Zacks Equity Research

January 31, 2011
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First Business Financial Services, Inc. (FBIZ-NASDAQ)

FBIZ: Reducing Recommendation to Neutral from Outperform

Current Recommendation	**Neutral**
Prior Recommendation	Outperform
Date of Last Change	01/30/2011
Current Price (01/31/11)	$12.28
Six- Month Target Price	**$12.75**

OUTLOOK

We are reducing our recommendation on First Business Financial Services, Inc. (FBIZ) to Neutral from Outperform, as the stock has exceeded our previous target price. At the same time, we are increasing our new six-month price target to $12.75 to reflect the rolling over of estimates to the new year. When combined with the Company's current dividend yield, our new target price for FBIZ represents a total return of approximately 5%, in line with our expectations for broader U.S. equity market gains during this period; hence, our Neutral recommendation. FBIZ is expected to release fourth quarter earnings in mid-March, as it usually does. We are continuing our 2010 and 2011 diluted EPS estimates at $1.50 and $1.80, respectively. Our estimates reflect gains in net interest income on improved margins and modest loan growth, as well as slowing deterioration in asset quality in 2010 and slight improvement in 2011, leading to reduced loan loss provisions. Near-term risks include a halt in the US economic recovery, greater-than-expected asset quality deterioration, and increased political risk, with longer term risks including reliance on the confidence-sensitive brokered deposit market and potential dilution from sale of additional common stock.

SUMMARY DATA

52-Week High	**$14.90**
52-Week Low	**$8.67**
One-Year Return (%)	**21.04**
Beta	**0.07**
Average Daily Volume (sh)	**1,332**
Shares Outstanding (mil)	**2.5**
Market Capitalization ($mil)	**$31**
Short Interest Ratio (days)	**0.65**
Institutional Ownership (%)	**3**
Insider Ownership (%)	**20**
Annual Cash Dividend	**$0.28**
Dividend Yield (%)	**2.28**
5-Yr. Historical Growth Rates	
Net Revenue (%)	**13.1**
Earnings Per Share (%)	**(29.6)**
Dividend (%)	**47.0**
P/E using TTM EPS	**11.7**
P/E using 2010 Estimate	**8.2**
P/E using 2011 Estimate	**6.8**
Zacks Rank	**3**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Banks-Midwest**
Zacks Rank in Industry	**13 of 43**

ZACKS ESTIMATES

Net Revenue

(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2008	7.2 A	7.9 A	7.9 A	8.4 A	31.4 A
2009	8.0 A	8.3 A	9.2 A	8.9 A	34.5 A
2010	9.5 A	9.4 A	9.8 A	10.1 E	38.8 E
2011					40.9 E

Earnings per Share

(EPS is operating earnings before nonrecurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2008	0.32 A	0.44 A	0.48 A	0.05 A	1.28 A
2009	(0.08) A	0.10 A	0.53 A	(0.14) A	0.41 A
2010	0.35 A	0.46 A	0.38 A	0.30 E	1.50 E
2011					1.80 E

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

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NEW RECOMMENDATION AND TARGET PRICE

We are reducing our recommendation on First Business Financial Services, Inc. (FBIZ) to Neutral from Outperform, as the stock has exceeded our previous target price. At the same time, we are increasing our new six-month price target to $12.75 to reflect the rolling over of estimates to the new year. When combined with the Company's current dividend yield, our new target price for FBIZ represents a total return of approximately 5%, in line with our expectations for broader U.S. equity market gains during this period. Therefore, we recommend a Neutral on FBIZ shares.

RECENT NEWS

The Company recently announced amendments to its annual incentive bonus plan, beginning in 2011, to reflect changing priorities for its business units and enhance profitability. From a practical perspective, we do not expect these changes to have a significant impact on compensation expense going forward. All entities are affected by changes in criteria at the holding company, with the new Companywide equally-weighted criteria including:

1. Return on Assets (ROA), defined as net income divided by average total assets;
2. Core Earnings, defined as preprovision, pretax earnings; and
3. Core Deposit/Total Deposits, with core deposits defined as nonbroker deposits.

These, of course, are different than the former Companywide criteria, which included:

1. Return on Equity (ROE), defined as net income divided by average common equity;
2. Adjusted Net Income, defined as preprovision, pretax earnings less net charge-offs for the year; and
3. Net Income.

