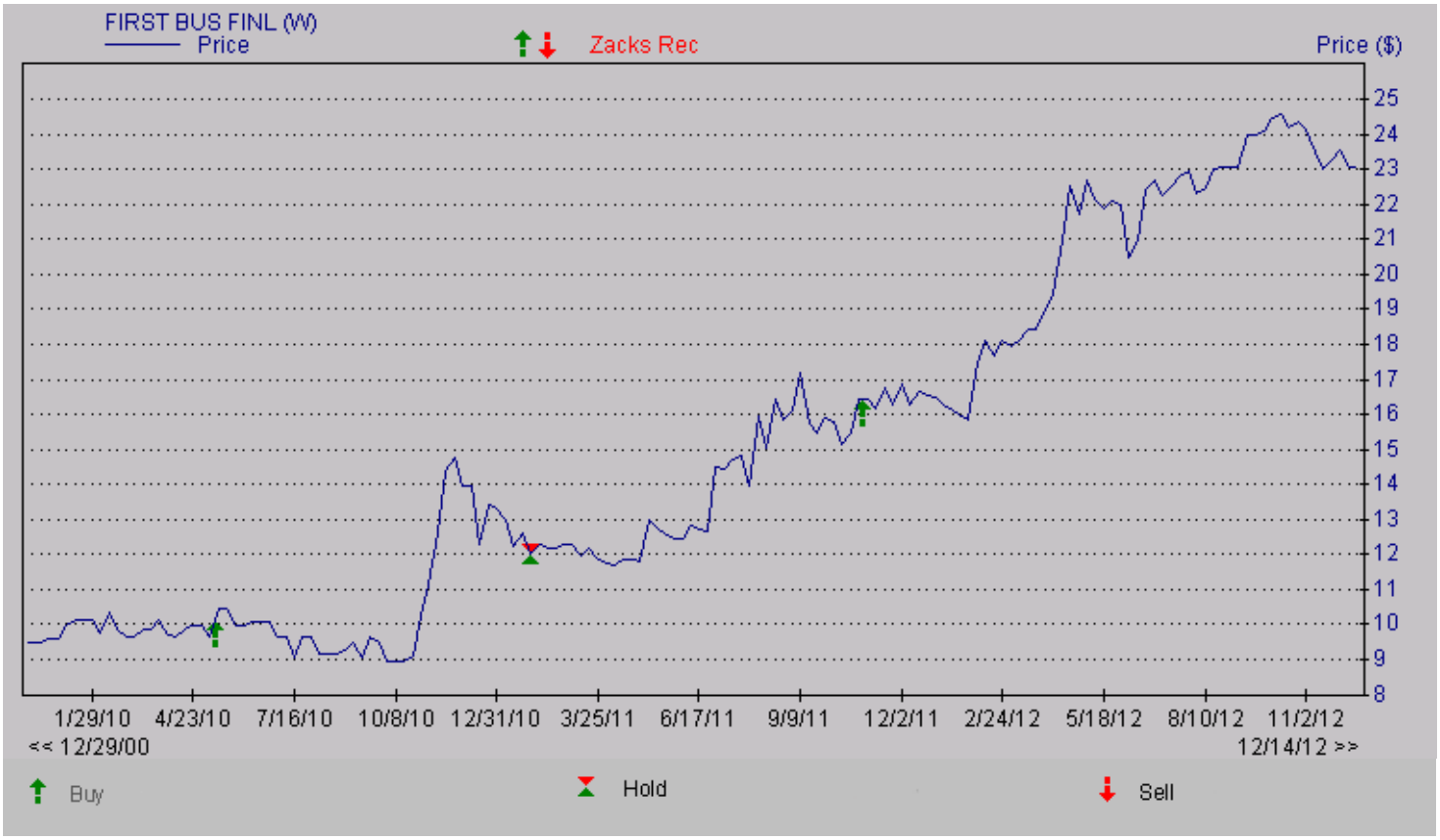
Income Statement and Balance Sheet

(Dollars in millions, except per share data)

