

HUDSON TECHNOLOGIES INC /NY  
Form 10QSB  
November 04, 2004

United States

Securities and Exchange Commission

Washington, D.C. 20549

Form 10-QSB

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2004

OR

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-13412

\_\_\_\_\_  
Hudson Technologies, Inc.  
\_\_\_\_\_

(Exact Name of Small Business Issuer as Specified in its Charter)

New York

13-3641539

(State or Other Jurisdiction of  
Incorporation or Organization)

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

275 North Middletown Road  
Pearl River, New York

**10965**

(Address of Principal Executive Offices)

(845) 735-6000

(Issuer's Telephone Number)  
\_\_\_\_\_

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Check whether the issuer: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 [X] No [ ]**.

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

Common stock, \$0.01 par value  
Class

25,517,594 shares  
Outstanding at October 29, 2004

Transitional Small Business Disclosure Format (check one): . Yes [ ] No [X]  
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Hudson Technologies, Inc.

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## Part I - FINANCIAL INFORMATION

## Hudson Technologies, Inc. and subsidiaries

## Consolidated Balance Sheets

(Amounts in thousands, except for share and par value amounts)

	<u>September 30,</u> <u>2004</u> (unaudited)	<u>December 31,</u> <u>2003</u>
<u>Assets</u>		
Current assets:		
Cash and cash equivalents	\$ 260	\$ 656
Trade accounts receivable - net of allowance for doubtful accounts of \$240 and \$272	2,175	1,954
Inventories	2,286	2,587
Prepaid expenses and other current assets	<u>606</u>	<u>269</u>
Total current assets	5,327	5,466
Property, plant and equipment, less accumulated depreciation	1,854	2,193
Other assets	<u>118</u>	<u>137</u>
Total Assets	\$ 7,299	\$ 7,796
	=====	=====
<u>Liabilities and Stockholders' Equity</u>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 2,528	\$ 3,033
Short-term debt and current maturities of long-term debt	<u>1,105</u>	<u>1,777</u>
Total current liabilities	3,633	4,810
Long-term debt, less current maturities	<u>299</u>	<u>380</u>
Total Liabilities	<u>3,932</u>	<u>5,190</u>
Commitments and contingencies		
Stockholders' equity:		
Preferred stock shares authorized 5,000,000:		
Series A Convertible Preferred stock, \$.01 par value (\$100 liquidation preference value); shares authorized 150,000; issued and outstanding none and 125,085	--	12,509
Common stock, \$.01 par value; shares authorized 50,000,000; issued and outstanding 25,517,594 and 8,999,626	255	90
Additional paid-in capital	35,054	22,665
Accumulated deficit	<u>(31,942)</u>	<u>(32,658)</u>
Total Stockholders' Equity	<u>3,367</u>	<u>2,606</u>
Total Liabilities and Stockholders' Equity	\$ 7,299	\$ 7,796
	=====	=====

See accompanying Notes to the Consolidated Financial Statements.

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## Hudson Technologies, Inc. and subsidiaries

## Consolidated Statements of Operations

(unaudited)

(Amounts in thousands, except for share and per share amounts)

	<u>Three month period</u> <u>ended September 30,</u>		<u>Six month period</u> <u>ended September 30,</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Revenues	\$3,571	\$3,988	\$11,747	\$14,729
Cost of sales	<u>2,175</u>	<u>2,971</u>	<u>7,261</u>	<u>10,566</u>
Gross profit	<u>1,396</u>	<u>1,017</u>	<u>4,486</u>	<u>4,163</u>
Operating expenses:				
Selling and marketing	330	312	1,025	1,330
General and administrative	600	907	2,109	2,804
Reorganization cost	--	--	--	350
Depreciation and amortization	<u>181</u>	<u>213</u>	<u>551</u>	<u>668</u>
Total operating expenses	<u>1,111</u>	<u>1,432</u>	<u>3,685</u>	<u>5,152</u>
Operating income (loss)	<u>285</u>	<u>(415)</u>	<u>801</u>	<u>(989)</u>
Other income (expense):				
Interest expense	(90)	(182)	(267)	(467)
Other income (expense)	105	8	105	(74)
Gain on sale of assets	<u>1</u>	<u>--</u>	<u>77</u>	<u>--</u>
Total other income (expense)	<u>16</u>	<u>(174)</u>	<u>(85)</u>	<u>(541)</u>
Income (loss) before income taxes	301	(589)	716	(1,530)
Income taxes	--	--	--	--
Net income (loss)	301	(589)	716	(1,530)
Preferred stock dividends	--	<u>(219)</u>	<u>(228)</u>	<u>(648)</u>
Available for common shareholders	<u>\$ 301</u>	<u>\$ (808)</u>	<u>\$ 488</u>	<u>\$ (2,178)</u>
Net income (loss) per common share - basic	<u>\$ 0.01</u>	<u>\$ (0.16)</u>	<u>\$ 0.02</u>	<u>\$ (0.42)</u>

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Net income (loss) per common share - diluted	\$ 0.01	\$ (0.16)	\$ 0.02	\$ (0.42)
	=====	=====	=====	=====
Weighted average number of shares outstanding - basic	25,517,594	5,166,320	20,011,605	5,165,353
	=====	=====	=====	=====
Weighted average number of shares outstanding - diluted	25,541,032	5,166,320	20,037,152	5,165,353
	=====	=====	=====	=====

See accompanying Notes to the Consolidated Financial Statements.

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Hudson Technologies, Inc. and subsidiaries

Consolidated Statements of Cash Flows

Increase (Decrease) in Cash and Cash Equivalents

(unaudited)

(Amounts in thousands)

	Nine month period ended <u>September</u> <u>30,</u>	
	<u>2004</u>	<u>2003</u>
Cash flows from operating activities:		
Net income (loss)	\$ 716	\$(1,530)
Adjustments to reconcile net income (loss) to cash provided (used) by operating activities:		
Depreciation and amortization	551	668
Allowance for doubtful accounts	90	90
Amortization of original issue discount	--	90
Gain on sale of assets	(77)	--
Changes in assets and liabilities:		
Trade accounts receivable	(311)	(826)
Inventories	301	942
Prepaid expenses and other current assets	(337)	(83)
Other assets	11	(263)
Accounts payable and accrued expenses	<u>(505)</u>	<u>320</u>
Cash provided (used) by operating activities	<u>439</u>	<u>(592)</u>
Cash flows from investing activities:		
Proceeds from sale of property, plant and equipment	111	--
Additions to patents	(2)	(14)
Additions to property, plant and equipment	<u>(237)</u>	<u>(212)</u>
Cash used by investing activities	<u>(128)</u>	<u>(226)</u>

Cash flows from financing activities:		
Proceeds from issuance of common stock - net	45	2
Repayment of short-term debt - net	(568)	(316)
Proceeds from long-term debt	--	1,538
Repayment of long-term debt	<u>(184)</u>	<u>(501)</u>
Cash (used) provided by financing activities	<u>(707)</u>	<u>723</u>
Decrease in cash and cash equivalents	(396)	(95)
Cash and cash equivalents at beginning of period	<u>656</u>	<u>545</u>
Cash and cash equivalents at end of period	\$ 260	\$ 450
	=====	=====
Supplemental disclosure of cash flow information:		
Cash paid during period for interest	\$ 267	\$ 377
Supplemental schedule of non-cash investing and financing activities:		
In-kind payment of preferred stock dividends	\$ 445	\$ 648

See accompanying Notes to the Consolidated Financial Statements

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Hudson Technologies, Inc. and subsidiaries

Notes to the Consolidated Financial Statements

Note 1- Summary of significant accounting policies

Business

Hudson Technologies, Inc., incorporated under the laws of New York on January 11, 1991, together with its subsidiaries (collectively, "Hudson" or the "Company"), is a refrigerant services company providing innovative solutions to recurring problems within the refrigeration industry. The Company's products and services are primarily used in commercial air conditioning, industrial processing and refrigeration systems, including (i) refrigerant sales, (ii) RefrigerantSide® Services performed at a customer's site, consisting of system decontamination to remove moisture, oils and other contaminants and (iii) reclamation of refrigerants. The Company operates through its wholly owned subsidiary Hudson Technologies Company.

The accompanying unaudited financial statements have been prepared in accordance with generally accepted accounting principles for interim financial statements and with the instructions of Regulation S-B. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. The financial information included in the quarterly report should be read in conjunction with the Company's audited financial statements and related notes thereto for the year ended December 31, 2003. Operating results for the nine month period ended September 30, 2004 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2004.

In the opinion of management, all estimates and adjustments considered necessary for a fair presentation have been included and all such adjustments were normal and recurring.

#### Consolidation

The consolidated financial statements represent all companies of which Hudson directly or indirectly has majority ownership or otherwise controls. Significant intercompany accounts and transactions have been eliminated. The Company's consolidated financial statements include the accounts of wholly-owned subsidiaries Hudson Holdings, Inc. and Hudson Technologies Company.

#### Fair value of financial instruments

The carrying values of financial instruments including trade accounts receivable, and accounts payable approximate fair value at September 30, 2004, because of the relatively short maturity of these instruments. The carrying value of short-and long-term debt approximates fair value, based upon quoted market rates of similar debt issues, as of September 30, 2004 and December 31, 2003.

#### Credit risk

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of temporary cash investments and trade accounts receivable. The Company maintains its temporary cash investments in highly-rated financial institutions that exceed FDIC insurance coverage. The Company's trade accounts receivables are primarily due from companies throughout the U.S. The Company reviews each customer's credit history before extending credit.

The Company establishes an allowance for doubtful accounts based on factors associated with the credit risk of specific accounts, historical trends, and other information and the carrying value of its accounts receivable are reduced by the established allowance. The allowance for doubtful accounts includes any accounts receivable balances that are determined to be uncollectable, along with a general reserve for the remaining accounts receivable balances. The Company may adjust its general or specific reserves based on factors that affect the collectibility of the accounts receivable balances.

During the nine month period ended September 30, 2004 and 2003, no customer accounted for 10% or more of the Company's revenues.

The loss of a principal customer or a decline in the economic prospects and purchases of the Company's products or services by any such customer could have an adverse effect on the Company's financial position and results of operations.

#### Cash and cash equivalents

Temporary investments with original maturities of ninety days or less are included in cash and cash equivalents.

#### Inventories

Inventories, consisting primarily of reclaimed refrigerant products available for sale, are stated at the lower of cost, on a first-in first-out basis, or market.

#### Property, plant and equipment

Property, plant and equipment are stated at cost, including internally manufactured equipment. The cost to complete equipment that is under construction is not considered to be material to the Company's financial position. Provision for depreciation is recorded (for financial reporting purposes) using the straight-line method over the useful lives of the respective assets. Leasehold improvements are amortized on a straight-line basis over the shorter of economic life or terms of the respective leases. Costs of maintenance and repairs are charged to expense when incurred.

Due to the specialized nature of the Company's business, it is possible that the Company's estimates of equipment useful life periods may change in the future.

#### Revenues and cost of sales

Revenues are recorded upon completion of service or product shipment and passage of title to customers in accordance with contractual terms. The Company evaluates each sale to ensure collectibility. In addition, each sale is based on an arrangement with the customer and the sales price to the buyer is fixed. License fees are recognized during the period of the license based on the respective performance measurements associated with the license. Royalty revenues are recognized when earned. Cost of sales is recorded based on the cost of products shipped or services performed and related direct operating costs of the Company's facilities. To the extent that the Company charges shipping fees such amounts are included as a component of revenue and the corresponding costs are included as a component of cost of sales.

The Company's revenues are derived from refrigerant and reclamation sales and RefrigerantSide® Services revenues. The revenues for each of these lines are as follows:

Nine month period ended September 30, (in thousands)	<u>2004</u>	<u>2003</u>
Refrigerant and reclamation sales	\$ 8,657	\$12,300
RefrigerantSide® Services	<u>3,090</u>	<u>2,429</u>
Total	\$11,747	\$14,729
	=====	=====

#### Income taxes

The Company utilizes the asset and liability method for recording deferred income taxes, which provides for the establishment of deferred tax asset or liability accounts based on the difference between tax and financial reporting bases of certain assets and liabilities.

The Company recognized a reserve allowance against the deferred tax benefit for the prior period losses. The tax benefit associated with the Company's net operating loss carry forwards is recognized to the extent that the Company recognized net income.

#### Income (loss) per common and equivalent shares

Income (loss) per common share, Basic, is calculated based on the net income (loss) for the period plus dividends on the outstanding Series A Preferred Stock, \$228,000 and \$648,000 for the nine month period ended September 30, 2004 and 2003, respectively, divided by the weighted average number of shares outstanding. If dilutive, common equivalent shares (common shares assuming exercise of options and warrants or conversion of Preferred Stock) utilizing the treasury stock method are considered in the presentation of dilutive earnings per share.



## Estimates and risks

The preparation of financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect reported amounts of certain assets and liabilities, the disclosure of contingent assets and liabilities, and the results of operations during the reporting period. Actual results could differ from these estimates.

The Company participates in an industry that is highly regulated, changes in which could affect operating results. Currently the Company purchases virgin and reclaimable refrigerants from domestic suppliers and its customers. To the extent that the Company is unable to obtain refrigerants on commercially reasonable terms or experiences a decline in demand for refrigerants, the Company could realize reductions in refrigerant processing and possible loss of revenues, which would have a material adverse affect on operating results.

The Company is subject to various legal proceedings. The Company assesses the merit and potential liability associated with each of these proceedings. In addition, the Company estimates potential liability, if any, related to these matters. To the extent that these estimates are not accurate, or circumstances change in the future, the Company could realize liabilities which would have a material adverse effect on operating results and its financial position.

## Impairment of long-lived assets and long-lived assets to be disposed of

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less the cost to sell.

## Stock options

The Company has historically used the intrinsic value method of accounting for employee stock options as permitted by SFAS No. 123, "Accounting for Stock-Based Compensation." Accordingly, compensation cost for stock options has been measured as the excess, if any, of the quoted market price of Company stock at the date of the grant over the amount the employee must pay to acquire the stock. The compensation cost is recognized over the vesting period of the options.

Both the stock-based employee compensation cost included in the determination of the net income as reported and the stock-based employee compensation cost that would have been included in the determination of net income if the fair value based method had been applied to all awards, as well as the resulting pro forma net income and earning per share using the fair value approach, are presented in the following table. These pro forma amounts may not be representative of future disclosures since the estimated fair value of stock options is amortized to expense over the vesting period, and additional options may be granted in future years.

Nine month period ended September 30, <u>Pro forma results</u> (In thousands, except per share amounts)	<u>2004</u>	<u>2003</u>
Net income (loss) available for common shareholders:		
As reported	\$ 488	\$ (2,178)
Total stock based employee compensation expense determined under fair value based method	<u>204</u>	<u>221</u>

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Pro forma	\$ 284	\$ (2,399)
	=====	=====
Income (loss) per common share-basic and diluted:		
As reported	\$ 0.02	\$ (0.42)
	=====	=====
Pro forma	\$	\$ (0.46)
	0.01	
	=====	=====

Note 2 - Other expenses

For the nine months ended September 30, 2004, other expense of \$85,000 consisted of interest expense of approximately \$267,000 offset by a gain on sale of assets and proceeds from an insurance settlement included as other income. For the nine month period ended September 30, 2003, other expense of \$541,000 consisted of interest expense of approximately \$467,000 and finance charges associated with the Company's prior credit facility of \$99,000 offset by sub-lease income of \$25,000.

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Note 3 - Stockholders' equity

On March 31, 2004, the holders of the Series A Preferred Stock converted all of their shares of the Series A Preferred Stock into Common Stock at a conversion price of \$.79 per share. As a result of the conversion, the holders of the Series A Preferred Stock received 16,397,468 shares of Common Stock.

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Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations

Safe Harbor Statement Under The Private Securities Litigation Reform Act of 1995

Certain statements contained in this section and elsewhere in this Form 10-QSB constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve a number of known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include, but are not limited to, changes in the markets for refrigerants (including unfavorable market conditions adversely affecting the demand for, and the price of refrigerants), the Company's ability to source chlorofluorocarbon ("CFC") based refrigerants, regulatory and economic factors, seasonality, competition, litigation, the nature of supplier or customer arrangements which become available to the Company in the future, adverse weather conditions, possible technological obsolescence of existing products and services, possible reduction in the carrying value of long-lived assets, estimates of the useful life of its assets, potential environmental liability, customer concentration, the ability to obtain financing, and other risks detailed in the Company's other periodic reports filed with the Securities and Exchange Commission. The words "believe", "expect", "anticipate", "may", "plan", "should" and similar expressions identify forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date the statement was made.

Critical Accounting Policies

The Company's discussion and analysis of its financial condition and results of operations are based upon its consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. Several of the Company's accounting policies involve significant judgments, uncertainties and estimations. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions. To the extent that actual results differ from management's judgments and estimates, there could be a material adverse effect on the Company. On an on-going basis, the Company evaluates its estimates, including, but not limited to, those estimates related to its allowance for doubtful accounts, inventories and commitments and contingencies. With respect to accounts receivable, the Company estimates the necessary allowance for doubtful accounts based on both historical and anticipated trends of payment history and the ability of the customer to fulfill its obligations. For inventory, the Company evaluates both current and anticipated sales prices of its products to determine if a write down of inventory to net realizable value is necessary. The Company utilizes both internal and external sources to evaluate potential current and future liabilities for various commitments and contingencies. In the event that the assumptions or conditions change in the future, the estimated liabilities could differ from the original estimates.

#### Overview

Over the past few years, the Company has been attempting to grow its service revenues through the development of a service offering known as RefrigerantSide® Services. RefrigerantSide® Services are sold to contractors and end-users associated with refrigeration systems in commercial air conditioning and industrial processing industries. These services are offered in addition to refrigerant sales and the Company's traditional refrigerant management services, which consist primarily of reclamation of refrigerants. The Company has created a network of service depots that provide a full range of the Company's RefrigerantSide® Services to facilitate the growth and development of its service offerings.

During 1999 and 2001, the Company completed sales of its Series A Preferred Stock. The net proceeds of these sales were used to expand the Company's service offering through a network of service depots and to provide working capital. Management believes that its RefrigerantSide® Services represent the Company's long term growth potential. However, during 2002 and portions of 2003 the Company had not been successful in growing its RefrigerantSide® Services revenue. As part of the Company's goal to grow its RefrigerantSide® Services business, in 2002, the Company commenced a restructuring of its sales and marketing efforts culminating in the reorganization of the Company in May 2003. As a result of the reorganization, the Company has determined to focus its future sales and marketing efforts on vertical markets; rather than geographic markets that had been the focus associated with its network of service depots. In pursuing its vertical strategy, the Company expects to focus its RefrigerantSide® Services on specific industries, including petrochemical, pharmaceutical, industrial power, manufacturing, commercial facility and property management and maritime. Moreover, to maintain its current ability to quickly respond to customer service requests throughout the United States, the Company intends to create strategic alliances with companies that will allow it to co-locate its equipment and to utilize these partners' sales and marketing resources to offer their customers the Company's RefrigerantSide® Services. In addition, as a result of the Company's new marketing strategy, the Company closed five of its service depots during 2003. The territories previously served by the closed depots are now served by the Company's remaining service depots. The Company is beginning to develop this new sales and marketing strategy and in the near term may incur additional expenses and losses related to the development of its RefrigerantSide® Services. During the nine months ended September 30, 2004 the Company's revenues from its RefrigerantSide® Services was \$3,090,000 compared to \$2,429,000 for the comparable 2003 period.

Sales of refrigerants continue to represent a majority of the Company's revenues. Most of the Company's refrigerant sales are CFC based refrigerants, which are no longer manufactured. In addition, the Company expects that the demand for CFC based refrigerants will continue to decrease as equipment that utilizes other chemical based refrigerants replaces those units that utilize CFC based refrigerants, particularly in the automotive aftermarket segment of the refrigerant sales industry. To the extent that the Company is unable to source CFC based refrigerants on commercially reasonable terms or at all, or the demand for CFC based refrigerants decreases, the Company's financial condition and results of operations could be materially adversely affected. In addition, to the extent that the Company is unable to source replacements to the CFC based refrigerants, the Company's financial condition and results of operations would be materially adversely affected.

The Company believes that, for the foreseeable future in the refrigeration industry overall, there will be a trend towards lower sales prices, volumes and gross profit margins on refrigerant sales, which may result in an adverse effect on the Company's operating results. In addition, to the extent that the Company is unable to obtain refrigerants on commercially reasonable terms or experiences a decline in demand for refrigerants, the Company could realize reductions in refrigerant processing, and loss of revenues, which would have a material adverse effect on its operating results.

#### Results of Operations

##### Three month period ended September 30, 2004 as compared to three month period ended September 30, 2003

Revenues for the three month period ended September 30, 2004 were \$3,571,000, a decrease of \$417,000 or 10% from the \$3,988,000 reported during the comparable 2003 period. The decrease in revenues was primarily attributable to a decrease in refrigerant revenues partially offset by an increase in RefrigerantSide® Services revenues. The decrease in refrigerant revenues is related to a reduction in the sales prices per pound and volume of CFC based refrigerants sold to the automotive aftermarket and to a lesser extent a reduction in the volume of other CFC based refrigerants sold. The Company believes that the decline in automotive refrigerants and the decline in volume of other CFC based refrigerants is due to a reduction in the number of refrigeration systems that use CFC based refrigerants. The increase in RefrigerantSide® Services was primarily attributed to an increase in the revenue per job sold, which is a consequence of the reorganization of the Company's sales and marketing efforts.

Cost of sales for the three month period ended September 30, 2004 was \$2,175,000, a decrease of \$796,000 or 27% from the \$2,971,000 reported during the comparable 2003 period. The decrease in cost of sales was primarily due to a reduction in materials cost of refrigerants sold, which is directly related to the reduction in refrigerant revenues described above, and to a lesser extent a reduction in payroll associated with the Company's RefrigerantSide® Services due to fewer employees supporting RefrigerantSide® Services. As a percentage of sales, cost of sales were 61% of revenues for 2004, a decrease from the 74% reported for the comparable 2003 period. The decrease in cost of sales as a percentage of revenues was primarily attributable to a reduction in material costs of refrigerants sold.

Operating expenses for the three month period ended September 30, 2004 were \$1,111,000, a decrease of \$321,000 or 22% from the \$1,432,000 reported during the comparable 2003 period. The decrease was primarily attributable to a reduction in general and administrative costs due to the Company's reorganization of the Company's RefrigerantSide® Service offering that occurred in May 2003 and a reduction in depreciation and amortization costs.

Other income (expense) for the three month period ended September 30, 2004 was \$16,000, compared to the \$(174,000) reported during the comparable 2003 period. Other income (expense) for the 2004 period includes interest expense of \$90,000 offset by a gain on sale of assets of \$1,000 and other income of \$105,000. Other income (expense) for the 2003 period includes interest expense of \$182,000 offset by sub-lease income of \$8,000. The decrease in interest expense in the 2004 period when compared to the 2003 period is primarily attributed to a reduction in outstanding indebtedness.

No income taxes for the three month period ended September 30, 2004 and 2003 were recognized. During the 2004 period no income taxes were recognized on the \$301,000 of income before taxes due to the utilization of net operating loss carry forwards from prior periods. The Company recognized a reserve allowance against the deferred tax benefit for the 2003 losses. The tax benefits associated with the Company's net operating loss carry forwards is recognized to the extent that the Company recognizes net income. A portion of the Company's net operating loss carry forwards are subject to annual limitations.

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Net income for the three month period ended September 30, 2004 was \$301,000, an increase of \$890,000 from the \$589,000 net loss reported during the comparable 2003 period. The increase in net income was primarily attributable to an increase in the gross profit on the Company's revenues and a decrease in general and administrative expenses due to the reorganization of the Company's RefrigerantSide® Service offering that occurred in May 2003.

