

FIRST BUSINESS FINANCIAL SERVICES, INC.

Form 10-Q

July 27, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2018

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number 001-34095

FIRST BUSINESS FINANCIAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

Wisconsin

39-1576570

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

401 Charmany Drive, Madison, WI 53719

(Address of Principal Executive Offices) (Zip Code)

(608) 238-8008

Registrant's telephone number, including area code

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

|  |   |  |  |  |
|--|---|--|--|--|
| Large accelerated filer <input type="checkbox"/> | Accelerated filer <input checked="" type="checkbox"/> | Non-accelerated filer <input type="checkbox"/> | Smaller reporting company <input type="checkbox"/> | Emerging growth company <input type="checkbox"/> |
|--|---|--|--|--|

(Do not check if a smaller reporting company)

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares outstanding of the registrant's sole class of common stock, par value \$0.01 per share, on July 26, 2018 was 8,760,103 shares.

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## PART I. Financial Information

## Item 1. Financial Statements

## First Business Financial Services, Inc.

## Consolidated Balance Sheets

|  | June 30,<br>2018<br>(Unaudited)      | December 31,<br>2017 |
|--|--------------------------------------|----------------------|
|  | (In Thousands, Except<br>Share Data) |                      |
| Assets   |                                      |                      |
| Cash and due from banks  | \$21,433                             | \$ 17,059            |
| Short-term investments   | 24,370                               | 35,480               |
| Cash and cash equivalents  | 45,803                               | 52,539               |
| Securities available-for-sale, at fair value   | 135,470                              | 126,005              |
| Securities held-to-maturity, at amortized cost   | 40,946                               | 37,778               |
| Loans held for sale  | 4,976                                | 2,194                |
| Loans and leases receivable, net of allowance for loan and lease losses of \$20,932 and \$18,763, respectively   | 1,574,021                            | 1,482,832            |
| Premises and equipment, net  | 3,358                                | 3,156                |
| Foreclosed properties  | 1,484                                | 1,069                |
| Bank-owned life insurance  | 40,912                               | 40,323               |
| Federal Home Loan Bank stock, at cost  | 9,295                                | 5,670                |
| Goodwill and other intangible assets   | 12,380                               | 12,652               |
| Accrued interest receivable and other assets   | 31,142                               | 29,848               |
| Total assets   | \$1,899,787                          | \$ 1,794,066         |
| Liabilities and Stockholders' Equity   |                                      |                      |
| Deposits   |                                      |                      |
| Federal Home Loan Bank advances and other borrowings   | \$1,337,725                          | \$ 1,394,331         |
| Junior subordinated notes  | 365,416                              | 207,898              |
| Accrued interest payable and other liabilities   | 10,026                               | 10,019               |
| Total liabilities  | 12,948                               | 12,540               |
|  | 1,726,115                            | 1,624,788            |
| Stockholders' equity:  |                                      |                      |
| Preferred stock, \$0.01 par value, 2,500,000 shares authorized, none issued or outstanding   | —                                    | —                    |
| Common stock, \$0.01 par value, 25,000,000 shares authorized, 9,018,953 and 9,021,985 shares issued, 8,760,103 and 8,763,539 shares outstanding at June 30, 2018 and December 31, 2017, respectively | 90                                   | 90                   |
| Additional paid-in capital   | 79,126                               | 78,620               |
| Retained earnings  | 103,391                              | 98,906               |
| Accumulated other comprehensive loss   | (1,824                               | ) (1,238             |
| Treasury stock, 258,850 and 258,446 shares at June 30, 2018 and December 31, 2017, respectively, at cost   | (7,111                               | ) (7,100             |
| Total stockholders' equity   | 173,672                              | 169,278              |
| Total liabilities and stockholders' equity   | \$1,899,787                          | \$ 1,794,066         |

See accompanying Notes to Unaudited Consolidated Financial Statements.