	2011				2012			
Summary Financial Data	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 A**	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 E**
Net interest income	8.5	9.0	9.1	8.9	8.9	9.6	9.9	10.2
Non-interest income	1.7	1.7	1.7	1.9	1.9	1.9	2.3	2.0
Total net revenue	10.2	10.7	10.8	10.8	10.8	11.5	12.2	12.2
Loan loss provision	1.4	1.5	0.4	0.9	0.5	2.0	0.9	0.6
Non-interest expense	6.8	6.6	6.8	6.2	6.8	7.1	7.3	7.5
Income taxes & other	0.7	0.8	1.4	1.3	1.3	0.8	1.4	1.5
Zacks adjusted income before NRI	1.3	1.8	2.2	2.4	2.2	1.6	2.6	2.6
GAAP net income	1.3	2.5	2.2	2.4	2.2	1.6	2.6	2.6
Diluted EPS before NRI	0.52	0.68	0.83	0.90	0.84	0.60	0.99	0.86
Reported EPS	0.52	0.97	0.83	0.90	0.84	0.60	0.99	0.86
Dividends per share	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07
Liquid assets	220.1	211.2	248.8	297.6	301.4	266.5	280.6	281.0
Loans & leases, gross	868.7	861.4	861.5	851.5	832.5	863.2	878.8	892.0
Total assets	1,112.9	1,096.4	1,135.6	1,177.2	1,162.0	1,160.0	1,192.1	1,201.7
Core deposits	956.9	938.3	973.9	997.3	979.8	975.2	1,007.3	1,019.8
Purchased funds	39.2	39.2	39.2	54.8	56.5	57.4	54.5	55.0
Long-term debt	49.8	49.8	49.8	49.8	49.3	49.3	49.3	25.5
Shareholders' equity	56.3	59.8	61.8	64.2	66.4	67.8	70.5	96.4
Profitability								
Return on avg assets*	0.48%	0.65%	0.78%	0.82%	0.74%	0.54%	0.88%	0.87%
Return on avg equity *	9.62%	12.27%	14.02%	15.00%	13.43%	9.16%	15.10%	12.43%
Net interest margin	3.14%	3.39%	3.40%	3.23%	3.15%	3.49%	3.50%	3.50%
Loan loss provision % avg assets*	0.50%	0.53%	0.16%	0.32%	0.17%	0.71%	0.29%	0.21%
Noninterest income % avg assets*	0.59%	0.63%	0.62%	0.66%	0.62%	0.66%	0.76%	0.66%
Noninterest expense % avg assets*	2.39%	2.40%	2.41%	2.16%	2.30%	2.47%	2.44%	2.50%
Preprovision pretax inc.% avg assets*	1.20%	1.48%	1.46%	1.58%	1.33%	1.52%	1.65%	1.57%
Tangible efficiency ratio	67%	62%	62%	58%	63%	62%	60%	62%
Payout ratio	13%	7%	8%	8%	8%	12%	7%	8%
Asset Quality								
Net charge-offs % avg loans*	0.40%	1.09%	1.04%	0.43%	0.10%	0.80%	0.44%	0.45%
Allowance % loans	1.93%	1.85%	1.64%	1.66%	1.74%	1.72%	1.67%	1.61%
NPAs % loans & related assets	4.77%	4.18%	3.37%	2.81%	2.73%	2.01%	1.71%	1.64%
Allowance % NPAs	40%	44%	49%	59%	63%	85%	98%	98%
Liquidity & Funding								
Liquid assets % purchased funds	561%	539%	634%	543%	533%	464%	515%	511%
Core deposits % loans	110%	109%	113%	117%	118%	113%	115%	114%
Liquid assets % assets	20%	19%	22%	25%	26%	23%	24%	23%
Loans % assets	78%	79%	76%	72%	72%	74%	74%	74%
Capital Adequacy								
Total equity % assets	5.06%	5.46%	5.44%	5.45%	5.72%	5.84%	5.92%	8.03%
Tangible equity % assets	5.06%	5.46%	5.44%	5.45%	5.72%	5.84%	5.92%	8.03%
Tier 1 capital ratio	6.92%	7.29%	7.60%	7.91%	8.21%	8.04%	8.12%	
Total capital ratio	11.64%	12.20%	12.66%	13.11%	13.56%	13.31%	13.33%	

*Annualized.

HISTORICAL ZACKS RECOMMENDATIONS



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