Nine months ended September 30, 2004 as compared to the nine months ended September 30, 2003

Revenues for the nine months ended September 30, 2004 were \$11,747,000, a decrease of \$2,982,000 or 20% from the \$14,729,000 reported during the comparable 2003 period. The decrease in revenues was primarily attributable to a decrease in refrigerant revenues offset by an increase in RefrigerantSide® Services revenues. The decrease in refrigerant revenues is related to a reduction in the sales prices per pound and volume of CFC based refrigerants sold to the automotive aftermarket and to a lesser extent a reduction in the volume of other CFC based refrigerants sold. The Company believes that the decline in automotive refrigerants and the decline in volume of other CFC based refrigerants is due to a reduction in the number of refrigeration systems that use CFC based refrigerants. The increase in RefrigerantSide® Services was primarily attributable to an increase in the revenue per job sold, which is a consequence of the reorganization of the Company's sales and marketing efforts.

Cost of sales for the nine months ended September 30, 2004 was \$7,261,000, a decrease of \$3,305,000 or 31% from the \$10,566,000 reported during the comparable 2003 period. The decrease in cost of sales was primarily due to a reduction in materials cost of refrigerants sold, which is directly related to the reduction in refrigerant revenues described above, and to a lesser extent a reduction in payroll associated with the Company's RefrigerantSide® Services. As a percentage of sales, cost of sales were 62% of revenues for 2004, a decrease from the 72% reported for the comparable 2003 period. The decrease in cost of sales as a percentage of revenues was primarily attributable to a reduction in material costs of refrigerants sold and to a lesser extent a reduction in payroll associated with the Company's RefrigerantSide® Services.

Operating expenses for the nine months ended September 30, 2004 were \$3,685,000 a decrease of \$1,467,000 or 28% from the \$5,152,000 reported during the comparable 2003 period. The decrease was primarily attributable to a reduction in selling, general and administrative and reorganization costs due to the Company's reorganization of the Company's RefrigerantSide® Service offering that occurred in May 2003 and a reduction in depreciation and amortization costs.

Other income (expense) for the nine months ended September 30, 2004 was (\$85,000), compared to the (\$541,000) reported during the comparable 2003 period. Other income (expense) includes interest expense of \$267,000 and \$467,000 for the comparable nine month periods ended September 30, 2004 and 2003, respectively. The decrease in interest expense is primarily attributed to a reduction in outstanding indebtedness. During the 2004 period interest expense was offset by a \$77,000 gain on sale of assets and other income of \$105,000. Other income (expense) of (\$74,000) during the 2003 period consisted of finance charges on the prior credit facility of \$99,000 offset by sub-lease income of \$25,000.

No income taxes for the nine months ended September 30, 2004 and 2003 were recognized. During the 2004 period no income taxes were recognized on the income before taxes of \$716,000 due to the utilization of net operating loss

carry forwards from prior periods. The Company recognized a reserve allowance against the deferred tax benefit for the 2003 losses. The tax benefits associated with the Company's net operating loss carry forwards is recognized to the extent that the Company recognizes net income. A portion of the Company's net operating loss carry forwards are subject to annual limitations.

Net income for the nine months ended September 30, 2004 was \$716,000 an increase of \$2,246,000 from the \$1,530,000 net loss reported during the comparable 2003 period. The increase in net income was primarily attributable to an increase in gross profits on the Company's revenues and a decrease in selling, general and administrative and reorganization expenses due to the reorganization of the Company's RefrigerantSide® Service offering that occurred in May 2003.

#### Liquidity and Capital Resources

At September 30, 2004, the Company had a working capital, which represents current assets less current liabilities, of approximately \$1,694,000, an increase of \$1,038,000 from the working capital of \$656,000 at December 31, 2003. The increase in working capital is primarily attributable to the net income recognized during the nine month period ended September 30, 2004 and proceeds from the issuance of Common Stock.

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Principal components of current assets are inventory and trade receivables. At September 30, 2004, the Company had inventories of \$2,286,000, a decrease of \$301,000, or 12% from the \$2,587,000 at December 31, 2003. The decrease in the inventory balance is due to the timing and availability of inventory purchases and the sale of refrigerants. The Company's ability to sell and replace its inventory on a timely basis and the prices at which it can be sold are subject, among other things, to current market conditions and the nature of supplier or customer arrangements and the Company's ability to source CFC refrigerants that are no longer being manufactured (see "Reliance on Suppliers and Customers" and "Seasonality and Fluctuations in Operating Results"). At September 30, 2004, the Company had trade receivables, net of allowance for doubtful accounts, of \$2,175,000, an increase of \$221,000 or 11% from the \$1,954,000 at December 31, 2003. The Company's trade receivables are concentrated with various wholesalers, brokers, contractors and end-users within the refrigeration industry that are primarily located in the continental United States.

The Company has historically financed its working capital requirements through cash flows from operations, the issuance of debt and equity securities and bank and related party borrowings. In recent years, the Company has not financed its working capital requirements through cash flows from operations but rather from issuances of equity securities and bank borrowings. During 2003, the Company completed several initiatives to lower its overall operating cost resulting in the elimination of approximately \$2,000,000 in annual expenses. The full impact of these cost reductions has been recognized through the second quarter of 2004.

Net cash provided by operating activities for the nine month period ended September 30, 2004, was \$439,000 compared with net cash used by operating activities of \$592,000 for the comparable 2003 period. Net cash provided by operating activities for the 2004 period was primarily attributable to the net income for the period and a reduction in inventories offset by an increase in trade receivables and accounts payable and accrued expenses.

Net cash used by investing activities for the nine month period ended September 30, 2004, was \$128,000 compared with net cash used by investing activities of \$226,000 for the prior comparable 2003 period. The net cash used by investing activities for the 2004 period was due to equipment additions primarily associated with the Company's alliance agreement with the BOC Group.

Net cash used by financing activities for the nine month period ended September 30, 2004, was \$707,000 compared with net cash provided by financing activities of \$723,000 for the comparable 2003 period. The net cash used by financing activities for the 2004 period primarily consisted of \$45,000 net proceeds received by the Company from the sale of Common Stock offset by repayment of short-term debt of \$568,000, and the repayment of long-term debt of \$184,000.

At September 30, 2004, the Company had cash and cash equivalents of \$260,000. The Company continues to assess its capital expenditure needs. The Company may, to the extent necessary, continue to utilize its cash balances to purchase equipment primarily associated with its reclamation facility and with the alliance with the BOC Group. The Company estimates that total capital expenditures during 2004 may range from approximately \$350,000 to \$450,000 and as of September 30, 2004, the Company has expended \$237,000.

On May 30, 2003, Hudson entered into a credit facility with Keltic Financial Partners, LLP ("Keltic") which provides for borrowings of up to \$5,000,000. The facility consists of a revolving line of credit and a term loan and expires on May 30, 2006. Advances under the revolving line of credit may not exceed \$4,600,000 and are limited to (i) 85% of eligible trade accounts receivable and (ii) 50% of eligible inventory. Advances available to Hudson under the term loan may not exceed \$400,000. The facility bears interest at a rate equal to the greater of the prime rate plus 2.0%, or 6.5%, and was 6.75% at September 30, 2004. Substantially all of Hudson's assets are pledged as collateral for its obligations to Keltic under the credit facility. In addition, among other things, the agreements restrict Hudson's ability to declare or pay any cash dividends on its capital stock. As of September 30, 2004, Hudson had in the aggregate \$997,000 of borrowings outstanding under the Keltic revolving line of credit and \$1,635,000 available for borrowing under the revolving line of credit. In addition, the Company had \$300,000 of borrowings outstanding under its term loan with Keltic.

During 2003, the Company offered for sale its Common Stock through the issuance of rights to its then existing shareholders and offered the remaining unsubscribed shares to the public ("Rights Offering"). The Rights Offering closed on December 19, 2003. As a result of the Rights Offering and the conversion of all of the then existing Convertible Notes in the aggregate principal amount of \$1,660,000, the Company issued an aggregate of 3,833,306 shares of its Common Stock.

On March 30, 1999, the Company completed the sale of 65,000 shares of its Series A Preferred Stock, with a liquidation value of \$100 per share, to Fleming US Discovery Fund III, L.P. and Fleming US Discovery Offshore Fund III, L.P. The gross proceeds from the sale of the Series A Preferred Stock were \$6,500,000.

On February 16, 2001, the Company completed the sale of 30,000 shares of its Series A Preferred Stock, with a liquidation value of \$100 per share, to Fleming US Discovery Fund III, L.P. and Fleming US Discovery Offshore Fund III, L.P. The gross proceeds from the sale of the Series A Preferred Stock were \$3,000,000.

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Prior to March 31, 2004, the Company paid dividends, in arrears, on the Series A Preferred Stock, semi-annually, either in cash or additional shares, at the Company's option. On March 30, 2004, the Company declared and paid, in-kind, the dividends on the outstanding Series A Preferred Stock and issued 4,455, additional shares of its Series A Preferred Stock in satisfaction of the dividends due. The March 30, 2004 dividend payment represents the final dividend payment on the outstanding Series A Preferred Stock.

On March 31, 2004, the holders of the Series A Preferred Stock converted all of their shares of the Series A Preferred Stock into Common Stock at a conversion price of \$.79 per share. As a result of the conversion, the holders of the Series A Preferred Stock received 16,397,468 shares of Common Stock.

The Company is continuing to evaluate opportunities to rationalize its operating facilities and its depot network based on ways to reduce costs or to increase revenues. During the first half of 2003, based on evaluations by management, the Company began to consolidate certain of its facilities. Moreover, as the Company begins to implement its sales and marketing strategy to focus on industry rather than geographic markets it may discontinue certain operations, eliminate depot and overhead costs and, in doing so, may incur future charges to exit certain operations.

The Company believes that it will be able to satisfy its working capital requirements for the immediate future from anticipated cash flow from operations and available funds under its credit facility with Keltic. In addition, any unanticipated expenses, including, but not limited to, an increase in the cost of refrigerants purchased by the Company, an increase in operating expenses or failure to achieve expected revenues from the Company's depots and/or refrigerant sales or additional expansion or acquisition costs that may arise in the future would adversely affect the Company's future capital needs. There can be no assurances that the Company's proposed or future plans will be successful, and as such, the Company may need to significantly modify its plans or it may require additional capital sooner than anticipated, which capital may not be available.

#### Inflation

Inflation has not historically had a material impact on the Company's operations.

#### Reliance on Suppliers and Customers

The Company's financial performance is in part dependent on its ability to obtain sufficient quantities of virgin and reclaimable refrigerants from manufacturers, wholesalers, distributors, bulk gas brokers, and from other sources within the air conditioning and refrigeration and automotive aftermarket industries, and on corresponding demand for refrigerants. Most of the Company's refrigerant sales are CFC based refrigerants, which are no longer manufactured. To the extent that the Company is unable to obtain sufficient quantities of virgin or reclaimable refrigerants in the future, or resell refrigerants at a profit, the Company's financial condition and results of operations would be materially adversely affected.

During the nine month period ended September 30, 2004 and 2003, no customer accounted for 10% or more of the Company's revenues.

The loss of a principal customer or a decline in the economic prospects and purchases of the Company's products or services by any such customer could have a material adverse effect on the Company's financial position and results of operations.

#### Seasonality and Fluctuations in Operating Results

The Company's operating results vary from period to period as a result of weather conditions, requirements of potential customers, non-recurring refrigerant and service sales, availability and price of refrigerant products (virgin or reclaimable), changes in reclamation technology and regulations, timing in introduction and/or retrofit or replacement of CFC-based refrigeration equipment, the rate of expansion of the Company's operations, and by other factors. The Company's business is seasonal in nature with peak sales of refrigerants occurring in the first half of each year. During past years, the seasonal decrease in sales of refrigerants have resulted in additional losses during the second half of the year. Delays in securing adequate supplies of refrigerants at peak demand periods, lack of refrigerant demand, increased expenses, declining refrigerant prices and a loss of a principal customer could result in significant losses. There can be no assurance that the foregoing factors will not occur and result in a material adverse effect on the Company's financial position and significant losses. The Company believes that there is a similar seasonal element to RefrigerantSide® Service revenues as refrigerant sales and is continuing to assess its seasonal trend.



Item 3 - Controls and Procedures

An evaluation was carried out under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness of the Company's disclosure controls and procedures as of the end of the quarter ended September 30, 2004. Based on that evaluation, the CEO and CFO have concluded that the Company's disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. During the quarter ended September 30, 2004, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

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PART II - OTHER INFORMATION

Item 1 - Legal Proceedings

In September 1998, United Water of New York, Inc. ("United") commenced an action against the Company in the Supreme Court of the State of New York, Rockland County, seeking damages in the amount of \$1.2 million allegedly sustained as a result of alleged contamination of certain of United's wells which are in close proximity to the Company's Hillburn, New York facility.

On April 1, 1999, the Company reported a release at the Company's Hillburn, New York facility of approximately 7,800 lbs. of R-11, as a result of a failed hose connection to one of the Company's outdoor storage tanks allowing liquid R-11 to discharge from the tank into the concrete secondary containment area in which the subject tank was located.

Between April 1999 and May 1999, with the approval of the New York State Department of Environmental Conservation ("DEC"), the Company constructed and put into operation a remediation system at the Company's Hillburn facility to remove R-11 levels in the groundwater under and around the Company's facility.

In July 1999, United amended its complaint in the Rockland County action to allege facts relating to, and to seek damages allegedly resulting from, the April 1, 1999 R-11 release.

In September 2000, the Rockland County Supreme Court approved a settlement of the Rockland County action commenced by United. Under the settlement, the Company paid to United the sum of \$1,000,000 and had been making additional monthly payments in the amount of \$5,000. The final monthly payment was made by the Company in February 2004, satisfying all remaining obligations of the Company to United under the settlement. The Company carries \$1,000,000 environmental impairment insurance per occurrence and in connection with the settlement, exhausted all insurance proceeds available for that occurrence under all applicable policies.

In September 2000, the Company signed an Order on Consent with the DEC regarding all past contamination of the United well field, whereby, the Company agreed to continue operating the remediation system it installed at its Hillburn facility in May 1999, until remaining groundwater contamination has been effectively abated. In May 2001, the Company signed an amendment to the Order on Consent with the DEC, pursuant to which the Company installed one additional monitoring well and modified the Company's existing remediation system to incorporate a second recovery well. The Company is continuing to operate the remediation system pursuant to that Order on Consent.

In May 2000, the Company's Hillburn facility was nominated by the United States Environmental Protection Agency ("EPA") for listing on the National Priorities List ("NPL"), pursuant to the Comprehensive Environmental Response, Compensation and Liability Act of 1980. The Company believes that the agreements reached with the DEC and United, together with the reduced levels of contamination present in United's wells, make such listing unnecessary and counterproductive. The Company submitted opposition to the listing within the sixty-day comment period. In September 2003, the EPA advised the Company that it has no current plans to finalize the process for listing the Hillburn facility on the NPL. The EPA also advised the Company that it will not at this time withdraw the proposal of the Hillburn facility on the NPL.

In October 2001, the Company learned that trace levels of R-11 were detected in one of United's wells that is in the closest proximity to the Village of Suffern's ("Village") well system. During February 2002, the Village expressed concern over the possibility of R-11 reaching its well system and advised the Company that it was investigating available options to protect its well system. No contamination of R-11 has ever been detected in any of the Village's wells and, as of October 2002, the level of R-11 in the United well closest to the Village was below 1 ppb. In October 2002, the Village advised the Company that it intends to proceed with plans to protect its wells and would look to the Company to reimburse the Village for any costs it may incur. In September 2004, the Village advised that it intends to continue performing additional sampling of its wells at a cost of approximately \$5,000 per year, and has requested that the Company reimburse the Village for the costs for such sampling. To date, no other detailed cost estimate, formal demand or claim has been presented by the Village, however, to the extent the Village proceeds with its plans, the Company may incur additional costs. The Company has reimbursed the Village for approximately \$12,000 of costs incurred to date for additional sampling by the Village of its wells and for minor preparatory work in connection with the Village's plan for protecting its wells.

In February 2003, the Company agreed to extend the statute of limitations applicable to any claims that may be available to Ramapo Land Company ("Ramapo"), the lessor of the Company's Hillburn facility, arising out of the April 1, 1999 incident for an additional two years. Between April 2004 and September 2004, Ramapo advised the Company that it had incurred approximately \$80,000 in legal and consulting fees relating to the April 1, 1999 incident and has requested reimbursement from the Company for these costs and for future costs that may be incurred in this regard. In September 2004, Ramapo advised the Company that the value of the real property upon which the Hillburn facility is situated has been diminished in value by an unspecified amount as a result of the April 1, 1999 incident. There can be no assurance that a claim asserted by Ramapo for diminishment of the value of the Hillburn facility, and for legal and environmental costs incurred, will not have a material adverse effect on the Company's financial condition or results of operations.

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There can be no assurance that the R-11 will not spread beyond the United's well system and impact the Village of Suffern's wells, or that the ultimate outcome of such a spread of contamination will not have a material adverse effect on the Company's financial condition and results of operations. There can be no assurance that the EPA will not change its current plans and seek to finalize the process of listing the Hillburn facility on the NPL, or that the ultimate outcome of such a listing will not have a material adverse effect on the Company's financial condition and results of operations.

Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds

During the three months ended September 30, 2004, the Company granted options to purchase an aggregate of 109,375 shares of Common Stock to employees pursuant to its Stock Option Plans. With respect to these option grants the Company relied on the exemption from registration provided by Section 4(2) under the Securities Act of 1933, the ("Act") as transactions by an issuer not involving a public offering and /or Section 2(a) (3) of the Act.

Item 4 - Submission of Matters to a Vote of Security Holders

On September 10, 2004 the Company held an Annual Meeting of Shareholders at which the Company's security holders voted for: (a) the election of four directors whose class was set to expire in 2004 (Messrs. Dominic J. Monetta, Harry C. Schell, Robert M. Zech and Kevin J. Zugibe) to serve until the Annual Meeting of Shareholders of the Company to be held in 2006 and (b) a proposal to approve the Company's 2004 Stock Incentive Plan. In addition to the foregoing individuals, Messrs. Vincent P. Abbatecola, Robert L. Burr and Otto C. Morch, directors of the Company whose terms expire in 2005, continued to serve as directors of the Company after the Annual Meeting of Shareholders. The results of the vote were as follows:

(a) Election of Directors

<u>Director</u>	<u>Votes Cast "For"</u>	<u>Votes Withheld</u>
Dominic J. Monetta	24,167,187	421,660
Harry C. Schell	24,160,787	428,060
Robert M. Zech	24,146,687	442,160
Kevin J. Zugibe	24,286,902	302,945

(b) Approval of 2004 Stock Incentive Plan

<u>Votes Cast "For"</u>	<u>Votes Cast "Against"</u>	<u>Votes "Abstaining"</u>
21,500,150	724,029	52,715

In addition, there were 2,311,953 shares that were not voted on this proposal.

Item 5 - Other Information

(a). On September 17, 2004, the Company granted options to purchase: (i) 18,750 shares of its Common Stock to Kevin J. Zugibe, its Chief Executive Officer, (ii) 12,500 shares of its Common Stock to Brian F. Coleman, its President, (iii) 9,375 shares of its Common Stock to Charles F. Harkins, its Vice President of Sales and Operations, (iv) 6,250 shares of its Common Stock to Stephen P. Mandracchia, its Vice President and (v) 6,250 shares of its Common Stock to James R. Buscemi, its Chief Financial Officer. All such options were issued at an exercise price of \$.83 and vest in eight equal quarterly installments over a two year period with the first installment vesting on October 1, 2004 and expire on September 17, 2014, subject to earlier termination in certain circumstances

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Item 6 - Exhibits

The following exhibits are attached to this report:

Exhibit Number

10.1 Incentive Stock Option Agreement made as of September 17, 2004 between the Company and Kevin J. Zugibe.

10.2 Incentive Stock Option Agreement made as of September 17, 2004 between the Company and Brian F. Coleman.

- 10.3 Incentive Stock Option Agreement made as of September 17, 2004 between the Company and Stephen P. Mandracchia.
- 10.4 Incentive Stock Option Agreement made as of September 17, 2004 between the Company and Charles F. Harkins.
- 10.5 Incentive Stock Option Agreement made as of September 17, 2004 between the Company and James R. Buscemi.
- 10.6 Form of Incentive Stock Option Agreement under the 1997 Stock Option Plan of the Company with full vesting upon issuance.
- 10.7 Form of Incentive Stock Option Agreement under the 1997 Stock Option Plan of the Company with options vesting in equal quarterly installments over two year period.
- 10.8 Form of Non-Incentive Stock Option Agreement under the 1997 Stock Option Plan of the Company with full vesting upon issuance.
- 10.9 2004 Stock Incentive Plan (incorporated by reference to Appendix B to the Company's Definitive Proxy Statement on Schedule 14A filed with the Securities and Exchange Commission on August 18, 2004).
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this Report to be signed in its behalf by the undersigned, thereunto duly authorized.

HUDSON TECHNOLOGIES, INC.

By: /s/ Kevin J. Zugibe  
Kevin J. Zugibe  
Chairman and  
Chief Executive Officer

November 5, 2004  
Date

By: /s/ James R. Buscemi  
James R. Buscemi  
Chief Financial Officer

November 5, 2004  
Date

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Net interest income after provision for loan and lease losses

14,323

11,024

42,237

32,535

Non-interest income:

Trust and investment services fee income

1,251

1,137

3,737

3,315

Gain on sale of SBA loans

927

—

2,274

—

Gain on sale of residential mortgage loans

244

—

614

—

Service charges on deposits

705

620

2,094

1,787

Loan fees

486

386

1,487

1,156

Increase in cash surrender value of bank-owned life insurance

243

215

715

630

Other

246

101

1,155

250

Total non-interest income

4,102

2,459

12,076

7,138

Non-interest expense:

Compensation

7,320

5,193

21,598

14,991

Occupancy

486

324

1,472

963

Professional fees

1,268

674

3,772

2,201

Data processing

587

389

1,772

1,227

Marketing

693



409

2,036

1,120

Equipment

308

145

914

400

FDIC insurance

260

179

693

542

Collateral liquidation costs

22

32

402

276

Net gain on foreclosed properties

(163  
)

(9  
)

(178  
)

(5  
)  
Other

1,203

711

3,209

1,933

Total non-interest expense

11,984

8,047

35,690

23,648

Income before income tax expense

6,441

5,436

18,623

16,025

Income tax expense

2,060

1,883

6,192

5,630

Net income

\$  
4,381

\$  
3,553

\$  
12,431

\$  
10,395

Earnings per common share:

Basic

\$  
0.50

\$  
0.45

\$  
1.43

\$

1.32

Diluted

\$  
0.50

\$  
0.45

\$  
1.43

\$  
1.31

Dividends declared per share

\$  
0.11

\$  
0.105

\$  
0.33

\$  
0.315

See accompanying Notes to Unaudited Consolidated Financial Statements.

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First Business Financial Services, Inc.

Consolidated Statements of Comprehensive Income (Unaudited)

	For the Three Months Ended September 30, 2015		For the Nine Months Ended September 30, 2015	
	2014		2014	
	(In Thousands)			
Net income	\$4,381	\$3,553	\$12,431	\$10,395
Other comprehensive income (loss), before tax				
Securities available-for-sale:				
Net unrealized securities gains (losses) arising during the period	443	(431	) 298	1,711
Securities held-to-maturity:				
Unrealized losses transferred to held-to-maturity	—	—	—	(874
Amortization of net unrealized losses transferred from available-for-sale	54	75	181	100
Income tax (expense) benefit	(192	) 137	(185	) (362
Comprehensive income	\$4,686	\$3,334	\$12,725	\$10,970

See accompanying Notes to Unaudited Consolidated Financial Statements.

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First Business Financial Services, Inc.

Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

	Common shares outstanding	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive (loss) income	Treasury stock	Total
	(In Thousands, Except Share Data)						
Balance at December 31, 2013	8,252,481	\$41	\$56,002	\$57,143	\$ (342 )	\$(3,569)	\$109,275
Net income	—	—	—	10,395	—	—	10,395
Other comprehensive income	—	—	—	—	575	—	575
Exercise of stock options	4,000	—	48	—	—	—	48
Share-based compensation - restricted shares	46,772	—	618	—	—	—	618
Share-based compensation - tax benefits	—	—	226	—	—	—	226
Cash dividends (\$0.315 per share)	—	—	—	(2,485 )	—	—	(2,485 )
Treasury stock purchased	(20,536 )	—	—	—	—	(460 )	(460 )
Balance at September 30, 2014	8,282,717	\$41	\$56,894	\$65,053	\$ 233	\$(4,029)	\$118,192

	Common shares outstanding	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Treasury stock	Total
	(In Thousands, Except Share Data)						
Balance at December 31, 2014	8,671,854	\$45	\$74,963	\$67,886	\$ 218	\$(5,364)	\$137,748
Net income	—	—	—	12,431	—	—	12,431
Other comprehensive income	—	—	—	—	294	—	294
Common stock dividends	—	44	(44 )	—	—	—	—
Exercise of stock options	24,000	—	300	—	—	—	300
Share-based compensation - restricted shares	43,602	—	717	—	—	—	717
Share-based compensation - tax benefits	—	—	253	—	—	—	253
Cash dividends (\$0.33 per share)	—	—	—	(2,859 )	—	—	(2,859 )
Treasury stock purchased	(40,681 )	—	—	—	—	(917 )	(917 )
Balance at September 30, 2015	8,698,775	\$89	\$76,189	\$77,458	\$ 512	\$(6,281)	\$147,967

See accompanying Notes to Unaudited Consolidated Financial Statements.

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First Business Financial Services, Inc.

Consolidated Statements of Cash Flows (Unaudited)

	For the Nine Months Ended September	
	30,	2014
	2015	2014
	(In Thousands)	
Operating activities		
Net income	\$12,431	\$10,395
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes, net	319	283
Provision for loan and lease losses	1,491	—
Depreciation, amortization and accretion, net	(379)	) 1,324
Share-based compensation	717	618
Increase in cash surrender value of bank-owned life insurance	(715)	) (630)
Origination of loans for sale	(52,295)	) —
Sale of loans originated for sale	53,612	—
Gain on sale of loans originated for sale	(2,887)	) —
Net (gain) loss on foreclosed properties, including impairment valuation	(178)	) (5)
Excess tax benefit from share-based compensation	(253)	) (226)
Decrease (increase) in accrued interest receivable and other assets	(1,107)	) (396)
Increase (decrease) in accrued interest payable and other liabilities	1,342	(124)
Net cash provided by operating activities	12,098	11,239
Investing activities		
Proceeds from maturities, redemptions and paydowns of available-for-sale securities	32,930	34,185
Proceeds from maturities, redemptions and paydowns of held-to-maturity securities	3,253	1,231
Purchases of available-for-sale securities	(32,614)	) (40,310)
Proceeds from sale of foreclosed properties	528	232
Net increase in loans and leases	(96,898)	) (60,836)
Investment in limited partnerships	—	(500)
Distributions from limited partnerships	332	676
Investment in FHLB and FRB Stock	(1,349)	) (467)
Proceeds from sale of FHLB Stock	846	373
Purchases of leasehold improvements and equipment, net	(498)	) (285)
Net cash used in investing activities	(93,470)	) (65,701)
Financing activities		
Net increase in deposits	101,529	139,345
Net increase in short-term borrowed funds	2,500	—
Proceeds from issuance of subordinated notes payable	—	15,000
Repayment of subordinated notes payable	—	(4,000)
Excess tax benefit from share-based compensation	253	226
Cash dividends paid	(2,859)	) (2,485)
Exercise of stock options	300	48
Purchase of treasury stock	(917)	) (460)
Net cash provided by financing activities	100,806	147,674
Net (decrease) increase in cash and cash equivalents	19,434	93,212
Cash and cash equivalents at the beginning of the period	103,237	81,286

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Cash and cash equivalents at the end of the period	\$122,671	\$174,498
Supplementary cash flow information		
Cash paid during the period for:		
Interest paid on deposits and borrowings	\$9,817	\$7,575
Income taxes paid	3,793	5,128
Non-cash investing and financing activities:		
Transfer of securities from available-for-sale to held-to-maturity	—	44,587
Unrealized loss on transfer from available-for-sale to held-to-maturity	—	(874 )
Transfer to foreclosed properties	289	—
See accompanying Notes to Unaudited Consolidated Financial Statements.		

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## Notes to Unaudited Consolidated Financial Statements

## Note 1 — Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations. The accounting and reporting practices of First Business Financial Services, Inc. (the “Corporation”), its wholly owned subsidiaries, First Business Bank (“FBB”), First Business Bank – Milwaukee (“FBB – Milwaukee”) and Alterra Bank (“Alterra”), have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). FBB, FBB – Milwaukee and Alterra are sometimes referred to together as the “Banks.” FBB operates as a commercial banking institution in the Madison, Wisconsin market, consisting primarily of Dane County and the surrounding areas, with loan production offices in Northeast Wisconsin. FBB also offers trust and investment services through First Business Trust & Investments (“FBTI”), a division of FBB. FBB – Milwaukee operates as a commercial banking institution in the Milwaukee, Wisconsin market, consisting primarily of Waukesha County and the surrounding areas, with a loan production office in Kenosha, Wisconsin. Alterra operates as a commercial banking institution in the Kansas City market and the surrounding areas. The Banks provide a full range of financial services to businesses, business owners, executives, professionals and high net worth individuals. The Banks are subject to competition from other financial institutions and service providers and are also subject to state and federal regulations. FBB has the following wholly owned subsidiaries: First Business Capital Corp. (“FBCC”), First Madison Investment Corp. (“FMIC”), First Business Equipment Finance, LLC (“FBEF”), Rimrock Road Investment Fund, LLC (“Rimrock Road”) and BOC Investment, LLC (“BOC”). FMIC is located in and was formed under the laws of the state of Nevada. FBB-Milwaukee has one subsidiary, FBB – Milwaukee Real Estate, LLC (“FBBMRE”).

Basis of Presentation. The accompanying unaudited Consolidated Financial Statements were prepared in accordance with 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 and should be read in conjunction with the Corporation’s Consolidated Financial Statements and footnotes thereto included in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2014. The unaudited Consolidated Financial Statements include the accounts of the Corporation and its wholly owned subsidiaries. In accordance with the provisions of Accounting Standards Codification (“ASC”) Topic 810, the Corporation’s ownership interest in FBFS Statutory Trust II (“Trust II”) has not been consolidated into the financial statements. All significant intercompany balances and transactions have been eliminated in consolidation.

Management of the Corporation is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements as well as reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that could significantly change in the near-term include the value of foreclosed property, lease residuals, property under operating leases, securities, income taxes and the level of the allowance for loan and lease losses. The results of operations for the nine-month period ended September 30, 2015 are not necessarily indicative of results that may be expected for any other interim period or the entire fiscal year ending December 31, 2015. Certain amounts in prior periods may have been reclassified to conform to the current presentation. Subsequent events have been evaluated through the date of the issuance of the Consolidated Financial Statements. No significant subsequent events have occurred through this date requiring adjustment to the financial statements or disclosures.

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, 2014 except as described further below in this Note 1.

## Recent Accounting Pronouncements

In August 2015, the FASB issued ASU No. 2015-14, “Revenue from Contracts with Customers (Topic 606).” In May 2014, the FASB issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606),” with an original effective date for annual reporting periods beginning after December 15, 2016. The ASU is a converged standard between the FASB and the IASB that provides a single comprehensive revenue recognition model for all contracts with customers across transactions and industries. The primary objective of the ASU is revenue recognition that represents the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2015-14 deferred the effective

date of ASU 2014-09 to annual and interim reporting periods in fiscal years beginning after December 15, 2017. Earlier application is permitted only as of annual and interim reporting periods in fiscal years beginning after December 15, 2016. The Corporation is in the process of evaluating the impact of this standard but does not expect this standard to have a material impact on the Corporation's consolidated results of operations, financial position, or liquidity.

In June 2014, the FASB issued ASU No. 2014-12, "Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period." This ASU requires a reporting

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entity to treat a performance target that affects vesting and that could be achieved after the requisite service period as a performance condition. A reporting entity should apply FASB ASC Topic 718, Compensation-Stock Compensation, to awards with performance conditions that affect vesting. For all entities, ASU 2014-12 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. ASU 2014-12 may be adopted either prospectively for share-based payment awards granted or modified on or after the effective date, or retrospectively, using a modified retrospective approach. The modified retrospective approach would apply to share-based payment awards outstanding as of the beginning of the earliest annual period presented in the financial statements on adoption, and to all new or modified awards thereafter. While the Corporation does not have any performance-based awards outstanding as of the reporting date, the Corporation's equity incentive plan does allow for such awards. The Corporation adopted the accounting standard during the third quarter of 2015 with no material impact on its results of operations, financial position, or liquidity.

In August 2014, the FASB issued ASU 2014-15, "Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern." This ASU describes how an entity should assess its ability to meet obligations and sets rules for how this information should be disclosed in the financial statements. The standard provides accounting guidance that will be used along with existing auditing standards. The ASU is effective for interim and annual periods beginning after December 15, 2016. Early application is permitted. The Corporation adopted the accounting standard during the third quarter of 2015 with no material impact on its results of operations, financial position, or liquidity.

In February 2015, the FASB issued ASU 2015-02, "Consolidation (Topic 810): Amendments to the Consolidation Analysis." This ASU changes the way reporting enterprises evaluate whether (a) they should consolidate limited partnerships and similar entities, (b) fees paid to a decision maker or service provider are variable interests in a variable interest entity (VIE), and (c) variable interests in a VIE held by related parties of the reporting enterprise require the reporting enterprise to consolidate the VIE. It also eliminates the VIE consolidation model based on majority exposure to variability that applied to certain investment companies and similar entities. The new guidance excludes money market funds that are required to comply with Rule 2a-7 of the Investment Company Act of 1940 and similar entities from the U.S. GAAP consolidation requirements. The new consolidation guidance is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2015. At the effective date, all previous consolidation analysis that the guidance affects must be reconsidered. This includes the consolidation analysis for all VIEs and for all limited partnerships and similar entities that previously were consolidated by the general partner even though the entities were not VIEs. Early adoption is permitted, including early adoption in an interim period. If a reporting enterprise chooses to early adopt in an interim period, adjustments resulting from the revised consolidation analysis must be reflected as of the beginning of the fiscal year that includes that interim period. The Corporation is in the process of evaluating the impact of this standard but does not expect this standard to have a material impact on the Corporation's consolidated results of operations, financial position, or liquidity.

In April 2015, the FASB issued ASU 2015-03, "Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs." This ASU intends to simplify the presentation of debt issuance costs. This ASU is effective for public business entities for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The Corporation is in the process of evaluating the impact of this standard but does not expect this standard to have a material impact on the Corporation's consolidated results of operations, financial position, or liquidity.

In April 2015, the FASB issued ASU 2015-05, "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement." This ASU provides explicit guidance to help companies evaluate the accounting for fees paid by a customer in a cloud computing arrangement. The new guidance clarifies that if a cloud computing arrangement includes a software license, the customer should account for the license consistent with its accounting for other software licenses. If the arrangement does not include a software license, the customer should account for the arrangement as a service contract. This ASU is effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. An entity can elect to adopt the amendments either prospectively for all arrangements entered

into or materially modified after the effective date, or retrospectively. Early adoption is permitted for all entities. The Corporation adopted the accounting standard during the third quarter of 2015 with no material impact on its results of operations, financial position, or liquidity.

In May 2015, the FASB issued ASU 2015-07, "Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)." This ASU will eliminate the requirement to categorize investments in the fair value hierarchy if their fair value is measured at net asset value (NAV) per share (or its equivalent) using the practical expedient in the FASB's fair value measurement guidance. Reporting entities are required to adopt the ASU retrospectively. The effective date for public business entities is fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted for all entities. The Corporation adopted the accounting standard during the third quarter of 2015 with no material impact on its results of operations, financial position, or liquidity.

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## Note 2 — Earnings Per Common Share

Earnings per common share are computed using the two-class method. Basic earnings per common share are computed by dividing net income allocated to common shares by the weighted average number of shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include unvested restricted shares. Unvested restricted shares are considered participating securities because holders of these securities receive non-forfeitable dividends at the same rate as holders of the Corporation's common stock. Diluted earnings per share are computed by dividing net income allocated to common shares, adjusted for reallocation of undistributed earnings of unvested restricted shares, by the weighted average number of shares determined for the basic earnings per common share computation plus the dilutive effect of common stock equivalents using the treasury stock method. For both the three and nine month periods ending September 30, 2015 and 2014, there were no average anti-dilutive employee share-based awards (all shares and earnings per share amounts have been adjusted to reflect the 2-for-1 stock split in the form of a 100% stock dividend completed in August 2015).

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2015	2014	2015	2014
	(Dollars in Thousands, Except Per Share Data)			
Basic earnings per common share				
Net income	\$4,381	\$3,553	\$12,431	\$10,395
Less: earnings allocated to participating securities	68	75	206	222
Basic earnings allocated to common shareholders	\$4,313	\$3,478	\$12,225	\$10,173
Weighted-average common shares outstanding, excluding participating securities	8,546,563	7,739,918	8,538,219	7,727,300
Basic earnings per common share	\$0.50	\$0.45	\$1.43	\$1.32
Diluted earnings per common share				
Earnings allocated to common shareholders	\$4,313	\$3,478	\$12,225	\$10,173
Reallocation of undistributed earnings	—	—	—	1
Diluted earnings allocated to common shareholders	\$4,313	\$3,478	\$12,225	\$10,174
Weighted-average common shares outstanding, excluding participating securities	8,546,563	7,739,918	8,538,219	7,727,300
Dilutive effect of share-based awards	—	43,694	1,486	44,185
Weighted-average diluted common shares outstanding, excluding participating securities	8,546,563	7,783,612	8,539,705	7,771,485
Diluted earnings per common share	\$0.50	\$0.45	\$1.43	\$1.31

## Note 3 — Share-Based Compensation

The Corporation adopted the 2012 Equity Incentive Plan (the "Plan") during the quarter ended June 30, 2012. The Plan is administered by the Compensation Committee of the Board of Directors of the Corporation and provides for the grant of equity ownership opportunities through incentive stock options and nonqualified stock options (together, "Stock Options"), restricted stock, restricted stock units, dividend equivalent units, and any other type of award permitted by the Plan. As of September 30, 2015, 313,190 shares were available for future grants under the Plan, after giving effect to the 2-for-1 stock split completed in the form of a 100% stock dividend effected in August 2015. Shares covered by awards that expire, terminate or lapse will again be available for the grant of awards under the Plan. The Corporation may issue new shares and shares from treasury for shares delivered under the Plan.



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## Stock Options

The Corporation may grant Stock Options to senior executives and other employees under the Plan. Stock Options generally have an exercise price that is equal to the fair value of the common shares on the date the option is awarded. Stock Options granted under the Plan are subject to graded vesting, generally ranging from 4 years to 8 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. No Stock Options have been granted since the Corporation became a reporting company under the Securities Exchange Act of 1934, as amended, and no Stock Options have been modified, repurchased or canceled since such time. For that reason, no stock-based compensation expense related to Stock Options was recognized in the Consolidated Financial Statements for the three and nine months ended September 30, 2015 and 2014. As of September 30, 2015, no Stock Options remain outstanding. The benefits of tax deductions as a result of disqualifying dispositions upon exercise of stock options are recognized as a financing cash flow.

Stock Option activity for the year ended December 31, 2014 and nine months ended September 30, 2015 was as follows (all amounts have been adjusted to reflect the 2-for-1 stock split in the form of a 100% stock dividend completed in August 2015):

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)
Outstanding at December 31, 2013	102,000	\$ 12.12	0.88
Granted	—	—	
Exercised	(78,000 )	12.00	
Expired	—	—	
Forfeited	—	—	
Outstanding at December 31, 2014	24,000	\$ 12.50	0.13
Exercisable at December 31, 2014	24,000	\$ 12.50	0.13
Outstanding as of December 31, 2014	24,000	\$ 12.50	0.13
Granted	—	—	
Exercised	(24,000 )	12.50	
Expired	—	—	
Forfeited	—	—	
Outstanding as of September 30, 2015	—	\$—	
Exercisable at September 30, 2015	—	\$—	

## Restricted Stock

Under the Plan, the Corporation may grant restricted shares to plan participants, subject to forfeiture upon the occurrence of certain events until the 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 the Plan are typically subject to a vesting period. Compensation expense is recognized over the requisite service period of generally four years for the entire award on a straight-line basis. Upon vesting of restricted share awards, the benefit of tax deductions in excess of recognized compensation expense is recognized as a financing cash flow activity.

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Restricted share activity for the year ended December 31, 2014 and the nine months ended September 30, 2015 was as follows (all amounts have been adjusted to reflect the 2-for-1 stock split in the form of a 100% stock dividend completed in August 2015):

	Number of Restricted Shares	Weighted Average Grant-Date Fair Value
Nonvested balance as of December 31, 2013	169,418	\$11.55
Granted	64,522	22.49
Vested	(78,942 )	9.86
Forfeited	—	—
Nonvested balance as of December 31, 2014	154,998	16.97
Granted	52,540	22.45
Vested	(57,441 )	14.36
Forfeited	(8,938 )	15.69
Nonvested balance as of September 30, 2015	141,159	\$20.15

As of September 30, 2015, \$2.6 million of deferred compensation expense was included in additional paid-in capital in the Consolidated Balance Sheets related to unvested restricted shares, which the Corporation expects to recognize over a weighted-average period of approximately 3.0 years. As of September 30, 2015, all restricted shares that vested were issued.

For the three and nine months ended September 30, 2015 and 2014, share-based compensation expense related to restricted stock included in the Consolidated Statements of Income was as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2015	2014	2015	2014
	(In Thousands)			
Share-based compensation expense	\$268	\$229	\$717	\$618

## Note 4 — Securities

The amortized cost and estimated fair value of securities available-for-sale and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income were as follows:

	As of September 30, 2015			
	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Estimated fair value
	(In Thousands)			
Available-for-sale:				
U.S. Government agency obligations - government-sponsored enterprises	\$8,047	\$29	\$(8 )	\$8,068
Municipal obligations	4,141	16	(3 )	4,154
Asset-backed securities	1,381	—	(56 )	1,325
Collateralized mortgage obligations - government issued	48,799	1,064	(70 )	49,793
Collateralized mortgage obligations - government-sponsored enterprises	80,001	481	(93 )	80,389



\$142,369    \$1,590    \$(230    ) \$143,729

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	As of December 31, 2014			
	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Estimated fair value
	(In Thousands)			
Available-for-sale:				
U.S. Government agency obligations - government-sponsored enterprises	\$9,046	\$—	\$(81)	) \$8,965
Municipal obligations	573	5	—	) 578
Asset-backed securities	1,514	\$—	(4)	) 1,510
Collateralized mortgage obligations - government issued	67,740	1,390	(256)	) 68,874
Collateralized mortgage obligations - government-sponsored enterprises	64,763	234	(226)	) 64,771
	\$143,636	\$1,629	\$(567)	) \$144,698

The amortized cost and estimated fair value of securities held-to-maturity and the corresponding amounts of gross unrecognized gains and losses were as follows:

	As of September 30, 2015			
	Amortized cost	Gross unrecognized holding gains	Gross unrecognized holding losses	Estimated fair value
	(In Thousands)			
Held-to-maturity:				
U.S. Government agency obligations - government-sponsored enterprises	\$1,495	\$6	\$(4)	) \$1,497
Municipal obligations	16,050	196	(7)	) 16,239
Collateralized mortgage obligations - government issued	12,391	118	(1)	) 12,508
Collateralized mortgage obligations - government-sponsored enterprises	8,428	84	(12)	) 8,500
	\$38,364	\$404	\$(24)	) \$38,744

	As of December 31, 2014			
	Amortized cost	Gross unrecognized holding gains	Gross unrecognized holding losses	Estimated fair value
	(In Thousands)			
Held-to-maturity:				
U.S. Government agency obligations - government-sponsored enterprises	\$1,490	\$—	\$(17)	) \$1,473
Municipal obligations	16,088	85	(18)	) 16,155
Collateralized mortgage obligations - government issued	14,505	57	(31)	) 14,531
Collateralized mortgage obligations - government-sponsored enterprises	9,480	74	(19)	) 9,535
	\$41,563	\$216	\$(85)	) \$41,694

U.S. Government agency obligations - government-sponsored enterprises represent securities issued by the Federal Home Loan Mortgage Corporation (“FHLMC”) and Federal National Mortgage Association (“FNMA”). Collateralized mortgage obligations - government issued represent securities guaranteed by the Government National Mortgage Association

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(“GNMA”). Collateralized mortgage obligations - government-sponsored enterprises include securities guaranteed by the FHLMC and the FNMA. Asset-backed securities represent securities issued by the Student Loan Marketing Association (“SLMA”) which are 97% guaranteed by the U.S. government. Municipal obligations include securities issued by various municipalities located primarily within the State of Wisconsin and are primarily general obligation bonds that are tax-exempt in nature. There were no sales of securities available-for-sale for the three and nine months ended September 30, 2015 and 2014.

At September 30, 2015 and December 31, 2014, securities with a fair value of \$25.3 million and \$32.7 million, respectively, were pledged to secure interest rate swap contracts, outstanding Federal Home Loan Bank (“FHLB”) advances, if any, and additional FHLB availability.

The amortized cost and estimated fair value of securities by contractual maturity at September 30, 2015 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay certain obligations without call or prepayment penalties.

	Available-for-Sale		Held-to-Maturity	
	Amortized cost	Estimated fair value	Amortized cost	Estimated fair value
	(In Thousands)			
Due in one year or less	\$—	\$—	\$—	\$—
Due in one year through five years	13,038	13,093	3,645	3,659
Due in five through ten years	85,139	85,966	13,400	13,565
Due in over ten years	44,192	44,670	21,319	21,520
	\$142,369	\$143,729	\$38,364	\$38,744

The tables below show the Corporation’s gross unrealized losses and fair value of available-for-sale investments with unrealized losses, aggregated by investment category and length of time that individual investments were in a continuous loss position at September 30, 2015 and December 31, 2014. At September 30, 2015 and December 31, 2014, the Corporation held 34 and 59 available-for-sale securities that were in an unrealized loss position, respectively. Such securities have not experienced credit rating downgrades; however, they have primarily declined in value due to the current interest rate environment. At September 30, 2015, the Corporation held 13 available-for-sale securities that had been in a continuous unrealized loss position for twelve months or greater.

The Corporation also has not specifically identified available-for-sale securities in a loss position that it intends to sell in the near term and does not believe that it will be required to sell any such securities. It is expected that the Corporation will recover the entire amortized cost basis of each security based upon an evaluation of the present value of the expected future cash flows. Accordingly, no other than temporary impairment was recorded in the Consolidated Statements of Income for the nine months ended September 30, 2015 and 2014.

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

	As of September 30, 2015				Total Fair value	Unrealized losses
	Less than 12 months		12 months or longer			
	Fair value	Unrealized losses	Fair value	Unrealized losses		
	(In Thousands)					
Available-for-sale:						
U.S. Government agency obligations - government-sponsored enterprises	\$998	\$1	\$2,744	\$7	\$3,742	\$8
Municipal obligations	745	3	—	—	745	3
Asset-backed securities	1,325	56	—	—	1,325	56
Collateralized mortgage obligations - government issued	—	1	5,997	69	5,997	70
Collateralized mortgage obligations - government-sponsored enterprises	21,636	64	2,573	29	24,209	93
	\$24,704	\$125	\$11,314	\$105	\$36,018	\$230
	As of December 31, 2014					
	Less than 12 months		12 months or longer		Total	Unrealized
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	losses
	(In Thousands)					
Available-for-sale:						
U.S. Government agency obligations - government-sponsored enterprises	\$3,486	\$12	\$5,479	\$69	\$8,965	\$81
Asset-backed securities	—	\$—	1,510	4	1,510	4
Collateralized mortgage obligations - government issued	9,201	50	9,536	206	18,737	256
Collateralized mortgage obligations - government-sponsored enterprises	29,498	97	4,993	129	34,491	226
	\$42,185	\$159	\$21,518	\$408	\$63,703	\$567

The tables below show the Corporation's gross unrecognized losses and fair value of held-to-maturity investments, aggregated by investment category and length of time that individual investments were in a continuous loss position at September 30, 2015 and December 31, 2014. At September 30, 2015 and December 31, 2014, the Corporation held nine and 57 held-to-maturity securities that were in an unrecognized loss position, respectively. Such securities have not experienced credit rating downgrades; however, they have primarily declined in value due to the current interest rate environment. There were four held-to-maturity securities that were in a continuous unrecognized loss position for

twelve months or greater as of September 30, 2015. It is expected that the Corporation will recover the entire amortized cost basis of each held-to-maturity security based upon an evaluation of the present value of the expected future cash flows. Accordingly, no other than temporary impairment was recorded in the Consolidated Statements of Income for the nine months ended September 30, 2015.