The shift to ROA from ROE reflects the Company's belief that ROA produces a more consistent measure of profitability over time because it is not affected by capital structure. At the subsidiary level, ROA is used as each subsidiary's capital structure is promulgated by and managed at the holding company. Moreover, any increase in equity relative to risk-adjusted assets would depress future bonus payouts, which would not occur using ROA.

Since FBIZ is capital deficient pursuant to regulatory requirements under Basel III (we note that FBIZ and its banks are well-capitalized under current regulatory guidelines), FBIZ estimates that it will need an additional $12-14 million of common equity to comply with regulations by 2019. However, the long period of implementation combined with growth in retained earnings should be sufficient to allow FBIZ to meet this goal. That said, the Company would consider a common share offering under the right circumstances.

The modification in the definition of earnings to Core Earnings from Adjusted Net Income is not a significant one, in our opinion. However, the addition of the third item, Core Deposits/Total Deposits, represents an important change in operating philosophy.

To date, FBIZ has relied to a great extent on brokered deposits to fund its lending operations. At September 30, 2010, brokered deposits totalled $492 million and were 49% of total deposits, much higher than is typical for a bank of its size. FBIZ found the brokered deposit market to be a lower-cost and more efficient method to raise funds than the regular nonbrokered retail deposit market. However, reliance on confidence-sensitive brokered deposits is also a more risky funding strategy, and one to which investors are not particularly partial. Given this, we believe this change is a positive one and will gradually reduce the Company's risk profile over time.

This requirement will also have an impact on the types of lending in which FBIZ engages going forward. Specifically, FBIZ will pursue more commercial and industrial (C&I) business, rather than commercial real estate (CRE). C&I loans offer more opportunities for the Company to add to its nonbrokered deposit base and are also more profitable on a risk-adjusted basis than CRE loans. Interestingly, the recent Marshall & Ilsley acquisition, a regional Milwaukee-based bank holding company with about $110 billion in assets, by Bank of Montreal in Canada, could present some incremental new lending opportunites for FBIZ in the future.

In additon to Companywide performance metrics, susbsidiaries have unique equally-weighted bonus criteria, which account for 75% of their bonus payouts (the other 25% is based upon the Companywide criteria discussed above). At First Business Bank, First Business Bank Milwaukee, and First Bank Northeast, these include the same performance metrics as those at the holding company, but measured at the subsidiary level. At First Business Capital Corp. and First Business Equipment Finance, FBIZ's nonbank lending subsidiaries, these include Return on Assets and Core Earnings. At First Business Trust & Investments, the performance measures are Core Earnings, New Assets under Management from existing Clients, and New Assets under Management from new Clients, the latter two designed to emphasize the importance of adding new business.

In other news, FBIZ paid on January 15, 2011 its $0.07 regular quarterly dividend that it had declared on December 16, 2010.

OVERVIEW

First Business Financial Services, Inc. (FBIZ or the Company) is a bank holding company headquartered in Madison, Wisconsin, with $1.1 billion in total assets at September 30, 2010. 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.

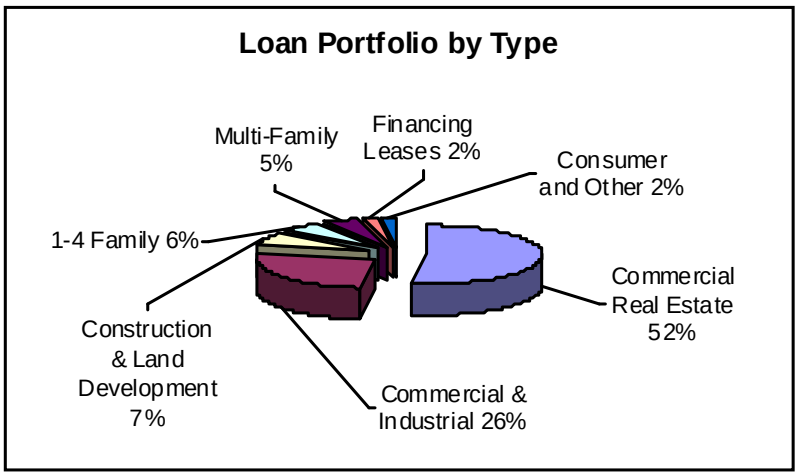
Banking operations are carried on through two banks, First Business Bank (FBB) located in Madison and First Business Bank-Milwaukee (FBB-Milwaukee), as well as First Business Trust & Investments (FBTI), a division of FBB that offers trust and investment services. FBB also has three loan production offices 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 five single-person business development offices, which are located in Minneapolis, Minnesota; Chicago, Illinois; St. Louis, Missouri; Detroit, Michigan; and Cleveland, Ohio. These subsidiaries include: First Business Capital Corp. (FBCC, with net income of $1.4 million in 2009), 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 a net loss of $25,000 in 2009), which is a commercial finance company that finances equipment for small and middle market companies.