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Consolidated Statements of Income (Unaudited)

|   | For the Three<br>Months Ended<br>June 30,<br>2018 |          | For the Six<br>Months Ended<br>June 30,<br>2017 |          |
|---|---|----------|---|----------|
|   | 2018  | 2017     | 2018  | 2017     |
|   | (In Thousands, Except Per Share Data)             |          |   |          |
| Interest income   |   |          |   |          |
| Loans and leases  | \$21,243  | \$18,284 | \$40,904  | \$35,806 |
| Securities  | 938   | 776      | 1,794   | 1,555    |
| Short-term investments  | 287   | 165      | 491   | 311      |
| Total interest income   | 22,468  | 19,225   | 43,189  | 37,672   |
| Interest expense  |   |          |   |          |
| Deposits  | 3,209   | 2,658    | 6,038   | 5,331    |
| Federal Home Loan Bank advances and other borrowings          | 2,051   | 811      | 3,467   | 1,422    |
| Junior subordinated notes                                     | 277   | 277      | 552   | 552      |
| Total interest expense  | 5,537   | 3,746    | 10,057  | 7,305    |
| Net interest income   | 16,931  | 15,479   | 33,132  | 30,367   |
| Provision for loan and lease losses                           | 2,579   | 3,656    | 5,054   | 4,228    |
| Net interest income after provision for loan and lease losses | 14,352  | 11,823   | 28,078  | 26,139   |
| Non-interest income   |   |          |   |          |
| Trust and investment service fees                             | 1,987   | 1,648    | 3,884   | 3,277    |
| Gain on sale of Small Business Administration loans           | 274   | 535      | 543   | 895      |
| Service charges on deposits                                   | 720   | 766      | 1,504   | 1,531    |
| Loan fees   | 389   | 675      | 917   | 1,133    |
| Increase in cash surrender value of bank-owned life insurance | 297   | 316      | 589   | 627      |
| Commercial loan swap fees                                     | 70  | 250      | 703   | 449      |
| Other non-interest income                                     | 245   | 548      | 508   | 889      |
| Total non-interest income                                     | 3,982   | 4,738    | 8,648   | 8,801    |
| Non-interest expense  |   |          |   |          |
| Compensation  | 9,116   | 8,382    | 18,187  | 17,065   |
| Occupancy   | 544   | 519      | 1,073   | 994      |
| Professional fees   | 928   | 1,041    | 1,963   | 2,051    |
| Data processing   | 626   | 635      | 1,236   | 1,219    |
| Marketing   | 591   | 582      | 925   | 952      |
| Equipment   | 343   | 300      | 686   | 583      |
| Computer software   | 679   | 639      | 1,420   | 1,322    |
| FDIC insurance  | 369   | 381      | 668   | 761      |
| Collateral liquidation costs                                  | 222   | 77       | 223   | 185      |
| Impairment of tax credit investments                          | 329   | 112      | 442   | 225      |
| SBA recourse provision (benefit)                              | 99  | 774      | (196)   | 780      |
| Other non-interest expense                                    | 621   | 779      | 1,747   | 1,644    |
| Total non-interest expense                                    | 14,467  | 14,221   | 28,374  | 27,781   |
| Income before income tax expense                              | 3,867   | 2,340    | 8,352   | 7,159    |
| Income tax expense  | 578   | 454      | 1,414   | 1,876    |
| Net income  | \$3,289   | \$1,886  | \$6,938   | \$5,283  |
| Earnings per common share                                     |   |          |   |          |
| Basic   | \$0.38  | \$0.22   | \$0.79  | \$0.61   |

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|                              |      |      |      |      |
|------------------------------|------|------|------|------|
| Diluted                      | 0.38 | 0.22 | 0.79 | 0.61 |
| Dividends declared per share | 0.14 | 0.13 | 0.28 | 0.26 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