A summary of unrecognized loss information for securities held-to-maturity, categorized by security type follows:

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	As of September 30, 2015					
	Less than 12 months		12 months or longer		Total	
	Fair value	Unrecognized losses	Fair value	Unrecognized losses	Fair value	Unrecognized losses
	(In Thousands)					
Held-to-maturity:						
U.S. Government agency obligations - government-sponsored enterprises	\$—	\$—	\$1,000	\$4	\$1,000	\$4
Municipal obligations	600	2	398	5	998	7
Collateralized mortgage obligations - government issued	663	1	—	—	663	1
Collateralized mortgage obligations - government-sponsored enterprises	2,058	12	—	—	2,058	12
	\$3,321	\$15	\$1,398	\$9	\$4,719	\$24
	As of December 31, 2014					
	Less than 12 months		12 months or longer		Total	
	Fair value	Unrecognized losses	Fair value	Unrecognized losses	Fair value	Unrecognized losses
	(In Thousands)					
Held-to-maturity:						
U.S. Government agency obligations - government-sponsored enterprises	\$1,490	\$17	\$—	\$—	\$1,490	\$17
Municipal obligations	2,222	18	—	—	2,222	18
Collateralized mortgage obligations - government issued	3,247	31	—	—	3,247	31
Collateralized mortgage obligations - government-sponsored enterprises	3,076	19	—	—	3,076	19
	\$10,035	\$85	\$—	\$—	\$10,035	\$85

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## Note 5 — Loan and Lease Receivables, Impaired Loans and Leases and Allowance for Loan and Lease Losses

Loan and lease receivables consist of the following:

	September 30, 2015	December 31, 2014
	(In Thousands)	
Commercial real estate		
Commercial real estate — owner occupied	\$ 170,195	\$ 163,884
Commercial real estate — non-owner occupied	416,421	417,962
Construction and land development	157,651	121,160
Multi-family	90,514	72,578
1-4 family <sup>(2)</sup>	44,476	36,182
Total commercial real estate	879,257	811,766
Commercial and industrial <sup>(3)</sup>	450,307	416,654
Direct financing leases, net	28,958	34,165
Consumer and other		
Home equity and second mortgages	8,908	7,866
Other	13,809	11,341
Total consumer and other	22,717	19,207
Total gross loans and leases receivable	1,381,239	1,281,792
Less:		
Allowance for loan and lease losses	15,359	14,329
Deferred loan fees	1,157	1,025
Loans and leases receivable, net	\$ 1,364,723	\$ 1,266,438

(1) Includes guaranteed portion of SBA loans held for sale totaling \$1.5 million as of September 30, 2015.

(2) Includes residential real estate loans held for sale totaling \$307,000 as of September 30, 2015 and \$1.3 million as of December 31, 2014.

(3) Includes guaranteed portion of SBA loans held for sale totaling \$1.1 million as of September 30, 2015.

Loans transferred to third parties consist of the guaranteed portion of SBA loans as well as participation interests in other originated loans. The total principal amount of loans transferred during the three months ended September 30, 2015 and 2014 was \$28.7 million and \$5.5 million, respectively. For the nine months ended September 30, 2015 and 2014, \$74.0 million and \$16.1 million of loans were transferred to third parties, respectively. Each of the transfers of these financial assets met the qualifications for sale accounting, including the requirements specific to loan participations, and therefore all of the loans transferred during the three and nine months ended September 30, 2015 and September 30, 2014 have been derecognized in the unaudited Consolidated Financial Statements. The Corporation has a continuing involvement in each of the agreements by way of relationship management and servicing the loans; however, there are no further obligations to the third-party participant required of the Corporation in the event of a borrower's default, other than standard representations and warranties related to sold amounts. The guaranteed portion of SBA loans were transferred at their fair value and the related gain was recognized upon the transfer as non-interest income in the unaudited Consolidated Financial Statements. No gain or loss was recognized on participation interests in other originated loans as they were transferred at or near the date of loan origination and the payments received for servicing the portion of the loans participated represents adequate compensation. The total amount of loan participations purchased on the Corporation's Consolidated Balance Sheets as of September 30, 2015 and December 31, 2014 was \$471,000 and \$482,000, respectively.

The total amount of outstanding loans transferred to third parties as loan participations sold at September 30, 2015 and December 31, 2014 was \$148.8 million and \$116.6 million, respectively, all of which was treated as a sale and derecognized under the applicable accounting guidance in effect at the time of the transfers of the financial assets. The



Corporation's continuing involvement with these loans is by way of partial ownership, relationship management and all servicing responsibilities. As of September 30, 2015 and December 31, 2014, the total amount of the Corporation's partial ownership of loans on the Corporation's Consolidated Balance Sheets was \$105.6 million and \$96.4 million, respectively. As of September 30, 2015, \$1.7 million loans in this participation sold portfolio were considered impaired as compared to \$1.2 million as of December 31, 2014. The Corporation does not share in the participant's portion of the charge-offs.

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The Corporation sells residential real estate loans, servicing released, in the secondary market. The total principal amount of residential real estate loans sold during the three and nine months ended September 30, 2015 was \$9.0 million and \$28.6 million, respectively. No residential real estate loans were originated or sold during the three and nine months ended September 30, 2014. Each of the transfers of these financial assets met the qualifications for sale accounting, and therefore all of the loans transferred during the three and nine months ended September 30, 2015 have been derecognized in the unaudited Consolidated Financial Statements. The Corporation has a continuing involvement in each of the transactions by way of relationship management; however, there are no further obligations of the Corporation in the event of a borrower's default, other than standard representations and warranties related to the sold amount. The loans were transferred at their fair value and the related gain was recognized as non-interest income upon the transfer in the unaudited Consolidated Financial Statements.

ASC 310-30, Accounting for Certain Loans or Debt Securities Acquired in a Transfer, applies to purchased loans with evidence of deterioration in credit quality since origination for which it is probable at acquisition that the Corporation will be unable to collect all contractually required payments are considered to be credit impaired. Purchased credit-impaired loans are initially recorded at fair value, which is estimated by discounting the cash flows expected to be collected at the acquisition date. Because the estimate of expected cash flows reflects an estimate of future credit losses expected to be incurred over the life of the loans, an allowance for credit losses is not recorded at the acquisition date. The excess of cash flows expected at acquisition over the estimated fair value, referred to as the accretable yield, is recognized in interest income over the remaining life of the loan on a level-yield basis, contingent on the subsequent evaluation of future expected cash flows. The difference between the contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the nonaccretable difference. A subsequent decrease in the estimate of cash flows expected to be received on purchased credit-impaired loans generally results in the recognition of an allowance for credit losses. Subsequent increases in cash flows result in reversal of any nonaccretable difference (or allowance for loan and lease losses to the extent any has been recorded) with a positive impact on interest income recognized. The measurement of cash flows involves assumptions and judgments for interest rates, prepayments, default rates, loss severity, and collateral values. All of these factors are inherently subjective and significant changes in the cash flow estimates over the life of the loan can result.

The following table reflects the contractually required payments receivable and fair value of the Corporation's purchased credit impaired loans as of September 30, 2015 and December 31, 2014:

	September 30, 2015	December 31, 2014
	(In Thousands)	
Contractually required payments	\$5,714	\$6,874
Fair value of purchased credit impaired loans	\$3,578	\$4,025

The following table presents a rollforward of the Corporation's accretable yield as of September 30, 2015 and December 31, 2014:

	As of and for the Nine Months Ended September 30, 2015	As of and for the Year Ended December 31, 2014
	(In Thousands)	
Accretable yield, beginning of period	\$676	\$683
Accretion recognized in earnings	(22	) (7
Reclassification to nonaccretable difference for loans with changing cash flows <sup>(1)</sup>	(22	) —
Changes in accretable yield for non-credit related changes in expected cash flows <sup>(2)</sup>	(163	) —
Accretable yield, end of period	\$469	\$676

(1) Represents changes in accretable yield for those loans that are driven primarily by credit performance.

(2) Represents changes in accretable yield for those loans that are driven primarily by changes in actual and estimated payments.

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The following information illustrates ending balances of the Corporation's loan and lease portfolio, including impaired loans by class of receivable, and considering certain credit quality indicators as of September 30, 2015 and December 31, 2014:

As of September 30, 2015	Category				Total
	I	II	III	IV	
	(Dollars in Thousands)				
Commercial real estate:					
Commercial real estate — owner occupied	\$ 146,041	\$ 11,945	\$ 10,983	\$ 1,226	\$ 170,195
Commercial real estate — non-owner occupied	392,777	19,325	3,419	900	416,421
Construction and land development	146,334	2,466	4,285	4,566	157,651
Multi-family	90,143	365	—	6	90,514
1-4 family	34,626	4,904	2,667	2,279	44,476
Total commercial real estate	809,921	39,005	21,354	8,977	879,257
Commercial and industrial	407,976	9,078	25,772	7,481	450,307
Direct financing leases, net	27,121	1,199	638	—	28,958
Consumer and other:					
Home equity and second mortgages	7,890	444	142	432	8,908
Other	13,136	3	—	670	13,809
Total consumer and other	21,026	447	142	1,102	22,717
Total gross loans and leases receivable	\$ 1,266,044	\$ 49,729	\$ 47,906	\$ 17,560	\$ 1,381,239
Category as a % of total portfolio	91.66	% 3.60	% 3.47	% 1.27	% 100.00

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As of December 31, 2014	Category				Total
	I	II	III	IV	
	(Dollars in Thousands)				
Commercial real estate:					
Commercial real estate — owner occupied	\$ 131,094	\$ 15,592	\$ 16,621	\$ 577	\$ 163,884
Commercial real estate — non-owner occupied	378,671	20,823	17,498	970	417,962
Construction and land development	100,934	8,193	6,876	5,157	121,160
Multi-family	70,897	751	913	17	72,578
1-4 family	25,997	5,278	3,336	1,571	36,182
Total commercial real estate	707,593	50,637	45,244	8,292	811,766
Commercial and industrial	383,755	18,524	12,026	2,349	416,654
Direct financing leases, net	32,756	1,120	289	—	34,165
Consumer and other:					
Home equity and second mortgages	7,039	205	189	433	7,866
Other	10,570	50	—	721	11,341
Total consumer and other	17,609	255	189	1,154	19,207
Total gross loans and leases receivable	\$ 1,141,713	\$ 70,536	\$ 57,748	\$ 11,795	\$ 1,281,792
Category as a % of total portfolio	89.07	% 5.50	% 4.51	% 0.92	% 100.00

Credit underwriting through a committee process is a key component of the Corporation's operating philosophy. Business development officers have relatively low individual lending authority limits, and thus a significant portion of the Corporation's new credit extensions require approval from a loan approval committee regardless of the type of loan or lease, asset quality grade of the credit, amount of the credit, or the related complexities of each proposal. In addition, the Corporation makes every effort to ensure that there is appropriate collateral at the time of origination to protect the Corporation's interest in the related loan or lease.

Each credit is evaluated for proper risk rating upon origination, at the time of each subsequent renewal, upon receipt and evaluation of updated financial information from the Corporation's borrowers, or as other circumstances dictate. The Corporation uses a nine grade risk rating system to monitor the ongoing credit quality of its loans and leases. The risk rating grades follow a consistent definition, and are then applied to specific loan types based on the nature of the loan. Each risk rating is subjective and, depending on the size and nature of the credit, subject to various levels of review and concurrence on the stated risk rating. In addition to its nine grade risk rating system, the Corporation groups loans into four loan and related risk categories which determine the level and nature of review by management. Category I — Loans and leases in this category are performing in accordance with the terms of the contract and generally exhibit no immediate concerns regarding the security and viability of the underlying collateral, financial stability of the borrower, integrity or strength of the borrower's management team or the industry in which the borrower operates. Loans and leases in this category are not subject to additional monitoring procedures above and beyond what is required at the origination or renewal of the loan or lease. The Corporation monitors Category I loans and leases through payment performance, continued maintenance of its personal relationships with such borrowers and continued review of such borrowers' compliance with the terms of their respective agreements.

Category II — Loans and leases in this category are beginning to show signs of deterioration in one or more of the Corporation's core underwriting criteria such as financial stability, management strength, industry trends and collateral values. Management will place credits in this category to allow for proactive monitoring and resolution with the borrower to possibly mitigate the area of concern and prevent further deterioration or risk of loss to the Corporation. Category II loans are considered performing but are monitored frequently by the assigned business development

officer and by subcommittees of the Banks' loan committees.

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Category III — Loans and leases in this category are identified by management as warranting special attention. However, the balance in this category is not intended to represent the amount of adversely classified assets held by the Banks. Category III loans and leases generally exhibit undesirable characteristics such as evidence of adverse financial trends and conditions, managerial problems, deteriorating economic conditions within the related industry, or evidence of adverse public filings and may exhibit collateral shortfall positions. Management continues to believe that it will collect all required principal and interest in accordance with the original terms of the contracts relating to the loans and leases in this category, and therefore Category III loans are considered performing with no specific reserves established for this category. Category III loans are monitored by management and loan committees of the Banks on a monthly basis and the Banks' Boards of Directors at each of their regularly scheduled meetings.

Category IV — Loans and leases in this category are considered to be impaired. Impaired loans and leases have been placed on non-accrual as management has determined that it is unlikely that the Banks will receive the required principal and interest in accordance with the contractual terms of the agreement. Impaired loans are individually evaluated to assess the need for the establishment of specific reserves or charge-offs. When analyzing the adequacy of collateral, the Corporation obtains external appraisals at least annually for impaired loans and leases. External appraisals are obtained from the Corporation's approved appraiser listing and are independently reviewed to monitor the quality of such appraisals. To the extent a collateral shortfall position is present, a specific reserve or charge-off will be recorded to reflect the magnitude of the impairment. Loans and leases in this category are monitored by management and loan committees of the Banks on a monthly basis and the Banks' Boards of Directors at each of their regularly scheduled meetings.

Utilizing regulatory classification terminology, the Corporation identified \$11.1 million and \$27.1 million of loans and leases as Substandard as of September 30, 2015 and December 31, 2014, respectively. No loans were considered Special Mention, Doubtful or Loss as of either September 30, 2015 or December 31, 2014. The population of Substandard loans are a subset of Category III and Category IV loans.

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The delinquency aging of the loan and lease portfolio by class of receivable as of September 30, 2015 and December 31, 2014 is as follows:

As of September 30, 2015	30-59 days past due	60-89 days past due	Greater than 90 days past due	Total past due	Current	Total loans
	(Dollars in Thousands)					
Accruing loans and leases						
Commercial real estate:						
Owner occupied	\$39	\$—	\$—	\$39	\$169,002	\$169,041
Non-owner occupied	—	—	—	—	416,148	416,148
Construction and land development	—	—	—	—	153,285	153,285
Multi-family	—	—	—	—	90,508	90,508
1-4 family	—	—	—	—	42,980	42,980
Commercial and industrial	—	—	—	—	448,906	448,906
Direct financing leases, net	—	—	—	—	28,958	28,958
Consumer and other:						
Home equity and second mortgages	—	—	—	—	8,567	8,567
Other	—	—	—	—	13,139	13,139
Total	39	—	—	39	1,371,493	1,371,532
Non-accruing loans and leases						
Commercial real estate:						
Owner occupied	\$584	\$483	\$—	\$1,067	\$87	\$1,154
Non-owner occupied	—	—	—	—	273	273
Construction and land development	—	—	—	—	4,366	4,366
Multi-family	—	—	—	—	6	6
1-4 family	226	—	993	1,219	277	1,496
Commercial and industrial	491	35	832	1,358	43	1,401
Direct financing leases, net	—	—	—	—	—	—
Consumer and other:						
Home equity and second mortgages	—	—	99	99	242	341
Other	—	—	670	670	—	670
Total	1,301	518	2,594	4,413	5,294	9,707
Total loans and leases						
Commercial real estate:						
Owner occupied	\$623	\$483	\$—	\$1,106	\$169,089	\$170,195
Non-owner occupied	—	—	—	—	416,421	416,421
Construction and land development	—	—	—	—	157,651	157,651
Multi-family	—	—	—	—	90,514	90,514
1-4 family	226	—	993	1,219	43,257	44,476
Commercial and industrial	491	35	832	1,358	448,949	450,307
Direct financing leases, net	—	—	—	—	28,958	28,958
Consumer and other:						
	—	—	99	99	8,809	8,908



Home equity and second mortgages

Other	—	—	670	670	13,139	13,809
Total	\$1,340	\$518	\$2,594	\$4,452	\$1,376,787	\$1,381,239
Percent of portfolio	0.10	% 0.04	% 0.18	% 0.32	% 99.68	% 100.00

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As of December 31, 2014	30-59 days past due	60-89 days past due	Greater than 90 days past due	Total past due	Current	Total loans
	(Dollars in Thousands)					
Accruing loans and leases						
Commercial real estate:						
Owner occupied	\$—	\$—	\$—	\$—	\$163,384	\$163,384
Non-owner occupied	—	—	—	—	417,676	417,676
Construction and land development	—	—	—	—	116,228	116,228
Multi-family	—	—	—	—	72,561	72,561
1-4 family	—	—	—	—	35,492	35,492
Commercial and industrial	—	—	—	—	414,336	414,336
Direct financing leases, net	—	—	—	—	34,165	34,165
Consumer and other:						
Home equity and second mortgages	—	—	—	—	7,537	7,537
Other	—	—	—	—	10,621	10,621
Total	—	—	—	—	1,272,000	1,272,000
Non-accruing loans and leases						
Commercial real estate:						
Owner occupied	\$—	\$—	\$—	\$—	\$500	\$500
Non-owner occupied	—	215	—	215	71	286
Construction and land development	—	193	—	193	4,739	4,932
Multi-family	—	—	—	—	17	17
1-4 family	—	106	306	412	278	690
Commercial and industrial	364	146	736	1,246	1,072	2,318
Direct financing leases, net	—	—	—	—	—	—
Consumer and other:						
Home equity and second mortgages	—	—	—	—	329	329
Other	—	—	720	720	—	720
Total	364	660	1,762	2,786	7,006	9,792
Total loans and leases						
Commercial real estate:						
Owner occupied	\$—	\$—	\$—	\$—	\$163,884	\$163,884
Non-owner occupied	—	215	—	215	417,747	417,962
Construction and land development	—	193	—	193	120,967	121,160
Multi-family	—	—	—	—	72,578	72,578
1-4 family	—	106	306	412	35,770	36,182
Commercial and industrial	364	146	736	1,246	415,408	416,654
Direct financing leases, net	—	—	—	—	34,165	34,165
Consumer and other:						
Home equity and second mortgages	—	—	—	—	7,866	7,866
Other	—	—	720	720	10,621	11,341

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Total	\$364	\$660	\$1,762	\$2,786	\$1,279,006	\$1,281,792	
Percent of portfolio	0.03	% 0.05	% 0.14	% 0.22	% 99.78	% 100.00	%

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The Corporation's total impaired assets consisted of the following at September 30, 2015 and December 31, 2014, respectively.

	September 30, 2015	December 31, 2014	
	(Dollars in Thousands)		
Non-accrual loans and leases			
Commercial real estate:			
Commercial real estate — owner occupied	\$1,154	\$500	
Commercial real estate — non-owner occupied	273	286	
Construction and land development	4,366	4,932	
Multi-family	6	17	
1-4 family	1,496	690	
Total non-accrual commercial real estate	7,295	6,425	
Commercial and industrial	1,401	2,318	
Direct financing leases, net	—	—	
Consumer and other:			
Home equity and second mortgages	341	329	
Other	670	720	
Total non-accrual consumer and other loans	1,011	1,049	
Total non-accrual loans and leases	9,707	9,792	
Foreclosed properties, net	1,632	1,693	
Total non-performing assets	11,339	11,485	
Performing troubled debt restructurings	7,852	2,003	
Total impaired assets	\$19,191	\$13,488	
	September 30, 2015	December 31, 2014	
Total non-accrual loans and leases to gross loans and leases	0.70	% 0.76	%
Total non-performing assets to total gross loans and leases plus foreclosed properties, net	0.82	0.89	
Total non-performing assets to total assets	0.65	0.70	
Allowance for loan and lease losses to gross loans and leases	1.11	1.12	
Allowance for loan and lease losses to non-accrual loans and leases	158.22	146.33	

As of September 30, 2015 and December 31, 2014, \$6.8 million and \$7.4 million of the non-accrual loans were considered troubled debt restructurings, respectively. As of September 30, 2015, there were no unfunded commitments associated with troubled debt restructured loans and leases.

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	As of September 30, 2015			As of December 31, 2014		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
(Dollars in Thousands)						
Troubled debt restructurings:						
Commercial real estate						
Commercial real estate — owner occupied	2	\$ 625	\$ 555	2	\$ 624	\$ 577
Commercial real estate — non-owner occupied	5	1,151	900	5	1,095	970
Construction and land development	3	6,034	4,627	4	6,260	5,157
Multi-family	1	184	6	1	184	17
1-4 family	15	2,119	1,322	16	2,119	1,368
Commercial and industrial	6	6,411	6,209	4	361	155
Direct financing leases, net	—	—	—	—	—	—
Consumer and other:						
Home equity and second mortgages	5	680	333	6	772	431
Other	1	2,077	670	2	2,080	721
Total	38	\$ 19,281	\$ 14,622	40	\$ 13,495	\$ 9,396

All loans and leases modified as a troubled debt restructuring are evaluated for impairment. The nature and extent of the impairment of restructured loans, including those which have experienced a default, is considered in the determination of an appropriate level of the allowance for loan and lease losses.

As of September 30, 2015 and December 31, 2014, the Corporation's troubled debt restructurings grouped by type of concession were as follows:

	As of September 30, 2015		As of December 31, 2014	
	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
(Dollars in Thousands)				
Commercial real estate				
Extension of term	1	\$28	1	\$39
Interest rate concession	1	55	1	65
Combination of extension and interest rate concession	24	7,327	26	7,984
Commercial and industrial				
Combination of extension and interest rate concession	6	6,209	4	155
Consumer and other				
Extension of term	2	702	3	753
Combination of extension and interest rate concession	4	301	5	400
Total	38	\$14,622	40	\$9,396

There were no loans and leases modified in a troubled debt restructuring during the previous 12 months which subsequently defaulted during the nine months ended September 30, 2015.