In addition, the Company has four non-bank subsidiaries that help manage other aspects of its business. These include: First Business Real Estate LLC (FBBRE, owned by FBB and having an $8,000 net loss in 2009), and First Business Bank-Milwaukee Real Estate LCC (FBBMRE, owned by FBB-Milwaukee and posting net income of $8,000 in 2009), which are limited liability companies that dispose of real estate and other assets acquired through foreclosure; First Madison Investment Corp. (FMIC, owned by FBB, earning net income of $5.9 million in 2009), which is located in the state of Nevada and manages a portion of the Bank's investment portfolio; and First Madison Capital Corp Nevada Corp (FMCCNC, owned by FBCC and generating net earnings of $802,000 in 2009), which is domiciled in Nevada and invests in loans purchased from 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 52% of total loans at September 30, 2010. The rest of the lending book consists of commercial and industrial (accounting for 26% of total gross loans), construction and land development (7%), 1-4 family (6%), multi-family (5%), commercial 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, has increased on a relative basis, and is now a solid 19% of total assets (up from 17% a year ago). Transaction and money market accounts accounted for 42% of total deposits at September 30, 2010, with certificates of deposit (CDs) at 9%, and brokered CDs at 49% (down from 57%, about two years ago).



In 2009, net interest income contributed 81% of net revenue. Other significant net revenue sources include trust and investment services fee income (5 ½% of net revenues), services charges on deposits (4 ½%), loan fees (3%), and increase in cash surrender value of bank-owned life insurance (2%). FBIZ's 2010 business plan included: (1) improving the overall quality of its loan portfolio, (2) minimizing loan loss specific reserves and charge-offs, (3) generating organic growth in the loan portfolio, and (4) increasing its market share of in-market core deposits.

VALUATION

FBIZ stock has underperformed the industry, with a year-to-date price decline of 8.5% compared to a median increase of 1.5% for banks in the Zacks small-cap index, as shown in the following table. At its current price, FBIZ is trading at a discount to the industry median P/E of 52% in 2011 (versus a discount of 56% at the time of our last report on November 4, 2010), based upon our FBIZ EPS estimate. This is far in excess of the average 13% P/E discount for FBIZ, based upon 5-year historical P/E averages.

Turning to Price/Tangible Book Value, which is the valuation favored by most investors at present, FBIZ is valued at 0.55X versus the industry median of 0.72X. This represents a 24% discount, or about the same as FBIZ's average historical discount of roughly 25% since the end of 2005.

Applying the 0.55X ratio to our estimated book value for FBIZ six months out results in a price target of approximately $12.75. When combined with the Company's current dividend yield, our new target price for FBIZ represents a total return of approximately 5%, in line with our expectations for broader U.S. equity market gains during this period. Therefore, we recommend a Neutral on FBIZ shares.

Industry Comparables- Small-cap Banks

		Price / Earnings Ratios					Return on Equity		Return on Assets		
	Pr Chg YTD	TTM* EPS	2011E	2012E	5-Yr Avg	Price/ Tang Book	TTM*	5-Yr Avg	TTM*	5-Yr Avg	Div Yld
FIRST BUS FINL	**(8.5)**	**9.8**	**6.8**		**13.6**	**0.6**	**4.8**	**6.3**	**0.24**	**0.36**	**2.3**
S&P 500	1.5	22.4	13.8	12.9	18.4	3.6	23.1	-----	9.5	-----	1.9
Median	**1.5**	**15.5**	**14.3**	**12.5**	**15.6**	**0.7**	**3.8**	**4.8**	**0.31**	**0.39**	**-----**
Average	4.4	19.1	18.6	13.6	19.4	0.7	(8.3)	2.4	(0.10)	0.38	1.3
High	41.6	44.4	90.0	33.2	51.9	1.6	15.2	16.1	2.03	2.61	7.1
Low	(21.7)	6.5	6.7	6.0	10.3	0.1	(226.9)	(27.4)	(4.24)	(1.69)	-----

*Trailing twelve months

First Business Financial Services, Inc.