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The following represents additional information regarding the Corporation's impaired loans and leases by class:

## Impaired Loans and Leases

As of and for the Nine Months Ended September 30, 2015

	Recorded investment	Unpaid principal balance	Impairment reserve	Average recorded investment <sup>(1)</sup>	Foregone interest income	Interest income recognized	Net foregone interest income
(In Thousands)							
With no impairment reserve recorded:							
Commercial real estate:							
Owner occupied	\$642	\$642	\$—	\$ 566	\$21	\$—	\$21
Non-owner occupied	1,439	1,439	—	915	15	—	15
Construction and land development	4,566	7,236	—	4,916	102	—	102
Multi-family	6	373	—	12	25	—	25
1-4 family	1,291	1,365	—	1,509	46	2	44
Commercial and industrial	6,742	6,752	—	3,052	121	1	120
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	301	301	—	366	16	9	7
Other	670	1,337	—	696	61	—	61
Total	15,657	19,445	—	12,032	407	12	395
With impairment reserve recorded:							
Commercial real estate:							
Owner occupied	\$—	\$—	\$—	\$ 17	\$—	\$—	\$—
Non-owner occupied	45	85	45	47	2	—	2
Construction and land development	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
1-4 family	988	993	213	560	25	—	25
Commercial and industrial	739	739	276	215	12	—	12
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	131	131	26	76	7	—	7
Other	—	—	—	—	—	—	—
Total	1,903	1,948	560	915	46	—	46
Total:							
Commercial real estate:							
Owner occupied	\$642	\$642	\$—	\$ 583	\$21	\$—	\$21
Non-owner occupied	1,484	1,524	45	962	17	—	17
	4,566	7,236	—	4,916	102	—	102

Construction and land development							
Multi-family	6	373	—	12	25	—	25
1-4 family	2,279	2,358	213	2,069	71	2	69
Commercial and industrial	7,481	7,491	276	3,267	133	1	132
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	432	432	26	442	23	9	14
Other	670	1,337	—	696	61	—	61
Grand total	\$17,560	\$21,393	\$560	\$ 12,947	\$453	\$12	\$441

(1) Average recorded investment is calculated primarily using daily average balances.



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## Impaired Loans and Leases

As of and for the Year Ended December 31, 2014

	Recorded investment	Unpaid principal balance	Impairment reserve	Average recorded investment <sup>(1)</sup>	Foregone interest income	Interest income recognized	Net Foregone Interest Income
(In Thousands)							
With no impairment reserve recorded:							
Commercial real estate:							
Owner occupied	\$577	\$577	\$—	\$ 484	\$30	\$79	\$(49 )
Non-owner occupied	921	921	—	349	22	—	22
Construction and land development	5,157	7,828	—	5,285	155	—	155
Multi-family	17	384	—	24	53	—	53
1-4 family	1,181	1,218	—	380	15	12	3
Commercial and industrial	2,316	2,926	—	6,141	463	649	(186 )
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	380	380	—	495	18	—	18
Other	721	1,389	—	768	87	—	87
Total	11,270	15,623	—	13,926	843	740	103
With impairment reserve recorded:							
Commercial real estate:							
Owner occupied	\$—	\$—	\$—	\$—	\$—	\$—	\$—
Non-owner occupied	49	89	49	52	4	—	4
Construction and land development	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
1-4 family	390	390	155	405	18	—	18
Commercial and industrial	33	33	33	34	—	—	—
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	53	53	53	57	5	—	5
Other	—	—	—	—	—	—	—
Total	525	565	290	548	27	—	27
Total:							
Commercial real estate:							
Owner occupied	\$577	\$577	\$—	\$ 484	\$30	\$79	\$(49 )
Non-owner occupied	970	1,010	49	401	26	—	26
Construction and land development	5,157	7,828	—	5,285	155	—	155

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Multi-family	17	384	—	24	53	—	53
1-4 family	1,571	1,608	155	785	33	12	21
Commercial and industrial	2,349	2,959	33	6,175	463	649	(186 )
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	433	433	53	552	23	—	23
Other	721	1,389	—	768	87	—	87
Grand total	\$11,795	\$16,188	\$290	\$ 14,474	\$870	\$740	\$130

(1) Average recorded investment is calculated primarily using daily average balances.

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The difference between the loans and leases recorded investment and the unpaid principal balance of \$3.8 million and \$4.4 million as of September 30, 2015 and December 31, 2014 represents partial charge-offs resulting from confirmed losses due to the value of the collateral securing the loans and leases being below the carrying values of the loans and leases. Impaired loans and leases also included \$7.9 million and \$2.0 million of loans as of September 30, 2015 and December 31, 2014 that were performing troubled debt restructurings, and thus, while not on non-accrual, were reported as impaired, due to the concession in terms. When a loan is placed on non-accrual, interest accrual is discontinued and previously accrued but uncollected interest is deducted from interest income. Cash payments collected on non-accrual loans are first applied to principal. Foregone interest represents the interest that was contractually due on the note but not received or recorded. To the extent the amount of principal on a non-accrual note is fully collected and additional cash is received, the Corporation will recognize interest income.

To determine the level and composition of the allowance for loan and lease losses, the Corporation breaks out the portfolio by segments and risk ratings. First, the Corporation evaluates loans and leases for potential impairment classification. The Corporation analyzes each loan and lease determined to be impaired on an individual basis to determine a specific reserve based upon the estimated value of the underlying collateral for collateral-dependent loans, or alternatively, the present value of expected cash flows. The Corporation applies historical trends from established risk factors to each category of loans and leases that has not been individually evaluated for the purpose of establishing the general portion of the allowance.

A summary of the activity in the allowance for loan and lease losses by portfolio segment is as follows:

	As of and for the Nine Months Ended September 30, 2015			
	Commercial real estate	Commercial and industrial loans and leases	Consumer and other	Total
	(Dollars in Thousands)			
Allowance for credit losses:				
Beginning balance	\$8,619	\$5,492	\$218	\$14,329
Charge-offs	(94)	(447)	(5)	(546)
Recoveries	75	6	4	85
Provision	505	1,011	(25)	1,491
Ending balance	\$9,105	\$6,062	\$192	\$15,359
Ending balance: individually evaluated for impairment	\$232	\$276	\$26	\$534
Ending balance: collectively evaluated for impairment	\$8,847	\$5,786	\$166	\$14,799
Ending balance: loans acquired with deteriorated credit quality	\$26	\$—	\$—	\$26
Loans and lease receivables:				
Ending balance, gross	\$879,257	\$479,265	\$22,717	\$1,381,239
Ending balance: individually evaluated for impairment	\$6,178	\$6,960	\$874	\$14,012
Ending balance: collectively evaluated for impairment	\$870,280	\$471,785	\$21,615	\$1,363,680
Ending balance: loans acquired with deteriorated credit quality	\$2,799	\$520	\$228	\$3,547
Allowance as % of gross loans	1.04	% 1.26	% 0.85	% 1.11



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As of and for the Nine Months Ended September 30, 2014

	Commercial real estate	Commercial and industrial loans and leases	Consumer and other	Total
(Dollars in Thousands)				
Allowance for credit losses:				
Beginning balance	\$9,055	\$4,573	\$273	\$13,901
Charge-offs	—	—	(2)	(2)
Recoveries	20	1	10	31
Provision	(387)	417	(30)	—
Ending balance	\$8,688	\$4,991	\$251	\$13,930
Ending balance: individually evaluated for impairment	\$321	\$34	\$56	\$411
Ending balance: collectively evaluated for impairment	\$8,367	\$4,957	\$195	\$13,519
Ending balance: loans acquired with deteriorated credit quality	\$—	\$—	\$—	\$—
Loans and lease receivables:				
Ending balance, gross	\$654,588	\$371,220	\$16,834	\$1,042,642
Ending balance: individually evaluated for impairment	\$5,198	\$8,780	\$1,096	\$15,074
Ending balance: collectively evaluated for impairment	\$648,071	\$362,440	\$15,738	\$1,026,249
Ending balance: loans acquired with deteriorated credit quality	\$1,319	\$—	\$—	\$1,319
Allowance as % of gross loans	1.33	% 1.34	% 1.49	% 1.34

## Note 6 — Deposits

The composition of deposits at September 30, 2015 and December 31, 2014 was as follows. Average balances represent year-to-date averages.

	September 30, 2015			December 31, 2014		
	Balance	Average balance	Weighted average rate	Balance	Average balance	Weighted average rate
(Dollars in Thousands)						
Non-interest-bearing transaction accounts	\$222,497	\$206,547	—	% \$204,328	\$154,687	—
Interest-bearing transaction accounts	155,814	117,241	0.23	104,199	83,508	0.22
Money market accounts	591,190	605,907	0.56	575,766	493,322	0.52
Certificates of deposit	93,252	112,602	0.76	126,635	60,284	0.89
Wholesale deposits	476,617	439,744	1.39	427,340	416,202	1.49
Total deposits	\$1,539,370	\$1,482,041	0.71	\$1,438,268	\$1,208,003	0.78

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## Note 7 — FHLB Advances, Other Borrowings and Junior Subordinated Notes Payable

The composition of borrowed funds at September 30, 2015 and December 31, 2014 was as follows. Average balances represent year-to-date averages.

	September 30, 2015			December 31, 2014			
	Balance	Average balance	Weighted average rate	Balance	Average balance	Weighted average rate	
	(Dollars in Thousands)						
Federal funds purchased	\$—	\$148	0.81	% \$—	\$237	0.82	%
FHLB advances and other borrowings	9,920	17,244	0.97	10,058	5,093	0.56	
Senior line of credit	3,510	1,199	3.18	1,010	13	3.30	
Subordinated notes payable	22,926	22,926	6.97	22,926	13,362	7.07	
Junior subordinated notes	10,315	10,315	10.76	10,315	10,315	10.78	
	\$46,671	\$51,832	5.65	\$44,309	\$29,020	7.24	
Short-term borrowings	\$8,010			\$2,010			
Long-term borrowings	38,661			42,299			
	\$46,671			\$44,309			

As of September 30, 2015, the Corporation was in compliance with its debt covenants under its third party secured senior line of credit. Per the promissory note dated February 19, 2015, the Corporation pays a commitment fee on this senior line of credit. During the nine months ended September 30, 2015 the Corporation incurred \$10,000 additional interest expense due to this fee. Prior to February 19, 2015, the Corporation paid an unused line fee on this senior line of credit. During the nine months ended September 30, 2014, the Corporation incurred \$10,000 additional interest expense due to this fee.

## Note 8 — Fair Value Disclosures

The Corporation determines the fair values of its financial instruments based on the fair value hierarchy established in ASC Topic 820, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Fair value is defined as the price that would be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date and is based on exit prices. Fair value includes assumptions about risk such as nonperformance risk in liability fair values and is a market-based measurement, not an entity-specific measurement. The standard describes three levels of inputs that may be used to measure fair value.

Level 1 — 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 — 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 — Level 3 inputs are supported by little or no market activity and are significant to the fair value of the assets or liabilities.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Corporation's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.



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

September 30, 2015	Fair Value Measurements Using			Total
	Level 1	Level 2	Level 3	
	(In Thousands)			
Assets:				
Securities available-for-sale:				
Municipal obligations	\$—	\$4,154	\$—	\$4,154
Asset backed securities	—	1,325	—	1,325
U.S. Government agency obligations - government-sponsored enterprises	—	8,068	—	8,068
Collateralized mortgage obligations - government issued	—	49,793	—	49,793
Collateralized mortgage obligations - government-sponsored enterprises	—	80,389	—	80,389
Interest rate swaps	—	1,040	—	1,040
Liabilities:				
Interest rate swaps	\$—	\$1,040	\$—	\$1,040
	Fair Value Measurements Using			
December 31, 2014	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Assets:				
Securities available-for-sale:				
Municipal obligations	\$—	\$578	\$—	\$578
Asset backed securities	—	1,510	—	1,510
U.S. Government agency obligations - government-sponsored enterprises	—	8,965	—	8,965
Collateralized mortgage obligations - government issued	—	68,874	—	68,874
Collateralized mortgage obligations - government-sponsored enterprises	—	64,771	—	64,771
Interest rate swaps	—	575	—	575
Liabilities:				
Interest rate swaps	\$—	\$575	\$—	\$575

For assets and liabilities measured at fair value on a recurring basis, there were no transfers between the levels during the nine months ended September 30, 2015 or the year ended December 31, 2014 related to the above measurements.



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Assets and liabilities measured at fair value on a non-recurring basis, segregated by fair value hierarchy are summarized below:

	Balance at September 30, 2015 (In Thousands)	Fair Value Measurements Using			Total Gains (Losses)
		Level 1	Level 2	Level 3	
Impaired loans	\$8,388	\$—	\$5,549	\$2,839	\$—
Foreclosed properties	1,632	—	1,632	—	(29 )
Loan servicing rights	1,297	—	—	1,297	—

  

	Balance at December 31, 2014 (In Thousands)	Fair Value Measurements Using			Total Gains (Losses)
		Level 1	Level 2	Level 3	
Impaired loans	\$8,565	\$—	\$7,025	\$1,540	\$—
Foreclosed properties	1,693	—	1,693	—	(4 )
Loan servicing rights	943	—	—	943	—

Impaired loans which are collateral dependent were written down to their net realizable value of \$8.4 million and \$8.6 million at September 30, 2015 and December 31, 2014, respectively, 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, or cost approach were used to measure fair value and primarily included observable inputs for the individual impaired loans being evaluated such as current appraisals, recent sales of similar assets or other observable market data, and are reflected within Level 2 of the hierarchy. In cases where an input is unobservable, specifically discounts applied to appraisal values to adjust such values to current market conditions or to reflect net realizable value, the impaired loan balance is reflected within Level 3 of the hierarchy. The quantification of unobservable inputs for Level 3 impaired loan values range from 10% - 100%. The weighted average of those unobservable inputs as of the measurement date of September 30, 2015 was 44%. The majority of the impaired loans in the Level 3 category are considered collateral dependent loans.

Loan servicing rights represent the asset retained upon sale of the guaranteed portion of certain SBA loans. When SBA loans are sold, servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sales of loans. The servicing rights are subsequently measured using the amortization method, which requires amortization into interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

The Corporation periodically reviews this portfolio for impairment and engages a third-party valuation firm to assess the fair value of the overall servicing rights portfolio. Loan servicing rights do not trade in an active, open market with readily observable prices. While sales of loan servicing rights do occur, the precise terms and conditions typically are not readily available to allow for a “quoted price for similar assets” comparison. Accordingly, the Corporation utilizes an independent valuation from a third party which uses a discounted cash flow model to estimate the fair value of its loan servicing rights. The valuation model incorporates prepayment assumptions to project loan servicing rights cash flows based on the current interest rate scenario, which is then discounted to estimate an expected fair value of the loan servicing rights. The valuation model considers portfolio characteristics of the underlying serviced portion of the SBA loans and uses the following significant unobservable inputs: (1) constant prepayment rate (“CPR”) assumptions based on the SBA sold pools historical CPR as quoted in Bloomberg and (2) a discount rate of 10%. Due to the nature of the valuation inputs, loan servicing rights are classified in Level 3 of the fair value hierarchy.

As of September 30, 2015 and December 31, 2014, the estimated fair value of the Corporation’s loan servicing asset was \$1.3 million and \$943,000, respectively.



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Foreclosed properties, upon initial recognition, are re-measured and reported at fair value through a charge-off to the allowance for loan and lease losses, if deemed necessary, based upon the fair value of the foreclosed property. The fair value of a foreclosed property, upon initial recognition, is estimated using a market approach or Level 2 inputs based on observable market data, typically a current appraisal, or Level 3 inputs based upon assumptions specific to the individual property or equipment. Level 3 inputs typically include unobservable inputs such as management-applied discounts used to further reduce values to a net realizable value and may be used in situations when observable inputs become stale. Foreclosed property fair value inputs may transition to Level 1 upon receipt of an accepted offer for the sale of the related foreclosed property.

As of September 30, 2015, there were no foreclosed properties supported by a Level 3 valuation. Subsequent impairments of foreclosed properties are recorded as a loss on foreclosed properties. Based upon an evaluation of value of certain of the Corporation's foreclosed properties, impairment losses of \$29,000 were recognized for the nine months ended September 30, 2015. The activity of the Corporation's foreclosed properties is summarized as follows:

	As of and for the Nine Months Ended September 30, 2015 (In Thousands)	As of and for the Year Ended December 31, 2014
Foreclosed properties at the beginning of the period	\$1,693	\$333
Foreclosed properties acquired in acquisition, at fair value	—	1,605
Loans transferred to foreclosed properties, at lower of cost or fair value	289	—
Proceeds from sale of foreclosed properties	(528	) (255 )
Net gain on sale of foreclosed properties	207	14
Impairment valuation	(29	) (4 )
Foreclosed properties at the end of the period	\$1,632	\$1,693

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## Fair Value of Financial Instruments

The Corporation is required to disclose estimated fair values for its financial instruments. Fair value estimates, methods, and assumptions, consistent with exit price concepts for fair value measurements, are set forth below:

	September 30, 2015				
	Carrying Amount	Fair Value			
		Total	Level 1	Level 2	Level 3
	(In Thousands)				
Financial assets:					
Cash and cash equivalents	\$122,671	\$122,676	\$110,351	\$5,925	\$6,400
Securities available-for-sale	143,729	143,729	—	143,729	—
Securities held-to-maturity	38,364	38,744	—	38,744	—
Loans held for sale	2,910	2,910	—	2,910	—
Loans and lease receivables, net	1,361,813	1,393,771	—	5,549	1,388,222
Federal Home Loan Bank and Federal Reserve Bank stock	2,843	2,843	—	—	2,843
Cash surrender value of life insurance	28,029	28,029	28,029	—	—
Accrued interest receivable	4,347	4,347	4,347	—	—
Interest rate swaps	1,040	1,040	—	1,040	—
Financial liabilities:					
Deposits	\$1,539,370	\$1,541,923	\$969,501	\$572,422	\$—
Federal Home Loan Bank and other borrowings	36,354	37,115	—	37,115	—
Junior subordinated notes	10,315	7,060	—	—	7,060
Interest rate swaps	1,040	1,040	—	1,040	—
Accrued interest payable	1,900	1,900	1,900	—	—
Off-balance-sheet items:					
Standby letters of credit	124	124	—	—	124

\*Not meaningful

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	December 31, 2014				
	Carrying Amount	Fair Value			
		Total	Level 1	Level 2	Level 3
	(In Thousands)				
Financial assets:					
Cash and cash equivalents	\$ 103,237	\$ 103,227	\$ 85,937	\$ 6,890	\$ 10,400
Securities available-for-sale	144,698	144,698	—	144,698	—
Securities held-to-maturity	41,563	41,694	—	41,694	—
Loans held for sale	1,340	1,340	—	1,340	—
Loans and lease receivables, net	1,265,098	1,285,162	—	7,025	1,278,137
Federal Home Loan Bank and Federal Reserve Bank stock	2,340	2,340	—	—	2,340
Cash surrender value of life insurance	27,314	27,314	27,314	—	—
Accrued interest receivable	3,932	3,932	3,932	—	—
Interest rate swaps	575	575	—	575	—
Financial liabilities:					
Deposits	\$ 1,438,268	\$ 1,440,248	\$ 884,292	\$ 555,956	\$ —
Federal Home Loan Bank and other borrowings	33,994	34,590	—	34,590	—
Junior subordinated notes	10,315	7,101	—	—	7,101
Interest rate swaps	575	575	—	575	—
Accrued interest payable	1,574	1,574	1,574	—	—
Off-balance-sheet items:					
Standby letters of credit	192	192	—	—	192

## \*Not meaningful

Disclosure of fair value information about financial instruments, for which it is practicable to estimate that value, is required whether or not recognized in the Consolidated Balance Sheets. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Certain financial instruments and all non-financial instruments are excluded from the disclosure requirements. Accordingly, the aggregate fair value amounts presented do not necessarily represent the underlying value of the Corporation.

Cash and cash equivalents: The carrying amounts reported for cash and due from banks, interest-bearing deposits held by the Corporation, accrued interest receivable and accrued interest payable approximate fair value because of their immediate availability and because they do not present unanticipated credit concerns. As of September 30, 2015 and December 31, 2014, the Corporation held \$6.4 million and \$10.4 million, respectively, of commercial paper. The fair value of commercial paper is classified as a Level 3 input due to the lack of available independent pricing sources. The carrying value of brokered certificates of deposit purchased is equivalent to the purchase price of the instruments as the Corporation has not elected a fair value option for these instruments. The fair value of brokered certificates of deposits purchased is based on the discounted value of contractual cash flows using a discount rate reflective of rates currently offered for deposits of similar remaining maturities. As of September 30, 2015 and December 31, 2014, the Corporation held \$5.9 million and \$6.9 million, respectively, of brokered certificates of deposits.

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**Securities:** The fair value measurements of investment securities are determined by a third-party pricing service which considers observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, trade execution data, market consensus prepayment speeds, credit information and the securities' terms and conditions, among other things. The fair value measurements are subject to independent verification to another pricing source on a quarterly basis to review for reasonableness. Any significant differences in pricing are reviewed with appropriate members of management who have the relevant technical expertise to assess the results. The Corporation has determined that these valuations are classified in Level 2 of the fair value hierarchy. When the independent pricing service does not provide a fair value measurement for a particular security, the Corporation will estimate the fair value based on specific information about each security. Fair values derived in this manner are classified in Level 3 of the fair value hierarchy.

**Loans Held for Sale:** Loans held for sale, which consist of residential real estate mortgage loans and the guaranteed portion of SBA loans, are carried at the lower of cost or estimated fair value. The estimated fair value was based on what secondary markets are currently offering for portfolios with similar characteristics.

**Loans and Leases:** The fair value estimation process for the loan portfolio uses an exit price concept and reflects discounts that the Corporation believes are consistent with liquidity discounts in the market place. Fair values are estimated for portfolios of loans with similar financial characteristics. The fair value of performing and nonperforming loans is calculated by discounting scheduled and expected cash flows through the estimated maturity using estimated market rates that reflect the credit and interest rate risk inherent in the portfolio of loans and then applying a discount factor based upon the embedded credit risk of the loan and the fair value of collateral securing nonperforming loans when the loan is collateral dependent. The estimate of maturity is based on the Banks' historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions. Significant unobservable inputs include, but are not limited to, discounts (investor yield premiums) applied to fair value calculations to further determine the exit price value of a portfolio of loans.

**Federal Home Loan Bank and Federal Reserve Bank Stock:** The carrying amount of FHLB and FRB stock equals its fair value because the shares may be redeemed by the FHLB and the FRB at their carrying amount of \$100 per share.

**Cash Surrender Value of Life Insurance:** The carrying amount of the cash surrender value of life insurance approximates its fair value as the carrying value represents the current settlement amount.

**Deposits:** The fair value of deposits with no stated maturity, such as demand deposits and money market accounts, is equal to the amount payable on demand. The fair value of time deposits is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates do not include the intangible value that results from the funding provided by deposit liabilities compared to borrowing funds in the market.

**Borrowed Funds:** Market rates currently available to the Corporation and Banks for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.

**Financial Instruments with Off-Balance-Sheet Risks:** The fair value of the Corporation's off-balance-sheet instruments is based on quoted market prices and fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the credit standing of the related counterparty. Commitments to extend credit and standby letters of credit are generally not marketable. Furthermore, interest rates on any amounts drawn under such commitments would generally be established at market rates at the time of the draw. Fair value would principally derive from the present value of fees received for those products.

**Interest Rate Swaps:** The carrying amount and fair value of existing derivative financial instruments are based upon independent valuation models, which use widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative contract. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The Corporation incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, the Corporation considers the impact of netting and any applicable credit enhancements, such as collateral postings, thresholds, mutual puts and

guarantees.

Limitations: Fair value estimates are made at a discrete point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holding of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on judgments regarding future expected loss

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experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and are not considered in the estimates.

## Note 9 — Derivative Financial Instruments

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 accounting 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 primarily offsetting through earnings each period. The credit risk and risk of non-performance embedded in the fair value calculations is different between the dealer counterparties and the commercial borrowers, which may result in a difference in the changes in the fair value of the mirror-image swaps. The Corporation incorporates credit valuation adjustments to appropriately reflect both its own non-performance risk and the counterparty's risk in the fair value measurements. When evaluating the fair value of its derivative contracts for the effects of non-performance and credit risk, the Corporation considers the impact of netting and any applicable credit enhancements such as collateral postings, thresholds and guarantees.

At September 30, 2015, the aggregate amortizing notional value of interest rate swaps with various commercial borrowers was 27.1 million. The Corporation receives fixed rates and pays floating rates based upon LIBOR on the swaps with commercial borrowers. These interest rate swaps mature in March, 2016 through February, 2023. Commercial borrower swaps are completed independently with each borrower and are not subject to master netting arrangements. These commercial borrower swaps were reported on the Consolidated Balance Sheets as a derivative asset of \$1.0 million and are included in accrued interest receivable and other assets. In the event of default on a commercial borrower interest rate swap by the counterparty, a right of offset exists to allow the commercial borrower to set off amounts due against the related commercial loan. As of September 30, 2015, no interest rate swaps were in default and therefore all values for the commercial borrower swaps are recorded on a gross basis within the Corporation's financial position.

At September 30, 2015, the aggregate amortizing notional value of interest rate swaps with dealer counterparties was also 27.1 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 March, 2016 through February, 2023. Dealer counterparty swaps are subject to master netting agreements among the contracts within each of the Banks and are reported on the Consolidated Balance Sheets as a net derivative liability of \$1.0 million, included in accrued interest payable and other liabilities as of September 30, 2015. The gross amount of dealer counterparty swaps was also \$1.0 million as no right of offset existed with the dealer counterparty swaps as of September 30, 2015.

The table below provides information about the location and fair value of the Corporation's derivative instruments as of September 30, 2015 and December 31, 2014.

	Interest Rate Swap Contracts		Liability Derivatives	
	Asset Derivatives Balance Sheet Location (In Thousands)	Fair Value	Balance Sheet Location	Fair Value
Derivatives not designated as hedging instruments September 30, 2015	Accrued interest receivable and other assets	\$1,040	Accrued interest payable and other liabilities	\$1,040



December 31, 2014	Accrued interest receivable and other assets	\$575	Accrued interest payable and other liabilities	\$575
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No derivative instruments held by the Corporation for the nine months ended September 30, 2015 were considered hedging instruments. All changes in the fair value of these instruments are recorded in other non-interest income. Given the mirror-image terms of the outstanding derivative portfolio, the change in fair value for the nine months ended September 30, 2015 and 2014 had an insignificant impact on the unaudited Consolidated Statements of Income.

Note 10 — Regulatory Capital

The Corporation and the Banks are subject to various regulatory capital requirements administered by Federal, State of Wisconsin and State of Kansas banking agencies. Failure to meet minimum capital requirements can result in certain mandatory, and possibly additional discretionary actions on the part of regulators, that if undertaken, could have a direct material effect on the Banks' assets, liabilities and certain off-balance-sheet items as calculated under regulatory practices. The Corporation's and the Banks' capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. The Corporation regularly reviews and updates when appropriate its Capital and Liquidity Action Plan (the "Capital Plan"), which is designed to help ensure appropriate capital adequacy, to plan for future capital needs and to ensure that the Corporation serves as a source of financial strength to the Banks. The Corporation's and the Banks' Boards of Directors and management teams adhere to the appropriate regulatory guidelines on decisions which affect their respective capital positions, including but not limited to, decisions relating to the payment of dividends and increasing indebtedness.

As a bank holding company, the Corporation's ability to pay dividends is affected by the policies and enforcement powers of the Board of Governors of the Federal Reserve system (the "Federal Reserve"). Federal Reserve guidance urges companies to strongly consider eliminating, deferring or significantly reducing dividends if: (i) net income available to common shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividend; (ii) the prospective rate of earnings retention is not consistent with the bank holding company's capital needs and overall current prospective financial condition; or (iii) the bank holding company will not meet, or is in danger of not meeting, its minimum regulatory capital ratios. Management intends, when appropriate under regulatory guidelines, to consult with the Federal Reserve Bank of Chicago and provide it with information on the Corporation's then-current and prospective earnings and capital position in advance of declaring any cash dividends. As a Wisconsin corporation, the Corporation is subject to the limitations of the Wisconsin Business Corporation Law, which prohibit the Corporation from paying dividends if such payment would: (i) render the Corporation unable to pay its debts as they become due in the usual course of business, or (ii) result in the Corporation's assets being less than the sum of its total liabilities plus the amount needed to satisfy the preferential rights upon dissolution of any stockholders with preferential rights superior to those stockholders receiving the dividend.

The Banks are also subject to certain legal, regulatory and other restrictions on their ability to pay dividends to the Corporation. As a bank holding company, the payment of dividends by the Banks to the Corporation is one of the sources of funds the Corporation could use to pay dividends, if any, in the future and to make other payments. Future dividend decisions by the Banks and the Corporation will continue to be subject to compliance with various legal, regulatory and other restrictions as defined from time to time.

Qualitative measures established by regulation to ensure capital adequacy require the Corporation and the Banks to maintain minimum amounts and ratios of Total, common equity Tier 1 and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. These risk-based capital requirements presently address credit risk related to both recorded and off-balance-sheet commitments and obligations. Management believes, as of September 30, 2015, that the Corporation and the Banks met all applicable capital adequacy requirements.

In July 2013, the FRB and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's ("BCBS") capital guidelines for U.S. banks. These rules are applicable to all financial institutions that are subject to minimum capital requirements, including federal and state banks and savings and loan associations, as well as bank and savings and loan holding companies other than "small bank holding companies" (generally non-publicly traded bank holding companies with consolidated assets of less than \$1 billion). Under the final rules, minimum

requirements will increase for both the quantity and quality of capital held by the Corporation. The rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. The rules also permit banking organizations with less than \$15 billion to retain, through one-time election, the existing treatment for accumulated other comprehensive income, which would not affect regulatory capital. The Corporation elected to retain this treatment, which reduces the volatility of regulatory capital ratios. A new capital conservation buffer, comprised of common equity Tier 1 capital, is also established above the regulatory minimum capital requirements. This capital conservation buffer

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will be phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019.

The phase-in period for the final rules became effective for the Corporation on January 1, 2015, with full compliance with all of the final rules' requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of September 30, 2015, the Corporation's and the Bank's capital levels remained characterized as well capitalized under the new rules.

The following table summarizes the Corporation's and Banks' capital ratios and the ratios required by their federal regulators at September 30, 2015 and December 31, 2014, respectively:

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to Be Well Capitalized Under Prompt Corrective Action Requirements		
	Amount (Dollars in Thousands)	Ratio	Amount	Ratio	Amount	Ratio	
As of September 30, 2015							
Total capital (to risk-weighted assets)							
Consolidated	\$184,772	11.29	% \$130,895	8.00	% N/A	N/A	
First Business Bank	139,794	11.54	96,892	8.00	\$121,115	10.00	%
First Business Bank — Milwaukee	20,690	12.74	12,989	8.00	16,236	10.00	
Alterra Bank	29,115	11.02	21,127	8.00	26,409	10.00	
Tier 1 capital (to risk-weighted assets)							
Consolidated	\$146,487	8.95	% \$98,171	6.00	% N/A	N/A	
First Business Bank	127,808	10.55	72,669	6.00	\$96,892	8.00	%
First Business Bank — Milwaukee	18,984	11.69	9,742	6.00	12,989	8.00	
Alterra Bank	27,448	10.39	15,845	6.00	21,127	8.00	
Common equity tier 1 capital (to risk-weighted assets)							
Consolidated	\$136,487	8.34	% \$73,628	4.50	% N/A	N/A	
First Business Bank	127,808	10.55	54,502	4.50	\$106,352	6.50	%
First Business Bank — Milwaukee	18,984	11.69	7,306	4.50	78,725	6.50	
Alterra Bank	27,448	10.39	11,884	4.50	10,554	6.50	
Tier 1 capital (to average assets)							
Consolidated	\$146,487	8.59	% \$5,459	4.00	% N/A	N/A	
First Business Bank	127,808	10.60	5,112	4.00	\$6,390	5.00	%
First Business Bank — Milwaukee	18,984	7.78	759	4.00	949	5.00	
Alterra Bank	27,448	9.90	1,098	4.00	1,372	5.00	

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	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 December 31, 2014							
Total capital							
(to risk-weighted assets)							
Consolidated	\$173,263	12.13	% \$114,253	8.00	% N/A	N/A	
First Business Bank	131,411	12.19	86,272	8.00	\$107,841	10.00	%
First Business Bank — Milwaukee	19,128	12.47	12,274	8.00	15,343	10.00	
Alterra Bank	22,657	10.90	16,628	8.00	20,785	10.00	
Tier 1 capital							
(to risk-weighted assets)							
Consolidated	\$136,008	9.52	\$57,127	4.00	% N/A	N/A	
First Business Bank	118,907	11.03	43,136	4.00	\$64,704	6.00	%
First Business Bank — Milwaukee	17,641	11.50	6,137	4.00	9,206	6.00	
Alterra Bank	22,320	10.74	8,314	4.00	12,471	6.00	
Tier 1 capital							
(to average assets)							
Consolidated	\$136,008	8.71	\$62,490	4.00	% N/A	N/A	
First Business Bank	118,907	10.13	46,960	4.00	\$58,700	5.00	%
First Business Bank — Milwaukee	17,641	7.90	8,935	4.00	11,169	5.00	
Alterra Bank	22,320	9.01	9,910	4.00	12,388	5.00	

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

General

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

Forward-Looking Statements

When used in this report the words or phrases "may," "could," "should," "hope," "might," "believe," "expect," "plan," "assume," "estimate," "anticipate," "project," "likely," or similar expressions are intended to identify "forward-looking statements." Such statements are subject to risks and uncertainties, including among other things:

• Competitive pressures among depository and other financial institutions nationally and in our market areas may increase significantly.

• Adverse changes in the economy or business conditions, either nationally or in our market areas, could increase credit-related losses and expenses and/or limit growth.

• Increases in defaults by borrowers and other delinquencies could result in increases in our provision for losses on loans and related expenses.

• Our inability to manage growth effectively, including the successful expansion of our customer support, administrative infrastructure and internal management systems, could adversely affect our results of operations and prospects.

• Fluctuations in interest rates and market prices could reduce our net interest margin and asset valuations and increase our expenses.

• The consequences of continued bank acquisitions and mergers in our market areas, resulting in fewer but much larger and financially stronger competitors, could increase competition for financial services to our detriment.

• Changes in legislative or regulatory requirements applicable to us and our subsidiaries could increase costs, limit certain operations and adversely affect results of operations.

• Changes in tax requirements, including tax rate changes, new tax laws and revised tax law interpretations may increase our tax expense or adversely affect our customers' businesses.

• System failure or breaches of our network security, including with respect to our internet banking activities, could subject us to increased operating costs and other liabilities.

These risks could cause actual results to differ materially from what we have anticipated or projected. These risk factors and uncertainties should be carefully considered by our shareholders and potential investors. See Item 1A — Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2014 for discussion relating to risk factors impacting us. Investors should not place undue reliance on any such forward-looking statements, which speak only as of the date made. The factors described within this Form 10-Q could affect our financial performance and could cause actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods.

Where any such forward-looking statement includes a statement of the assumptions or bases underlying such forward-looking statement, we caution that, while our management believes such assumptions or bases are reasonable and are made in good faith, assumed facts or bases can vary from actual results, and the differences between assumed facts or bases and actual results can be material, depending on the circumstances. Where, in any forward-looking statement, an expectation or belief is expressed as to future results, such expectation or belief is expressed in good faith and believed to have a reasonable basis, but there can be no assurance that the statement of expectation or belief will be achieved or accomplished.

We do not intend to, and specifically disclaim any obligation to, update any forward-looking statements.

The following discussion and analysis is intended as a review of significant events and factors affecting our financial condition and results of operations for the periods indicated. The discussion should be read in conjunction with the Unaudited Consolidated Financial Statements and the Notes thereto presented in this Form 10-Q.

Overview

We are a registered bank holding company incorporated under the laws of the State of Wisconsin and are engaged in the commercial banking business through our wholly owned banking subsidiaries, FBB, FBB-Milwaukee and Alterra. All of our operations are conducted through the Banks and certain subsidiaries of FBB. We operate as a business bank focusing on

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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. Our commercial banking products and services includes commercial lending, SBA lending, asset-based lending, equipment financing, factoring, residential mortgage lending, trust and investment services, treasury management services and a broad range of deposit products. We do not utilize a branch network to attract retail clients. Our operating philosophy incorporates local decision making and local client service from each of our primary banking locations in Madison, Brookfield and Appleton, Wisconsin and Leawood, Kansas combined with the efficiency of centralized administrative functions, such as credit, information technology, marketing, finance and accounting and human resources. We have a niche business-banking model and we consistently operate within this model to provide value-added financial solutions to our clients through the high touch service of our experienced staff.

The acquisition of Alterra in November 2014 introduced new banking products to First Business that have proven to be earnings catalysts, particularly lending under the Small Business Administration (SBA) lending program. Traditional SBA lending, while very profitable in the short-term, is a transactional banking strategy with limited recurring revenue. Since its inception in 2010, Alterra's SBA lending strategy has been a full relationship client acquisition approach delivered through high touch service and experienced staff, much like the niche business-banking model First Business has employed since its inception. Our strategy is to obtain a client's entire banking relationship upon delivery of SBA funding, including the businesses operating account and related treasury management services. In most cases we sell the guaranteed portion of the loan to the secondary market and retain the unguaranteed portion, which then earns between Prime + 2.00% and Prime + 2.75% depending on the creditworthiness of the client. In addition, Alterra collects SBA packaging and servicing fees, the latter of which is based on Alterra's ongoing role in the servicing of the guaranteed portion of the loan sold. It is management's belief that this relationship-focused SBA strategy drives earnings growth and creates franchise value in the long-term. In the fourth quarter of 2015 we believe we will continue to build momentum organically, assisted by industry leading sales tools and driven by our experienced, client-centric business development staff. In-market deposit growth will remain a strategic focus as we continue to increase the number and volume of transaction accounts to support ongoing efforts to increase fee revenue associated with treasury management services. While we continue to invest for the future, our efficiency ratio will remain moderately higher than our 60% target. We believe timely investments in technology and people are imperative as we continue to drive operational efficiency to keep pace with our strategic growth trajectory.

**Operational Highlights**

Total assets increased to \$1.744 billion as of September 30, 2015 compared to \$1.629 billion as of December 31, 2014.

Net income for the three months ended September 30, 2015 was \$4.4 million compared to net income of \$3.6 million for the three months ended September 30, 2014. Net income for the nine months ended September 30, 2015 was \$12.4 million compared to net income of \$10.4 million for the nine months ended September 30, 2014.

Diluted earnings per common share for the three months ended September 30, 2015 were \$0.50 compared to diluted earnings per common share of \$0.45 for the three months ended September 30, 2014. Diluted earnings per common share for the nine months ended September 30, 2015 were \$1.43 compared to diluted earnings per common share of \$1.31 for the nine months ended September 30, 2014.

Net interest margin increased by 17 basis points to 3.61% for the three months ended September 30, 2015 compared to 3.44% for the three months ended September 30, 2014. Net interest margin increased by 16 basis points to 3.67% for the nine months ended September 30, 2015 compared to 3.51% for the nine months ended September 30, 2014.

Top line revenue, the sum of net interest income and non-interest income, increased 39.7% to \$18.7 million for the three months ended September 30, 2015 compared to \$13.4 million for the three months ended September 30, 2014. For the nine months ended September 30, 2015, top line revenue increased 40.7% to \$55.8 million as compared to \$39.7 million for the nine months ended September 30, 2014.

Annualized return on average assets ("ROAA") and annualized return on average equity ("ROAE") were 1.02% and 11.93%, respectively, for the three-month period ended September 30, 2015, compared to 1.06% and 12.10%, respectively, for the same time period in 2014. ROAA and ROAE were 0.98% and 11.55%, respectively, for the



nine-month period ended September 30, 2015, compared to 1.07% and 12.13%, respectively, for the same time period in 2014.

Our efficiency ratio was 64.8% for the three months end September 30, 2015, compared to 60.1% for the three months ended September 30, 2014. For the nine months ended September 30, 2015 our efficiency ratio was 64.2%, compared to 59.6% for the same time period in 2014.

Our effective tax rate was 33.2% and 35.1% for the nine months ended September 30, 2015 and 2014, respectively.

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- Our provision for loan and lease losses was \$287,000 for the three months ended September 30, 2015 compared to a negative provision of \$89,000 for the same period in the prior year. Provision for loan and lease losses was \$1.5 million for the nine months ended September 30, 2015 compared to no provision for the comparable period of 2014.
- Allowance for loan and lease losses as a percentage of gross loans and leases was 1.11% at September 30, 2015 compared to 1.12% at December 31, 2014.
- Non-performing assets as a percentage of total assets was 0.65% at September 30, 2015 compared to 0.70% at December 31, 2014.
- Non-accrual loans decreased by \$85,000, or 0.9%, to \$9.7 million at September 30, 2015 from \$9.8 million at December 31, 2014.

## Alterra Bank

During the third quarter of 2015, Alterra contributed \$2.9 million in net interest income, including \$385,000 related to the net accretion/amortization of purchase accounting adjustments, \$1.5 million in non-interest income, \$2.6 million in non-interest expense and \$355,000 in loan loss provision, contributing a total of \$1.5 million in pre-tax income to First Business's results. For the nine months ended September 30, 2015, Alterra produced \$9.5 million in net interest income, including \$2.2 million related to the net accretion/amortization of purchase accounting adjustments, \$4.0 million in non-interest income, \$7.3 million in non-interest expense and \$1.5 million in loan loss provision, contributing a total of \$4.7 million in pre-tax income to First Business's results.

## Results of Operations

## 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. Top line revenue increased 39.7% and 40.7% for the three and nine months ended September 30, 2015, respectively, as compared to the same period in the prior year primarily due to the acquisition of Alterra, which was completed on November 1, 2014. The components of top line revenue were as follows:

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,			
	2015	2014	Change	2015	2014	Change	
	(Dollars in Thousands)						
Net interest income	\$14,610	\$10,935	33.6	% \$43,728	\$32,535	34.4	%
Non-interest income	4,102	2,459	66.8	12,076	7,138	69.2	
Total top line revenue	\$18,712	\$13,394	39.7	\$55,804	\$39,673	40.7	

## Return on Average Assets and Return on Average Equity

ROAA for the three months ended September 30, 2015 decreased to 1.02% compared to 1.06% for the three months ended September 30, 2014. ROAA for the nine months ended September 30, 2015 was 0.98% compared to 1.07% for the nine months ended September 30, 2014. The decline in ROAA for both time periods presented was primarily due to the increase in total average assets exceeding the increase in net income primarily due to the acquisition of Alterra, as well as from elevated non-interest expenses as we continue to opportunistically invest to further build-out a scalable franchise. Total average assets for the three months ended September 30, 2015 increased 28.7% year over year while net income increased 23.3%. Total average assets for the nine months ended September 30, 2015 increased 30.3% year over year while net income increased 19.6%. ROAA is a critical metric used by us to measure the profitability of our organization and how efficiently our assets are deployed. It is a measurement that allows us to better benchmark our profitability to our peers without the need to consider different degrees of leverage which can ultimately influence return on equity measures.

ROAE for the three months ended September 30, 2015 was 11.93% compared to 12.10% for the three months ended September 30, 2014. ROAE for the nine months ended September 30, 2015 was 11.55% compared to 12.13% for the nine months ended September 30, 2014. The decline in ROAE in both time periods presented was primarily due to

the growth of our average equity outpacing the improvement in our net income for the comparable periods which can be directly

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attributable to the acquisition of Alterra and the issuance of 720,162 shares of common stock on a post-split basis as a portion of consideration paid in the transaction, as well as from elevated non-interest expenses as we continue to opportunistically invest to further build-out a scalable franchise. We view return on average equity to be an important measure of profitability, and we continue to focus on improving our return to our shareholders by enhancing the overall profitability of our client relationships, controlling our expenses and minimizing our credit costs.

**Efficiency Ratio**

Efficiency ratio is a non-GAAP measure representing non-interest expense excluding the effects of losses or gains on foreclosed properties and amortization of other intangible assets, if any, divided by top line revenue. We believe the efficiency ratio allows investors and analysts to better assess the Corporation's operating expenses in relation to its top line revenue by removing the volatility that is associated with certain one-time and other discrete items. The information provided below reconciles the efficiency ratio to its most comparable GAAP measure.

Please refer to the Non-Interest Expense section below for discussion on the primary drivers of the year-over-year increase in the efficiency ratio.

	For the Three Months Ended		For the Nine Months Ended		
	September 30,		September 30,		
	2015	2014	2015	2014	
	(Dollars in Thousands)				
Total non-interest expense	\$11,984	\$8,047	\$35,690	\$23,648	
Less:					
Net gain on foreclosed properties	(163	) (9	) (178	) (5	)
Amortization of other intangible assets	18	—	55	—	
Total operating expense	\$12,129	\$8,056	\$35,813	\$23,653	
Net interest income	\$14,610	\$10,935	\$43,728	\$32,535	
Total non-interest income	4,102	2,459	12,076	7,138	
Top line revenue	\$18,712	\$13,394	\$55,804	\$39,673	
Efficiency ratio	64.82	% 60.15	% 64.18	% 59.62	%

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## Net Interest Income

Net interest income levels depend on the amounts of and yields on interest-earning assets as compared to the amounts of and rates paid on interest-bearing liabilities. Net interest income is sensitive to changes in market rates of interest and the asset/liability management processes to prepare for and respond to such changes.

The following table provides information with respect to (1) the change in net interest income attributable to changes in rate (changes in rate multiplied by prior volume) and (2) the change in net interest income attributable to changes in volume (changes in volume multiplied by prior rate) for the three and nine months ended September 30, 2015 compared to the same period of 2014. The change in net interest income attributable to changes in rate and volume (changes in rate multiplied by changes in volume) has been allocated to the rate and volume changes in proportion to the relationship of the absolute dollar amounts of the change in each.

	Increase (Decrease) for the Three Months Ended September 30, 2015 Compared to 2014			Increase (Decrease) for the Nine Months Ended September 30, 2015 Compared to 2014		
	Rate	Volume	Net	Rate	Volume	Net
(In Thousands)						
Interest-earning assets						
Commercial real estate and other mortgage loans <sup>(1)</sup>	\$(225 )	\$2,514	\$2,289	\$(253 )	\$6,884	\$6,631
Commercial and industrial loans <sup>(1)</sup>	79	1,893	1,972	594	5,610	6,204
Direct financing leases <sup>(1)</sup>	(1 )	(22 )	(23 )	8	80	88
Consumer and other loans <sup>(1)</sup>	34	83	117	78	233	311
Total loans and leases receivable	(113 )	4,468	4,355	427	12,807	13,234
Mortgage-related securities <sup>(2)</sup>	(88 )	(26 )	(114 )	(301 )	(11 )	(312 )
Other investment securities <sup>(3)</sup>	(1 )	16	15	7	8	15
FHLB and FRB Stock	14	6	20	46	10	56
Short-term investments	(9 )	(3 )	(12 )	(43 )	83	40
Total net change in income on interest-earning assets	(197 )	4,461	4,264	136	12,897	13,033
Interest-bearing liabilities						
Transaction accounts	4	33	37	5	63	68
Money market accounts	61	141	202	164	574	738
Certificates of deposit	(32 )	121	89	(94 )	387	293
Wholesale deposits	(109 )	161	52	(378 )	315	(63 )
Total deposits	(76 )	456	380	(303 )	1,339	1,036
FHLB advances	2	27	29	42	37	79
Other borrowings	(15 )	195	180	(28 )	752	724
Junior subordinated notes	—	—	—	1	—	1
Total net change in expense on interest-bearing liabilities	(89 )	678	589	(288 )	2,128	1,840
Net change in net interest income	\$(108 )	\$3,783	\$3,675	\$424	\$10,769	\$11,193

(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 and held to maturity.

(3) Yields on tax-exempt municipal obligations are not presented on a tax-equivalent basis in this table.

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The table below shows our average balances, interest, average yields/rates, net interest margin and the spread between the combined average yields earned on interest-earning assets and average rates on interest-bearing liabilities for the three months ended September 30, 2015 and 2014. The average balances are derived from average daily balances.