Income Statement and Balance Sheet

(Dollars in millions, except per share data)

Summary Financial Data	12/05	12/06	12/07	12/08	12/09	12/10 E	12/11 E
Net interest income	17.7	18.9	23.2	26.3	28.1	32.1	34.0
Non-interest income	3.3	3.7	4.4	5.1	6.4	6.7	6.9
Total net revenue	21.0	22.6	27.6	31.4	34.5	38.8	40.9
Loan loss provision	0.4	1.5	2.9	4.3	8.2	6.8	6.4
Non-interest expense	14.4	15.7	19.7	21.9	24.5	25.9	26.9
Income taxes & other	2.1	1.7	1.7	2.1	0.8	2.3	3.0
Zacks adjusted income before NRI	4.1	3.7	3.3	3.1	1.0	3.8	4.6
GAAP net income	4.8	3.7	3.3	3.1	1.0	1.1	4.6
Diluted EPS before NRI	1.67	1.52	1.32	1.28	0.41	1.50	1.80
Reported EPS	1.93	1.52	1.32	1.28	0.41	0.41	1.80
Dividends per share	0.06	0.24	0.26	0.28	0.28	0.28	0.28
Liquid assets	108.5	119.3	114.9	132.8	235.0	217.1	218.4
Loans & leases, gross	539.7	648.3	781.6	852.8	854.5	888.7	933.9
Total assets	669.2	788.3	918.4	1,010.8	1,117.4	1,134.0	1,191.8
Core deposits	516.5	604.3	703.6	746.4	942.2	965.5	1,014.7
Purchased funds	73.2	88.4	105.0	129.5	58.2	45.0	45.0
Long-term debt	27.8	40.5	49.5	67.8	51.8	50.0	50.0
Shareholders' equity	41.8	45.8	48.6	53.0	54.4	56.1	60.0
Profitability							
Return on avg assets	0.67%	0.54%	0.39%	0.32%	0.10%	0.35%	0.40%
Return on avg equity	10.19%	8.65%	6.86%	6.11%	1.90%	6.80%	8.01%
Net interest margin	3.03%	2.87%	2.87%	2.81%	2.77%	3.03%	3.00%
Loan loss provision % avg assets	0.07%	0.22%	0.35%	0.44%	0.78%	0.61%	0.55%
Noninterest income % avg assets	0.54%	0.53%	0.53%	0.53%	0.61%	0.61%	0.59%
Noninterest expense % avg assets	2.36%	2.27%	2.34%	2.26%	2.33%	2.36%	2.31%
Preprovision pretax income % avg assets	1.09%	1.00%	0.95%	0.98%	0.95%	1.17%	1.20%
Tangible efficiency ratio	68%	69%	71%	70%	72%	67%	66%
Payout ratio	3%	16%	20%	22%	66%	68%	16%
Asset Quality							
Net charge-offs % avg loans	0.00%	(0.00)%	0.19%	0.28%	0.69%	0.58%	0.54%
Allowance % loans	1.25%	1.28%	1.26%	1.39%	1.65%	1.79%	1.86%
NPAs % loans & related assets	0.29%	0.17%	1.22%	2.25%	3.45%	3.75%	3.34%
Allowance % NPAs	439%	748%	103%	61%	48%	48%	56%
Liquidity & Funding							
Liquid assets % purchased funds	148%	135%	109%	103%	404%	482%	485%
Core deposits % loans	96%	93%	90%	88%	110%	109%	109%
Liquid assets % assets	16%	15%	13%	13%	21%	19%	18%
Loans % assets	81%	82%	85%	84%	76%	78%	78%
Capital Adequacy							
Total equity % assets	6.25%	5.80%	5.29%	5.24%	4.87%	4.95%	5.04%
Tangible equity % assets	5.85%	5.47%	5.00%	4.98%	4.63%	4.94%	5.04%
Tier 1 capital ratio	8.45%	6.24%	5.42%	6.48%	6.61%		
Total capital ratio	10.43%	10.40%	10.22%	12.00%	12.15%		
Parent Company Statistics							
Interest coverage	(1.2)X	(0.9)X	(1.1)X	(0.9)X	0.3X	0.3X	0.3X
Interest & dividend coverage	(1.1)X	(0.7)X	(0.9)X	(0.7)X	0.2X	0.3X	0.3X
Short-term debt coverage	8.7X	19.2X	16.9X	Lge	Lge	Lge	Lge
Total debt coverage	1.3X	1.4X	1.1X	0.9X	1.0X	1.0X	1.1X
Double leverage	144.0%	150.2%	169.1%	185.6%	187.0%	183.3%	179.0%

First Business Financial Services, Inc.