	For the Three Months Ended September 30,							
	2015			2014				
	Average balance	Interest	Average yield/rate <sup>(4)</sup>	Average balance	Interest	Average yield/rate <sup>(4)</sup>		
	(Dollars in Thousands)							
Interest-earning assets								
Commercial real estate and other mortgage loans <sup>(1)</sup>	\$856,488	\$9,994	4.67	% \$641,522	\$7,705	4.80	%	
Commercial and industrial loans <sup>(1)</sup>	454,184	6,741	5.94	326,579	4,769	5.84		
Direct financing leases <sup>(1)</sup>	28,352	328	4.63	30,278	351	4.64		
Consumer and other loans <sup>(1)</sup>	23,647	260	4.40	15,696	143	3.64		
Total loans and leases receivable <sup>(1)</sup>	1,362,671	17,323	5.09	1,014,075	12,968	5.12		
Mortgage-related securities <sup>(2)</sup>	152,763	602	1.57	158,832	716	1.80		
Other investment securities <sup>(3)</sup>	30,431	120	1.58	26,284	105	1.60		
FHLB and FRB stock	3,175	22	2.69	1,349	2	0.57		
Short-term investments	67,716	68	0.41	70,633	80	0.45		
Total interest-earning assets	1,616,756	18,135	4.49	1,271,173	13,871	4.36		
Non-interest-earning assets	100,863			63,485				
Total assets	\$1,717,619			\$1,334,658				
Interest-bearing liabilities								
Transaction accounts	\$138,489	84	0.24	\$84,434	47	0.22		
Money market accounts	587,063	829	0.56	484,402	627	0.52		
Certificates of deposit	102,477	204	0.80	44,423	115	1.04		
Wholesale deposits	466,516	1,668	1.43	422,618	1,616	1.53		
Total interest-bearing deposits	1,294,545	2,785	0.86	1,035,877	2,405	0.93		
FHLB advances	17,503	30	0.67	1,304	1	0.16		
Other borrowings	25,154	430	6.84	13,806	250	7.24		
Junior subordinated notes	10,315	280	10.86	10,315	280	10.86		
Total interest-bearing liabilities	1,347,517	3,525	1.05	1,061,302	2,936	1.11		
Non-interest-bearing demand deposit accounts	213,712			148,017				
Other non-interest-bearing liabilities	9,520			7,908				
Total liabilities	1,570,749			1,217,227				
Stockholders' equity	146,870			117,431				
Total liabilities and stockholders' equity	\$1,717,619			\$1,334,658				
Net interest income		\$14,610			\$10,935			
Interest rate spread			3.44	%		3.25	%	
Net interest-earning assets	\$269,239			\$209,871				
Net interest margin			3.61	%		3.44	%	
Average interest-earning assets to average interest-bearing	119.98	%			119.77	%		

liabilities

Return on average assets	1.02	1.06
Return on average equity	11.93	12.10
Average equity to average assets	8.55	8.80
Non-interest expense to average assets	2.79	2.41

(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 and held to maturity.

(3) Yields on tax-exempt municipal obligations are not presented on a tax-equivalent basis in this table.

(4) Represents annualized yields/rates.

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The table below shows our average balances, interest, average yields/rates, net interest margin and the spread between the combined average yields earned on interest-earning assets and average rates on interest-bearing liabilities for the nine months ended September 30, 2015 and 2014. The average balances are derived from average daily balances.

	For the Nine Months Ended September 30,							
	2015		2014					
	Average balance	Interest	Average yield/rate <sup>(4)</sup>	Average balance	Interest	Average yield/rate <sup>(4)</sup>		
Interest-earning assets								
Commercial real estate and other mortgage loans <sup>(1)</sup>	\$832,042	\$29,535	4.73	% \$638,187	\$22,904	4.79	%	
Commercial and industrial loans <sup>(1)</sup>	440,390	19,973	6.05	% 316,209	13,769	5.81	%	
Direct financing leases <sup>(1)</sup>	30,229	1,053	4.64	% 27,945	965	4.60	%	
Consumer and other loans <sup>(1)</sup>	24,213	767	4.22	% 16,603	456	3.66	%	
Total loans and leases receivable <sup>(1)</sup>	1,326,874	51,328	5.16	% 998,944	38,094	5.08	%	
Mortgage-related securities <sup>(2)</sup>	154,734	1,896	1.63	% 155,488	2,208	1.89	%	
Other investment securities <sup>(3)</sup>	29,213	350	1.60	% 28,556	335	1.56	%	
FHLB and FRB stock	2,902	60	2.74	% 1,346	4	0.44	%	
Short-term investments	75,469	237	0.42	% 50,768	197	0.52	%	
Total interest-earning assets	1,589,192	53,871	4.52	% 1,235,102	40,838	4.41	%	
Non-interest-earning assets	96,889			59,104				
Total assets	\$1,686,081			\$1,294,206				
Interest-bearing liabilities								
Transaction accounts	\$117,242	205	0.23	% \$81,039	137	0.23	%	
Money market	605,906	2,523	0.56	% 465,708	1,785	0.51	%	
Certificates of deposit	112,602	643	0.76	% 47,536	350	0.98	%	
Wholesale deposits	439,744	4,576	1.39	% 410,757	4,639	1.51	%	
Total interest-bearing deposits	1,275,494	7,947	0.83	% 1,005,040	6,911	0.92	%	
FHLB advances	16,569	85	0.68	% 4,604	6	0.16	%	
Other borrowings	24,948	1,279	6.84	% 10,297	555	7.19	%	
Junior subordinated notes	10,315	832	10.76	% 10,315	831	10.76	%	
Total interest-bearing liabilities	1,327,326	10,143	1.02	% 1,030,256	8,303	1.07	%	
Non-interest-bearing demand deposit accounts	206,547			142,302				
Other non-interest-bearing liabilities	8,646			7,406				
Total liabilities	1,542,519			1,179,964				
Stockholders' equity	143,562			114,242				
Total liabilities and stockholders' equity	\$1,686,081			\$1,294,206				
Net interest income		\$43,728			\$32,535			
Interest rate spread			3.50	%		3.34	%	
Net interest-earning assets	\$261,866			\$204,846				
Net interest margin			3.67	%		3.51	%	
Average interest-earning assets to average interest-bearing liabilities	119.73	%		119.88	%			



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Return on average assets	0.98	1.07
Return on average equity	11.55	12.13
Average equity to average assets	8.51	8.83
Non-interest expense to average assets	2.82	2.44

- (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 and held to maturity.
- (3) Yields on tax-exempt municipal obligations are not presented on a tax-equivalent basis in this table.
- (4) Represents annualized yields/rates.

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## Comparison of Net Interest Income for the Three Months Ended September 30, 2015 and 2014

Net interest income increased \$3.7 million, or 33.6%, during the three months ended September 30, 2015 compared to the same period in 2014. The increase in net interest income was primarily attributable to the addition of Alterra and the corresponding favorable volume variance on the loan and the lease portfolio, partially offset by an overall unfavorable variance on interest-bearing liabilities.

The yield on average earning assets for the three months ended September 30, 2015 was 4.49% compared to 4.36% for the three months ended September 30, 2014. The increase in the yield was volume driven primarily attributable to the addition of the Alterra loan portfolio at yields greater than that of the Wisconsin-based portfolio combined with the accretion related to purchase accounting adjustments on the Alterra loan portfolio. This benefit was partially offset by a 23 basis point decrease in the yield on average mortgage-related securities.

The overall weighted average rate paid on interest-bearing liabilities was 1.05% for the three months ended September 30, 2015, a decrease of 6 basis points from 1.11% for the three months ended September 30, 2014. The decrease in the overall rate on the interest-bearing liabilities was primarily caused by a decrease in rate paid on our wholesale deposits as well as our in-market certificates of deposit. This decrease was partially offset by an unfavorable rate and volume variance on money market accounts and by the addition of other borrowings resulting from the \$15.0 million of subordinated debt issued on August 26, 2014 and \$9.0 million of FHLB advances assumed in the Alterra acquisition both at rates that are significantly higher than our average cost of funds.

The weighted average rate paid on our interest-bearing deposits was 0.86% for the three months ended September 30, 2015, a decrease of 7 basis points from 0.93% for the three months ended September 30, 2014. The decrease in the weighted average rate paid on our interest-bearing deposits was primarily driven by the replacement of maturing wholesale deposits with in-market deposit relationships at lower current rates. The current low rate environment combined with the maturity structure of our wholesale deposits continues to provide us the opportunity to manage our liability structure in both term and rate to deliver an enhanced net interest margin. Further, the addition of Alterra in-market deposits combined with the continued success of attracting in-market deposits in our Wisconsin-based markets contributed to the overall decline in our cost of funds. Average in-market client deposits - comprised of all transaction accounts, money market accounts and non-wholesale deposits - increased 36.8% to \$1.042 billion for the three months ended September 30, 2015 from \$761.3 million for the three months ended September 30, 2014 primarily attributable to the acquisition of Alterra.

Net interest margin increased 17 basis points to 3.61% for the three months ended September 30, 2015 compared to 3.44% for the three months ended September 30, 2014. Net accretion/amortization on the Alterra purchase accounting adjustments of \$385,000 combined with the addition of the Alterra loan portfolio at yields greater than that of the Wisconsin-based portfolio drove a favorable impact of 21 basis points in net interest margin. While management expects the net accretion/amortization to trend lower, it may be volatile due to the uncertain nature of loan prepayments. In addition, the changing mix of our deposit base reduced our overall cost of funds and positively affected our net interest margin by approximately seven basis points, offsetting the eight basis point decrease related to the declining yield on our investment portfolio. Other factors, primarily the issuance of \$15.0 million of subordinated debt on August 26, 2014, negatively influenced the net interest margin by three basis points in the aggregate.

## Comparison of Net Interest Income for the Nine Months Ended September 30, 2015 and 2014

Net interest income increased \$11.2 million, or 34.4%, during the nine months ended September 30, 2015 compared to the same period in 2014. The increase in net interest income was primarily attributable to the addition of Alterra and the corresponding favorable rate and volume variances on the loan and the lease portfolio, partially offset by an overall unfavorable variance on interest-bearing liabilities.

The yield on average earning assets for the nine months ended September 30, 2015 was 4.52% compared to 4.41% for the nine months ended September 30, 2014. The reasons for the increase in the yield on average earning assets are consistent with explanations provided for the third quarter results discussed above.

The overall weighted average rate paid on interest-bearing liabilities was 1.02% for the nine months ended September 30, 2015, a decrease of five basis points from 1.07% for the nine months ended September 30, 2014. The reasons for the decrease in the overall weighted average rate paid on interest-bearing liabilities are consistent with

explanations provided for the third quarter results discussed above.

Net interest margin increased 16 basis points to 3.67% for the nine months ended September 30, 2015 compared to 3.51% for the nine months ended September 30, 2014. Net accretion/amortization on the Alterra purchase accounting

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adjustments of \$1.8 million combined with the addition of the Alterra loan portfolio at yields greater than that of the Wisconsin-based portfolio contributed a favorable 19 basis points in net interest margin. In addition, the changing mix of our deposit base reduced our overall cost of funds and positively affected our net interest margin by approximately eight basis points, offsetting the nine basis point decrease related to the declining yield on our investment portfolio. Other factors, primarily the issuance of the subordinated debt, negatively influenced the net interest margin by two basis points in the aggregate.

**Provision for Loan and Lease Losses**

We determine our provision for loan and lease losses based upon credit risk and other subjective factors pursuant to our allowance for loan and lease loss methodology, the magnitude of current and historical net charge-offs recorded and the amount of reserves established for impaired loans that present collateral shortfall positions.

We recorded provision expense of \$287,000 and negative provision of \$89,000 for the three months ended September 30, 2015 and 2014, respectively. Our provision expense was \$1.5 million for the nine months ended September 30, 2015 compared to no provision for the comparable period of 2014. Provision for the three and nine months ended September 30, 2015 primarily reflects additions commensurate with loan growth, partially offset by a reduction of the loss factors applied in calculating the probable losses within the loan and lease portfolio for which a reserve should be established, primarily due to improving macro and microeconomic factors.

During the three and nine months ended September 30, 2015 and 2014, the factors influencing the provision for loan and lease losses were the following:

	For the Three Months Ended September 30, 2015		For the Nine Months Ended September 30, 2015		For the Three Months Ended September 30, 2014		For the Nine Months Ended September 30, 2014	
	(In Thousands)							
Components of the provision for loan and lease losses:								
Net additions of specific reserves on impaired loans	\$ 101		\$ (196)	)	\$ 353		\$ 9	
Net decrease in allowance for loan and lease loss reserve due to subjective factor changes	(211	)	(350	)	(904	)	(852	)
Charge-offs in excess of specific reserves	22		2		370		2	
Recoveries	(11	)	(6	)	(85	)	(32	)
Change in inherent risk of the loan and lease portfolio	386		461		1,757		873	
Total provision for loan and lease losses	\$ 287		\$ (89	)	\$ 1,491		\$ —	

The net additions of specific reserves on impaired loans represents the new specific reserves established on impaired loans for which, although collateral shortfalls are present, we believe we will recover our principal, offset by any release of previously established reserves that are no longer required. A decrease in allowance for loan and lease losses reserves due to subjective factor changes reflects management's evaluation of the level of risk within the portfolio based upon the level and trend of certain criteria such as delinquencies, volume and average loan size, average risk rating, technical defaults, geographic concentrations, loans and leases on management attention watch lists, unemployment rates in our market areas, experience in credit granting functions, and changes in underwriting standards. As our asset quality metrics improve and the level and trend of the factors improve for a sustained period of time, the level of general reserve due to these factors may be reduced, causing an overall reduction in the level of the required reserve deemed to be appropriate by management. Conversely, increases in the level and trend of these factors may warrant an increase to our overall allowance for loan loss. Charge-offs in excess of specific reserves represent an additional provision for loan and lease losses required to maintain the allowance for loan and leases at a level deemed appropriate by management. This amount is net of the release of any specific reserve that may have already been provided. Charge-offs in excess of specific reserves can occur in situations where: (i) a loan has previously been partially written down to its estimated fair value and continues to decline, (ii) rapid deterioration of a credit requires an immediate partial or full charge-off, or (iii) the specific reserve was not adequate to cover the amount of the required charge-off. Change in the inherent risk of the portfolio can be influenced by portfolio growth or by migration in and out of an impaired loan classification where a specific evaluation of a particular credit may be

required rather than the application of a general reserve ratio. Refer to [Asset Quality](#) for further information regarding the overall credit quality of our loan and lease portfolio.

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Non-interest Income

Comparison of Non-Interest Income for the Three Months Ended September 30, 2015 and 2014

Non-interest income increased \$1.6 million, or 66.8%, to \$4.1 million for the three months ended September 30, 2015, from \$2.5 million for the three months ended September 30, 2014. The increase was primarily due to additional fee income related to the acquisition of Alterra, specifically gains from the sale of SBA loans and residential mortgage loans, and increased fees earned for trust and investment services.

Trust and investment services fee income increased by \$114,000, or 10.0%, to \$1.3 million for the three months ended September 30, 2015 from \$1.1 million for the three months ended September 30, 2014, despite negative market volatility affecting overall asset values during the third quarter of 2015. This increase was primarily driven by the amount of assets under management and administration as well as the mix of business at different fee structures and can be positively or negatively influenced by the timing and magnitude of volatility within the capital markets. At September 30, 2015, we had \$791.2 million of trust assets under management compared to \$773.2 million at December 31, 2014 and \$741.2 million at September 30, 2014. Assets under administration were \$187.5 million at September 30, 2015 compared to \$186.5 million at December 31, 2014 and \$186.2 million at September 30, 2014. Gain on sale of loans for the three months ended September 30, 2015 totaled \$1.2 million, an increase of \$1.2 million from the same period in 2014, attributable to \$244,000 from the sale of the residential real estate loans originated in our Kansas City market and \$927,000 from the sale of the guaranteed portion of SBA loans originated in our Kansas City and Wisconsin markets.

Comparison of Non-Interest Income for the Nine Months Ended September 30, 2015 and 2014

Non-interest income increased \$4.9 million, or 69.2%, to \$12.1 million for the nine months ended September 30, 2015, from \$7.1 million for the nine months ended September 30, 2014. The increase was primarily due to increased fees earned for trust and investment services and the additional fee income related to the acquisition of Alterra, specifically gains from the sale of SBA loans and residential mortgage loans.

Trust and investment services fee income increased by \$422,000, or 12.7%, to \$3.7 million for the nine months ended September 30, 2015 from \$3.3 million for the nine months ended September 30, 2014, despite negative market volatility affecting overall asset values during the third quarter of 2015. Consistent with the third quarter results discussed above, trust and investment services fee income was primarily driven by the amount of assets under management as market values continue to increase. Assets under management can be positively or negatively influenced by the timing and magnitude of volatility within the equity markets, which will therefore influence the level of fee income recognized.

Services charges on deposits increased by \$307,000, or 17.2%, to \$2.1 million for the nine months ended September 30, 2015, compared to \$1.8 million for the nine months ended September 30, 2014. The increase in services charges on deposits was due to the acquisition of Alterra in addition to the increase in transaction accounts in our Wisconsin markets.

Loan fees increased by \$331,000, or 28.6%, to \$1.5 million for the nine months ended September 30, 2015, compared to \$1,156,000 for the nine months ended September 30, 2014. The increase in loan fees was primarily due to the acquisition of Alterra and the related increase in fee income from our SBA business line.

Gain on sale of loans and leases for the nine months ended September 30, 2015 totaled \$2.9 million, an increase of \$2.9 million from the same period in 2014. Consistent with the third quarter results discussed above, the increase in gain on sale of loans and leases was attributable to \$614,000 from the sale of the residential real estate loans originated in our Kansas City market and \$2.3 million from the sale of the guaranteed portion of SBA loans originated in our Kansas City and Wisconsin markets.

Other non-interest income increased by \$814,000 to \$994,000 for the nine months ended September 30, 2015, compared to \$180,000 for the nine months ended September 30, 2014. The increase in other income was primarily due to gains recognized on the termination of leased assets, income recognized from our investment in various Community Development Entities and the unwinding of the reserve for unfunded commitments resulting from the fair value purchase accounting adjustments associated with the Alterra transaction. For the nine months ended September 30, 2015, we have recognized \$447,000 in non-interest income due to the unwinding of the reserve. The remaining reserve for unfunded commitments was \$50,000 as of September 30, 2015. Should the commitment be withdrawn for

any reason or become fully funded prior to maturity, we will accelerate the remaining liability accordingly.

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## Non-Interest Expense

## Comparison of Non-Interest Expense for the Three Months Ended September 30, 2015 and 2014

Non-interest expense increased by \$3.9 million, or 48.9%, to \$12.0 million for the three months ended September 30, 2015 from \$8.0 million for the comparable period of 2014. The acquisition of Alterra was the primary driver for the increase in all non-interest expense categories. Compensation, professional fees and marketing expenses comprise the majority of the overall increase.

Compensation expense increased by \$2.1 million, or 41.0%, to \$7.3 million for the three months ended September 30, 2015 from \$5.2 million for the three months ended September 30, 2014. In addition to the increase related to Alterra, the overall increase reflects growth in compensation costs related to annual merit increases, employee benefit costs and incentive compensation accruals on a larger base of employees than in the comparative period of the prior year. Full time equivalent employees as of September 30, 2015 were 236, up 45.7% from 162 at September 30, 2014. Most of the increase was the result of the Alterra acquisition. Excluding Alterra, full time equivalent employees as of September 30, 2015 increased by 18 compared to September 30, 2014. We expect to continue investing in talent to support our strategic growth efforts, both in the form of additional business development and operational staff.

Professional fees expense increased by \$594,000, or 88.1%, to \$1.3 million for the three months ended September 30, 2015 from \$674,000 for the three months ended September 30, 2014. In addition to the increase related to Alterra, the overall increase primarily reflects our ongoing strategy to invest in technology-based corporate initiatives that will drive operational efficiency. For the quarter ended September 30, 2015, professional fees specifically related to information technology ("IT") projects increased \$259,000. In addition, fees paid to other outside service providers increased \$218,000 primarily due to temp-to-hire employees required to support our strategic IT initiatives while fees paid to our external auditors increased by \$65,000 primarily resulting from additional services due to the inclusion of Alterra. The largest remaining item in the variance was an increase in recruiting expenses related to our ongoing investment in attracting talent, offset by a decrease in merger-related costs of \$104,000.

Marketing expense increased by \$284,000, or 69.4%, to \$693,000 for the three months ended September 30, 2015 from \$409,000 for the three months ended September 30, 2014. The addition of Alterra and related expansion of our marketing efforts into new geographic regions was the primary driver for the increase.

## Comparison of Non-Interest Expense for the Nine Months Ended September 30, 2015 and 2014

Non-interest expense increased by \$12.0 million, or 50.9%, to \$35.7 million for the nine months ended September 30, 2015 from \$23.6 million for the comparable period of 2014. The acquisition of Alterra was the primary driver for the increase in all non-interest expense categories. Compensation, professional fees and marketing expenses comprise the majority of the overall increase.

Compensation expense increased by \$6.6 million, or 44.1%, to \$21.6 million for the nine months ended September 30, 2015 from \$15.0 million for the nine months ended September 30, 2014. The reasons for the increase in compensation expense are consistent with explanations provided for the second quarter results discussed above.

Professional fees expense increased by \$1.6 million, or 71.4%, to \$3.8 million for the nine months ended September 30, 2015 from \$2.2 million for the nine months ended September 30, 2014. Consistent with the third quarter results discussed above, professional fees specifically related to IT projects increased \$696,000. In addition, fees paid to other outside service providers increased \$506,000 primarily due to temp-to-hire employees required to support our strategic IT initiatives while fees paid to our external auditors increased by \$211,000 primarily resulting from additional services due to the inclusion of Alterra. The largest item in the remaining variance is an increase in recruiting expenses related to our search for a new Chief Financial Officer and our ongoing investment in attracting talent, partially offset by a decrease in merger-related costs of \$321,000.

Marketing expense increased by \$916,000, or 81.8%, to \$2.0 million for the nine months ended September 30, 2015 from \$1.1 million for the nine months ended September 30, 2014. The addition of Alterra and related expansion of our marketing efforts into new geographic regions was the primary driver for the increase.



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## Income Taxes

Income tax expense was \$6.2 million for the nine months ended September 30, 2015, with an effective tax rate of 33.2%, compared to income tax expense of \$5.6 million for the nine months ended September 30, 2014, with an effective tax rate of 35.1%. The effective tax rate differs from the federal statutory corporate tax rate as follows:

	For the Nine Months Ended September 30,			
	2015		2014	
Statutory federal tax rate	34.4	%	34.4	%
State taxes, net of federal benefit	4.6		4.7	
FIN 48 expense, net of federal benefit	—		—	
Bank owned life insurance	(1.3	)	(1.3	)
Tax-exempt security and loan income, net of TEFRA adjustments	(3.4	)	(3.4	)
Federal new market tax credit	(1.0	)	—	
Non-deductible transaction costs	—		0.6	
Discrete items	(0.7	)	(0.3	)
Other	0.6		0.4	
	33.3	%	35.1	%

Generally, the provision for income taxes is determined by applying an estimated annual effective income tax rate to income before taxes and adjusting for discrete items. Typically, the rate is based on the most recent annualized forecast of pre-tax income, book versus tax differences and tax credits, if any. If we conclude that a reliable estimated annual effective tax rate cannot be determined, the actual effective tax rate for the year-to-date period may be used.

We re-evaluate the income tax rates each quarter. Therefore, the current projected effective tax rate for the entire year may change.

## Financial Condition

## General

Our total assets increased by \$114.8 million, or 7.0%, to \$1.744 billion as of September 30, 2015 compared to \$1.629 billion at December 31, 2014. The increase in total assets was primarily driven by growth in our loan and lease portfolio.

## Short-term investments

Short-term investments increased by \$17.2 million, or 19.4%, to \$105.5 million at September 30, 2015 from \$88.4 million at December 31, 2014. Our short-term investments primarily consist of interest-bearing deposits held at the FRB. We value the safety and soundness provided by the FRB and therefore we incorporate short-term investments in our on-balance-sheet liquidity program. As of September 30, 2015, our total investment in commercial paper, which is also considered a short-term investment, was \$6.4 million as compared to \$10.4 million at December 31, 2014. We approach our decisions to purchase commercial paper with similar rigor and underwriting standards applied to our loan and lease portfolio. The original maturities of the commercial paper are usually sixty days or less and provide an attractive yield in comparison to other short-term alternatives. These investments also assist us in maintaining a shorter duration of our overall investment portfolio which we believe is necessary to take advantage of an anticipated rising-rate environment. In general, the level of our short-term investments will be influenced by the timing of deposit gathering, scheduled maturities of wholesale deposits, funding of loan growth when opportunities are presented and the level of our available-for-sale securities portfolio. Please refer to Liquidity and Capital Resources for further discussion.

## Securities

Total securities, including available-for-sale and held-to-maturity, decreased by \$4.2 million to \$182.1 million at September 30, 2015 compared to \$186.3 million at December 31, 2014. During the nine months ended September 30, 2015, we recognized unrealized holding gains of \$298,000 before income taxes through other comprehensive income. As of September 30, 2015, our overall securities portfolio, including available-for-sale securities and held-to-maturity securities, had an estimated weighted average expected maturity of 3.01 years. Generally, our investment philosophy

remains unchanged from our statements made in our most recent Annual Report on Form 10-K.

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We use a third-party pricing service as our primary source of market prices for our securities portfolio. On a quarterly basis, we validate the reasonableness of prices received from this source through independent verification of a representative sample of the portfolio, data integrity validation through comparison of current price to prior period prices, and an expectation-based analysis of movement in prices based upon the changes in the related yield curves and other market factors. No securities within our portfolio were deemed to be other-than-temporarily impaired as of September 30, 2015. There were no sales of securities during the three and nine months ended September 30, 2015.

**Loans and Leases Receivable**

Loans and leases receivable, net of allowance for loan and lease losses, increased by \$96.7 million, or 7.6%, to \$1.362 billion at September 30, 2015 from \$1.265 billion at December 31, 2014 primarily due to successful business development efforts in our commercial and industrial (C&I) and commercial real estate (CRE) portfolios. We continue to have a concentration in CRE, as CRE loans represent approximately 64% of our total loans as of September 30, 2015. Over the past year we have generally seen a stabilization in the concentration level as we continue to direct our efforts toward growing our C&I portfolio. The types of loans and leases we originate and the various risks associated with these originations remain consistent with information previously outlined in our most recent Annual Report on Form 10-K.

Our C&I portfolio increased \$33.7 million, or 8.1%, to \$450.3 million at September 30, 2015 from \$416.7 million at December 31, 2014 while our CRE portfolio increased by \$67.5 million, or 8.3%, to \$879.3 million at September 30, 2015 from \$811.8 million at December 31, 2014. We believe loan growth relative to prior years reflects improvement in economic activity within our markets, the ability of our existing business development staff to capture market share from the competition and from the addition of new business development staff across our footprint throughout 2015. While we continue to experience significant competition as banks operating in our primary geographic area attempt to deploy excess liquidity, we remain committed to our underwriting standards. We expect our new loan and lease activity to be more than adequate to replace normal amortization and to continue to grow in future quarters.

Non-performing loans decreased \$85,000, or 0.9%, to \$9.7 million, compared to \$9.8 million at December 31, 2014. The Company's non-performing loans as a percentage of total gross loans and leases measured 0.70% and 0.76% at June 30, 2015 and December 31, 2014, respectively. Likewise, the ratio of non-performing assets to total assets decreased to 0.65% at June 30, 2015, compared to 0.70% at December 31, 2014. We do not expect any material changes in non-accrual loans as a percentage of gross loans and leases; however, we may experience some volatility from time to time. Please refer to Asset Quality for additional information.

**Deposits**

As of September 30, 2015, deposits increased by \$101.1 million to \$1.539 billion from \$1.438 billion at December 31, 2014. The increase in deposits was primarily due to an increase in the level of in-market deposits, specifically transaction accounts, which increased by \$69.8 million to \$378.3 million at September 30, 2015 from \$308.5 million at December 31, 2014. The remainder of the increase from the prior year end was principally due to the increase in wholesale deposits as we continue to strategically use brokered certificates of deposit to mitigate interest rate risk when funding long-term fixed rate loans. Deposit ending balances associated with in-market relationships will fluctuate based upon maturity of time deposits, client demands for the use of their cash, our ability to service and maintain client relationships and new client deposit relationships.

Our strategic efforts continue to be focused on adding in-market relationships and related transaction deposit accounts. We measure the success of deposit gathering efforts based on our ability to maintain the average balances of our in-market deposit accounts consistent with our current period mix and recent trends. Our Banks' in-market deposits, consisting of all transaction accounts, money market accounts and non-wholesale deposits, are obtained primarily from the South Central, Northeastern and Southeastern regions of Wisconsin and the greater Kansas City area. Of our total year-to-date average deposits, approximately \$1.042 billion, or 70.3%, were considered in-market deposits for the nine months ended September 30, 2015. This compares to in-market deposits of \$736.6 million, or 64.2%, for the year-to-date average at September 30, 2014.

The Corporation's operating range of ending wholesale deposits to ending total deposits is 30%-40%. As of September 30, 2015, the ratio of ending wholesale deposits to ending total deposits was 31.0%. We will continue to use wholesale deposits in specific maturity periods needed, typically three to five years, to effectively mitigate interest

rate risk measured through our asset/liability management process and to support asset growth initiatives while taking into consideration our operating goals and desired level of wholesale deposits. Refer to Liquidity and Capital Resources for further information regarding our use and monitoring of wholesale deposits.

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## FHLB Advances and Other Borrowings

As of September 30, 2015, FHLB advances and other borrowings increased by \$2.4 million, or 6.9%, to \$36.4 million from \$34.0 million at December 31, 2014. The primary reason for the increase in borrowings was due to a \$2.0 million draw on our third party secured line of credit which was used for general operations and other temporary cash flow mismatches.

## Asset Quality

## Non-performing Assets

Our total impaired assets consisted of the following at September 30, 2015 and December 31, 2014, respectively:

	September 30, 2015	December 31, 2014		
	(Dollars in Thousands)			
Non-accrual loans and leases				
Commercial real estate:				
Commercial real estate - owner occupied	\$1,154	\$500		
Commercial real estate - non-owner occupied	273	286		
Construction and land development	4,366	4,932		
Multi-family	6	17		
1-4 family	1,496	690		
Total non-accrual commercial real estate	7,295	6,425		
Commercial and industrial	1,401	2,318		
Direct financing leases, net	—	—		
Consumer and other:				
Home equity and second mortgages	341	329		
Other	670	720		
Total non-accrual consumer and other loans	1,011	1,049		
Total non-accrual loans and leases	9,707	9,792		
Performing troubled debt restructurings	7,852	2,003		
Total impaired loans and leases	17,559	11,795		
Foreclosed properties, net	1,632	1,693		
Total impaired assets	\$19,191	\$13,488		
Total non-accrual loans and leases to gross loans and leases	0.70	%	0.76	%
Total non-performing assets to total loans and leases plus other real estate owned	0.82		0.89	
Total non-performing assets to total assets	0.65		0.70	
Allowance for loan and lease losses to gross loans and leases	1.11		1.12	
Allowance for loan and lease losses to non-accrual loans and leases	158.22		146.33	

As of September 30, 2015 and December 31, 2014, \$6.8 million and \$7.4 million of the non-accrual loans were considered troubled debt restructurings, respectively.

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A summary of our non-accrual loan and lease activity from December 31, 2014 through September 30, 2015 is as follows:

(In Thousands)

Non-accrual loans and leases as of the beginning of the period	\$9,792	
Loans and leases transferred to non-accrual status	8,956	
Accretion of the fair value discount on purchased credit impaired loans	28	
Non-accrual loans and leases returned to accrual status	(6,245	)
Non-accrual loans and leases transferred to foreclosed properties	(289	)
Non-accrual loans and leases partially or fully charged-off	(546	)
Cash received and applied to principal of non-accrual loans and leases	(1,989	)
Non-accrual loans and leases as of the end of the period	\$9,707	

We use a wide variety of available metrics to assess the overall asset quality of the portfolio and no one metric is used independently to make a final conclusion as to the asset quality of the portfolio. As of September 30, 2015, non-performing assets as a percentage of total assets decreased to 0.65% from 0.70% at December 31, 2014. The decrease in non-performing assets is primarily due to cash collections on previously identified impaired loans and various partial charge-offs.

We also monitor early stage delinquencies to assist in the identification of potential future problems. As of September 30, 2015, the payment performance did not point to any new areas of concern, as approximately 99.7% of the loan and lease portfolio was in a current payment status. This metric can change rapidly however, if factors unknown to us change. We also monitor our asset quality through our established credit quality indicator categories. We are generally seeing positive trends with improving percentages of loans and leases in our higher quality loan categories which is indicative of overall credit quality improvement. While overall asset quality has improved, we will continue to actively monitor the credit quality of our loan and lease portfolios. Through this monitoring effort, we may identify additional loans and leases for which the borrowers or lessees are having difficulties making the required principal and interest payments based upon factors including, but not limited to, the inability to sell the underlying collateral, inadequate cash flow from the operations of the underlying businesses, liquidation events, or bankruptcy filings. We generally work proactively with our impaired loan borrowers to find meaningful solutions to difficult situations that are in the best interests of the Banks. Given our current low level of non-accrual loans, any meaningful improvement in reducing this balance further will likely be at a slower pace than what has been accomplished over the last several years. We expect to demonstrate an overall declining trend of non-accrual loan balances; however, we may experience some volatility in this trend from time to time.

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The following represents additional information regarding our impaired loans and leases:

	As of and for the Nine Months Ended September 30,		As of and for the Year Ended December 31,
	2015 (In Thousands)	2014	2014
Impaired loans and leases with no impairment reserves required	\$ 15,657	\$ 15,347	\$ 11,270
Impaired loans and leases with impairment reserves required	1,903	1,046	525
Total impaired loans and leases	17,560	16,393	11,795
Less:			
Impairment reserve (included in allowance for loan and lease losses)	560	411	290
Net impaired loans and leases	\$ 17,000	\$ 15,982	\$ 11,505
Average impaired loans and leases	\$ 12,947	\$ 14,940	\$ 14,474
Foregone interest income attributable to impaired loans and leases	\$ 453	\$ 657	\$ 870
Less: Interest income recognized on impaired loans and leases	12	311	740
Net foregone interest income on impaired loans and leases	\$ 441	\$ 346	\$ 130

Non-performing assets also include foreclosed properties. A summary of our current-period foreclosed properties activity is as follows:

(In Thousands)

Foreclosed properties as of December 31, 2014	\$ 1,693
Loans transferred to foreclosed properties	289
Proceeds from sale of foreclosed properties	(528 )
Net gain on sale of foreclosed properties	207
Impairment valuation	(29 )
Foreclosed properties as of September 30, 2015	\$ 1,632

Allowance for loan and lease losses.

The allowance for loan and lease losses as a percentage of gross loans and leases was 1.11% as of September 30, 2015 and 1.12% as of December 31, 2014. During the nine months ended September 30, 2015, we recorded net charge-offs on impaired loans and leases of approximately \$461,000, comprised of \$546,000 of charge-offs and \$85,000 of recoveries. During the nine months ended September 30, 2014, we recorded net recoveries on impaired loans and leases of approximately \$29,000, comprised of \$2,000 of charge-offs and \$31,000 of recoveries.

While charge-offs have been relatively low in recent periods, we will continue to experience some level of periodic charge-offs in the future as exit strategies are considered and executed. Loans and leases with previously established specific reserves may ultimately result in a charge-off under a variety of scenarios. There have been no substantive changes to our methodology for estimating the appropriate level of allowance for loan and lease loss reserves from what was previously outlined in our most recent Annual Report on Form 10-K. Based upon this methodology, which includes actively monitoring the asset quality and inherent risks within the loan and lease portfolio, management concluded that an allowance for loan and lease losses of \$15.4 million, or 1.11% of total loans and leases, was appropriate as of September 30, 2015. Given ongoing complexities with current workout situations and the measured pace of improvement in economic conditions, further charge-offs and increased provisions for loan and lease losses may be recorded if additional facts and circumstances lead us to a different conclusion. In addition, various federal and state regulatory agencies review appropriateness of the allowance for loan and lease losses. These agencies could require certain loan and lease balances to be classified differently or charged off if their credit evaluations differ from

those of management, based on their judgments about information available to them at the time of their examination.

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As of September 30, 2015 and December 31, 2014, our allowance for loan and lease losses to total non-accrual loans and leases was 158.22% and 146.33%, respectively. Impaired loans and leases exhibit weaknesses that inhibit repayment in compliance with the original terms of the note or lease. However, the measurement of impairment on loans and leases may not always result in a specific reserve included in the allowance for loan and lease losses. As part of the underwriting process, as well as our ongoing monitoring efforts, we endeavor to have appropriate collateral to protect our interest in the related loan or lease. As a result of this practice, a significant portion of our outstanding balance of non-performing loans or leases either does not require additional specific reserves or requires only a minimal amount of required specific reserve, as we believe the loans and leases are adequately collateralized as of the measurement period. In addition, management is proactive in recording charge-offs to bring loans to their net realizable value in situations where it is determined with certainty that we will not recover the entire amount of our principal. This practice may lead to a lower allowance for loan and lease loss to non-accrual loans and leases ratio as compared to our peers or industry expectations. In general, as asset quality remains strong, our allowance for loan and lease loss is measured more through general characteristics, including historical loss experience of our portfolio rather than through specific identification and we therefore expect to see this ratio to rise. If we identify additional impaired loans which are adequately collateralized and therefore require no specific or general reserve, this ratio could fall. Given our business practices and evaluation of our existing loan and lease portfolio, we believe this coverage ratio is appropriate for the probable losses inherent in our loan and lease portfolio as of September 30, 2015.

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

	As of and for the Three Months		As of and for the Nine Months	
	Ended September 30,		Ended September 30,	
	2015	2014	2015	2014
	(Dollars in Thousands)			
Allowance at beginning of period	\$15,199	\$14,015	\$14,329	\$13,901
Charge-offs:				
Commercial real estate				
Commercial real estate — owner occupied	—	—	—	—
Commercial real estate — non-owner occupied	—	—	—	—
Construction and land development	—	—	—	—
Multi-family	—	—	—	—
1-4 family	(3	) —	(94	) —
Commercial and industrial	(135	) —	(448	) —
Direct financing leases	—	—	—	—
Consumer and other				
Home equity and second mortgages	—	—	—	—
Other	—	(2	) (4	) (2
Total charge-offs	(138	) (2	) (546	)
Recoveries:				
Commercial real estate				
Commercial real estate — owner occupied	—	—	—	8
Commercial real estate — non-owner occupied	—	—	—	4
Construction and land development	8	—	69	—
Multi-family	—	—	—	—
1-4 family	2	3	6	8
Commercial and industrial	—	—	6	1
Direct financing leases	—	—	—	—
Consumer and other				
Home equity and second mortgages	1	3	3	10
Other	—	—	1	—
Total recoveries	11	6	85	31
Net (charge-offs) recoveries	(127	) 4	(461	) 29
Provision for loan and lease losses	287	(89	) 1,491	—
Allowance at end of period	\$15,359	\$13,930	\$15,359	\$13,930
Annualized net charge-offs as a % of average gross loans and leases	(0.04	)% —	% (0.05	)% —
				%

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## Liquidity and Capital Resources

The Corporation expects to meet its liquidity needs through existing cash on hand, established cash flow sources, its third party senior line of credit and dividends received from the Banks. While the Banks are subject to certain regulatory limitations regarding their ability to pay dividends to the Corporation, we do not believe that the Corporation will be adversely affected by these dividend limitations. The Corporation's principal liquidity requirements at September 30, 2015 were the interest payments due on subordinated and junior subordinated notes. FBB has declared and paid \$4.0 million in dividends through September 30, 2015. During the year ended December 31, 2014, FBB declared and paid dividends totaling \$8.0 million. The capital ratios of the Corporation and its subsidiaries continue to meet all applicable regulatory capital adequacy requirements. The Corporation's and the Banks' respective Boards of Directors and management teams adhere to the appropriate regulatory guidelines on decisions which affect their capital positions, including but not limited to, decisions relating to the payment of dividends and increasing indebtedness.

The Banks maintain liquidity by obtaining funds from several sources. The Banks' primary sources of funds are principal and interest repayments on loans receivable and mortgage-related securities, deposits and other borrowings, such as federal funds and FHLB 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.

We view on-balance-sheet liquidity as a critical element to maintaining adequate liquidity to meet our cash and collateral obligations. We define our on-balance-sheet liquidity as the total of our short-term investments, our unencumbered securities' fair value and our unencumbered pledged loans. As of September 30, 2015 and December 31, 2014, our immediate on-balance-sheet liquidity was \$334.7 million and \$290.8 million, respectively. At September 30, 2015 and December 31, 2014, the Banks had \$93.1 million and \$70.5 million on deposit with the FRB, respectively. Any excess funds not used for loan funding or satisfying other cash obligations were maintained as part of our on-balance-sheet liquidity in our interest-bearing accounts with the FRB, as we value the safety and soundness provided by the FRB. We plan to utilize excess liquidity to fund loan and lease portfolio growth, pay down maturing debt, allow run-off of maturing brokered certificates of deposit, or invest in securities to maintain adequate liquidity at an improved margin.

We had \$476.6 million of outstanding wholesale deposits at September 30, 2015, compared to \$427.3 million of wholesale deposits as of December 31, 2014, which represented 31.0% and 29.7%, respectively, of the ending balance of total deposits. While we are committed to our continued efforts to raise in-market deposits and maintain our overall mix of wholesale deposits and in-market deposits, wholesale deposits continue to be an efficient source of funding for the Banks and allow them to gather funds across a larger geographic base at price levels and maturities that are more attractive than local time deposits when required to raise a similar level of in-market deposits within a short time period. Access to such deposits allows us the flexibility to refrain from pursuing single-service deposit relationships in markets that have experienced unfavorable pricing levels. In addition, the administrative costs associated with wholesale deposits are considerably lower than those that would be incurred to administer a similar level of local deposits with a similar maturity structure. During the time frames necessary to accumulate wholesale deposits in an orderly manner, we will use FHLB short-term advances to meet our temporary funding needs. The FHLB short-term advances will typically have terms of one week to one month to cover the overall expected funding demands. Our in-market relationships remain stable; however, deposit balances associated with those relationships will fluctuate. We expect to establish new client relationships and continue marketing efforts aimed at increasing the balances in existing clients' deposit accounts. Nonetheless, we will continue to use wholesale deposits in specific maturity periods, typically three to five years, needed to effectively mitigate the interest rate risk measured through our asset/liability management process or in shorter time periods if in-market deposit balances decline. In order to provide for ongoing liquidity and funding, all of our wholesale deposits are certificates of deposit which do not allow for withdrawal at the option of the depositor before the stated maturity with the exception of deposits accumulated through the internet listing service which have the same early withdrawal privileges and fees as do our other in-market deposits. The Banks limit the percentage of wholesale deposits to total deposits in accordance with liquidity policies approved by their respective Boards of Directors. The Corporation's overall operating range of wholesale deposits to

total deposits is 30%-40%. The Banks were in compliance with their respective policy limits as of September 30, 2015 and December 31, 2014.

The Banks were able to access the wholesale deposit market as needed at rates and terms comparable to market standards during the nine-month period ended September 30, 2015. In the event there is a disruption in the availability of wholesale deposits at maturity, the Banks have managed the maturity structure, in compliance with our approved liquidity policy, so at least one year of maturities could be funded through on-balance-sheet liquidity. These potential funding sources include deposits with the FRB and borrowings from the FHLB or Federal Reserve Discount Window utilizing currently unencumbered securities and acceptable loans as collateral. As of September 30, 2015, the available liquidity was in excess of

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the stated policy minimum. As on-balance-sheet liquidity is utilized to fund growth, asset quality remains stable and the ratio of in-market deposits to total deposits remains within an acceptable range, management may consider reducing the number of months of maturity coverage slightly while remaining confident in its ability to manage the maturities of wholesale deposits in the event of a disruption in the wholesale market. We believe the Banks will also have access to the unused federal funds lines, cash flows from borrower repayments and cash flows from security maturities. The Banks also have the ability to raise local market deposits by offering attractive rates to generate the level required to fulfill their liquidity needs.

The Banks are required by federal regulation to maintain sufficient liquidity to ensure safe and sound operations. We believe the Banks have sufficient liquidity to match the balance of net withdrawable deposits and short-term borrowings in light of present economic conditions and deposit flows.

During the nine months ended September 30, 2015, operating activities resulted in a net cash inflow of \$12.1 million. Operating cash flows included net income of \$12.4 million. Net cash used in investing activities for the nine months ended September 30, 2015 was approximately \$93.5 million which consisted of cash outflows to fund net loan growth and reinvestment of cash flows within purchases of additional securities available-for-sale offset by cash inflows from maturities, redemptions and paydowns of available-for-sale and held-to-maturity securities. Net cash provided by financing activities for the nine months ended September 30, 2015 was \$100.8 million primarily from net increases in deposits and the use of our unsecured senior line of credit for general operations and other temporary cash flow mismatches. Please refer to the Consolidated Statements of Cash Flows for further details regarding significant sources of cash flow for the Corporation.

### Contractual Obligations and Off-Balance-Sheet Arrangements

As of September 30, 2015, there were no significant changes to our contractual obligations and off-balance-sheet arrangements disclosed in our Annual Report on Form 10-K for the year ended December 31, 2014. We continue to believe that we have 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 and net interest income 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 Boards 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. In this measurement technique 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 that include a simultaneous, instant and sustained change in interest rates. 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. In general, 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 and the corresponding effect of contractual interest rate floors, 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. Currently, we do not employ any derivatives to assist in managing our interest rate risk exposure; however, management has the authorization, as permitted within applicable approved policies, and ability to utilize such instruments should they be appropriate to manage interest rate exposure.

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 changes in interest rates at September 30, 2015 has not changed materially since December 31, 2014.

#### Item 4. Controls and Procedures

##### Disclosure 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, as amended). 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, 2015.

##### Changes in Internal Control over Financial Reporting

There was no change in the Corporation's internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) that occurred during the quarter ended September 30, 2015 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

## 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

There were no material changes to the risk factors previously disclosed in Item 1A. to Part I of the Corporation's Form 10-K for the year ended December 31, 2014.

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

(a) None.

(b) Not applicable.

#### (c) Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased <sup>(1)</sup>	Average Price Paid Per Share	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, 2015 - July 31, 2015	—	\$—	—	\$—
August 1, 2015 - August 31, 2015	11,285	\$43.95	—	\$—
September 1, 2015 - September 30, 2015	—	\$—	—	\$—
Total	11,285	\$—	—	\$—

(1) The shares in this column represent the shares that were surrendered to us to satisfy income tax withholding obligations in connection with the vesting of restricted shares.

Item 3. Defaults Upon Senior Securities  
Not applicable.

Item 4. Mine Safety Disclosures  
Not applicable.

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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. Section 1350

101 The following financial information from First Business Financial Services, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2015, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets as of September 30, 2015 and December 31, 2014, (ii) Consolidated Statements of Income for the three and nine months ended September 30, 2015 and 2014, (iii) Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2015 and 2014, (iv) Consolidated Statements of Changes in Stockholders' Equity for the three and nine months ended September 30, 2015 and 2014, (v) Consolidated Statements of Cash Flows for the nine months ended September 30, 2015 and 2014, and (vi) the Notes to Unaudited Consolidated Financial Statements

Signatures

Pursuant to the requirements 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.

October 30, 2015

/s/ Corey A. Chambas  
Corey A. Chambas  
Chief Executive Officer

October 30, 2015

/s/ James F. Ropella  
James F. Ropella  
Chief Financial Officer (Principal Financial and Accounting  
Officer)



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FIRST BUSINESS FINANCIAL SERVICES, INC.

Exhibit Index to Quarterly Report on Form 10-Q

Exhibit Number

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