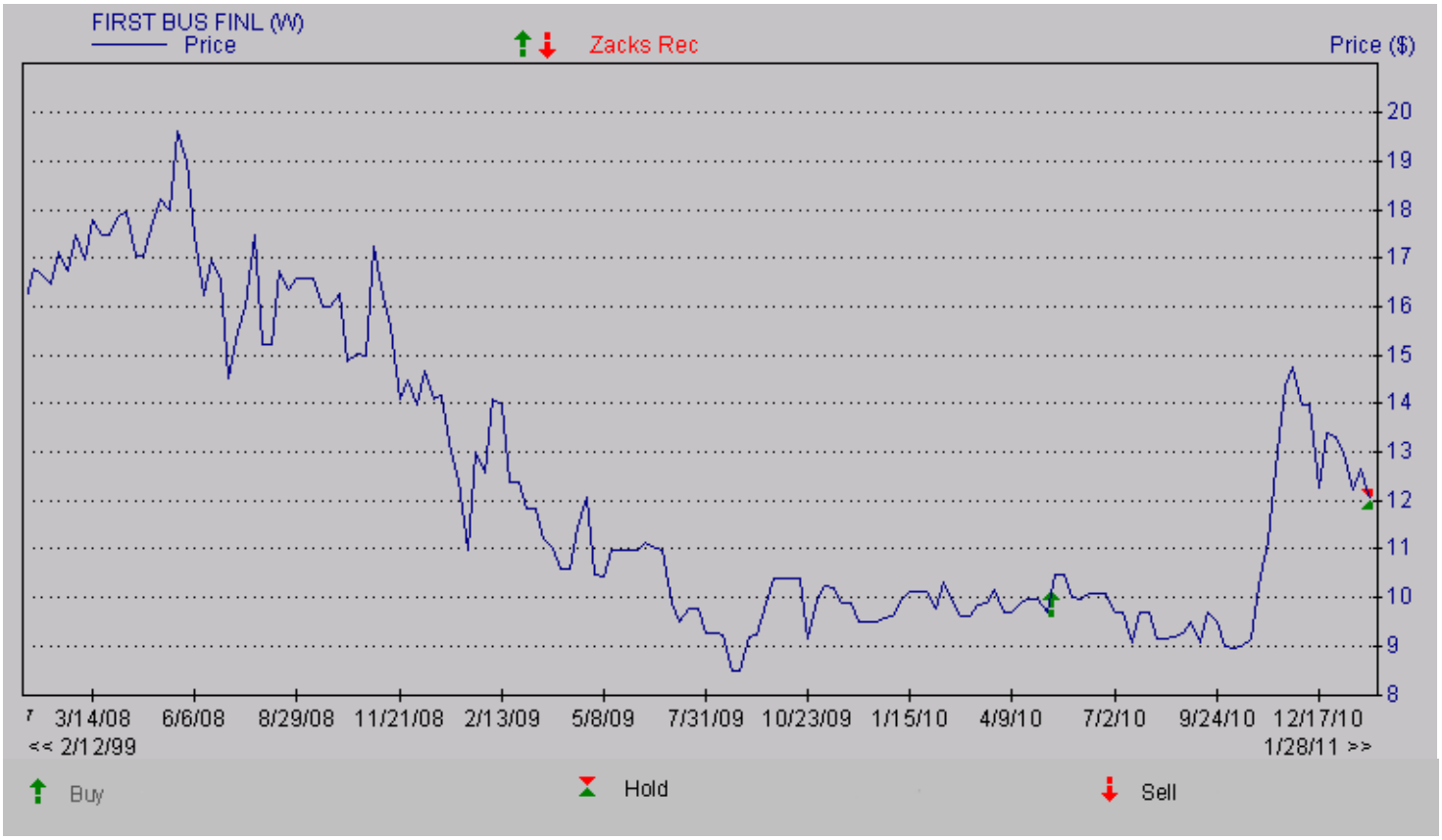
Income Statement and Balance Sheet

(Dollars in millions, except per share data)

	2009				2010			
Summary Financial Data	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 A**	**Q1 A**	**Q2 A**	**Q3 A**	**Q4 E**
Net interest income	6.4	6.8	7.3	7.4	7.9	7.7	8.1	8.4
Non-interest income	1.6	1.5	1.9	1.5	1.6	1.7	1.7	1.7
Total net revenue	8.0	8.3	9.2	8.9	9.5	9.4	9.8	10.1
Loan loss provision	2.2	1.6	1.4	3.0	1.3	1.1	1.9	2.4
Non-interest expense	6.2	6.3	5.5	6.6	6.5	6.5	6.4	6.5
Income taxes & other	(0.2)	0.1	0.9	(0.3)	0.8	0.6	0.5	0.4
Zacks adjusted income before NRI	(0.2)	0.3	1.4	(0.4)	0.9	1.2	1.0	0.8
GAAP net income	(0.2)	0.3	1.4	(0.4)	0.9	(1.5)	1.0	0.8
Diluted EPS before NRI	(0.08)	0.10	0.53	(0.14)	0.35	0.46	0.38	0.30
Reported EPS	(0.08)	0.10	0.53	(0.14)	0.35	(0.63)	0.38	0.30
Dividends per share	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07
Liquid assets	139.6	172.6	178.1	235.0	219.0	203.0	217.3	217.1
Loans & leases, gross	861.9	858.9	871.1	854.5	855.2	845.0	879.9	888.7
Total assets	1,026.0	1,055.5	1,073.7	1,117.4	1,101.8	1,073.9	1,122.8	1,134.0
Core deposits	797.9	829.8	844.2	942.2	922.3	896.4	955.9	965.5
Purchased funds	92.5	92.5	108.5	58.2	60.2	60.2	44.2	45.0
Long-term debt	67.8	67.8	51.8	51.8	49.8	49.8	49.8	50.0
Shareholders' equity	53.4	53.5	55.1	54.4	55.5	54.3	55.5	56.1
Profitability								
Return on avg assets*	(0.08)%	0.10%	0.51%	(0.14)%	0.33%	0.43%	0.35%	0.27%
Return on avg equity *	(1.43)%	1.92%	9.88%	(2.71)%	6.46%	8.22%	6.96%	5.53%
Net interest margin	2.65%	2.72%	2.88%	2.77%	3.00%	2.96%	3.12%	3.05%
Loan loss provision % avg assets*	0.87%	0.63%	0.52%	1.10%	0.49%	0.39%	0.72%	0.85%
Noninterest income % avg assets*	0.62%	0.56%	0.71%	0.56%	0.59%	0.62%	0.61%	0.60%
Noninterest expense % avg assets*	2.43%	2.40%	2.09%	2.40%	2.39%	2.40%	2.33%	2.30%
Preprovision pretax inc.% avg assets*	0.74%	0.78%	1.39%	0.86%	1.07%	1.05%	1.26%	1.29%
Tangible efficiency ratio	77%	75%	62%	74%	69%	70%	65%	64%
Payout ratio	(89)%	66%	13%	(46)%	19%	(11)%	18%	23%
Asset Quality								
Net charge-offs % avg loans*	0.52%	0.88%	0.58%	0.78%	0.06%	0.62%	0.64%	1.00%
Allowance % loans	1.50%	1.48%	1.47%	1.65%	1.79%	1.79%	1.78%	1.79%
NPAs % loans & related assets	2.53%	2.75%	2.78%	3.45%	3.85%	3.87%	3.65%	3.75%
Allowance % NPAs	59%	54%	53%	48%	47%	46%	49%	48%
Liquidity & Funding								
Liquid assets % purchased funds	151%	187%	164%	404%	364%	337%	492%	482%
Core deposits % loans	93%	97%	97%	110%	108%	106%	109%	109%
Liquid assets % assets	14%	16%	17%	21%	20%	19%	19%	19%
Loans % assets	84%	81%	81%	76%	78%	79%	78%	78%
Capital Adequacy								
Total equity % assets	5.20%	5.07%	5.13%	4.87%	5.04%	5.06%	4.94%	4.95%
Tangible equity % assets	4.95%	4.82%	4.88%	4.63%	4.80%	5.05%	4.94%	4.94%
Tier 1 capital ratio	6.34%	6.52%	6.62%	6.61%	6.71%	6.82%	6.59%	
Total capital ratio	11.78%	12.06%	12.15%	12.15%	12.25%	11.48%	11.15%	

*Annualized.

HISTORICAL ZACKS RECOMMENDATIONS



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