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Consolidated Statements of Comprehensive Income (Unaudited)

|   | For the Three<br>Months Ended<br>June 30,<br>2018 |         | For the Six<br>Months Ended<br>June 30,<br>2017 |         |   |
|---|---|---------|---|---------|---|
|   | 2018  | 2017    | 2018  | 2017    |   |
|   | (In Thousands)                                    |         |   |         |   |
| Net income  | \$3,289   | \$1,886 | \$6,938   | \$5,283 |   |
| Other comprehensive loss, before tax                                      |   |         |   |         |   |
| Securities available-for-sale:  |   |         |   |         |   |
| Unrealized securities (losses) gains arising during the period            | (531  | ) 109   | (1,890  | ) 26    |   |
| Securities held-to-maturity:  |   |         |   |         |   |
| Amortization of net unrealized losses transferred from available-for-sale | 17  | 29      | 36  | 55      |   |
| Interest rate swaps:  |   |         |   |         |   |
| Unrealized gains on interest rate swaps arising during the period         | 358   | —       | 1,030   | —       |   |
| Income tax benefit (expense)  | 73  | (53     | ) 238   | (50     | ) |
| Total other comprehensive (loss) income                                   | (83   | ) 85    | (586  | ) 31    |   |
| Comprehensive income  | \$3,206   | \$1,971 | \$6,352   | \$5,314 |   |

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<br>Shares<br>Outstanding   | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Treasury<br>Stock | Total     |
|---|-----------------------------------|-----------------|----------------------------------|----------------------|---|-------------------|-----------|
|   | (In Thousands, Except Share Data) |                 |                                  |                      |   |                   |           |
| Balance at December 31, 2016                      | 8,715,856                         | \$ 90           | \$ 77,542                        | \$91,317             | \$ (522 )                                     | \$(6,777)         | \$161,650 |
| Net income  | —                                 | —               | —                                | 5,283                | —   | —                 | 5,283     |
| Other comprehensive income                        | —                                 | —               | —                                | —                    | 31  | —                 | 31        |
| Share-based compensation - restricted shares, net | (484 )                            | —               | 544                              | —                    | —   | —                 | 544       |
| Cash dividends (\$0.26 per share)                 | —                                 | —               | —                                | (2,267 )             | —   | —                 | (2,267 )  |
| Treasury stock purchased                          | (309 )                            | —               | —                                | —                    | —   | (7 )              | (7 )      |
| Balance at June 30, 2017                          | 8,715,063                         | \$ 90           | \$ 78,086                        | \$94,333             | \$ (491 )                                     | \$(6,784)         | \$165,234 |

|   | Common<br>Shares<br>Outstanding   | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Treasury<br>Stock | Total     |
|---|-----------------------------------|-----------------|----------------------------------|----------------------|---|-------------------|-----------|
|   | (In Thousands, Except Share Data) |                 |                                  |                      |   |                   |           |
| Balance at December 31, 2017                      | 8,763,539                         | \$ 90           | \$ 78,620                        | \$98,906             | \$ (1,238 )                                   | \$(7,100)         | \$169,278 |
| Net income  | —                                 | —               | —                                | 6,938                | —   | —                 | 6,938     |
| Other comprehensive loss                          | —                                 | —               | —                                | —                    | (586 )  | —                 | (586 )    |
| Share-based compensation - restricted shares, net | (3,032 )                          | —               | 506                              | —                    | —   | —                 | 506       |
| Cash dividends (\$0.28 per share)                 | —                                 | —               | —                                | (2,453 )             | —   | —                 | (2,453 )  |
| Treasury stock purchased                          | (404 )                            | —               | —                                | —                    | —   | (11 )             | (11 )     |
| Balance at June 30, 2018                          | 8,760,103                         | \$ 90           | \$ 79,126                        | \$103,391            | \$ (1,824 )                                   | \$(7,111)         | \$173,672 |

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 Six Months<br>Ended June 30, |           |
|---|--------------------------------------|-----------|
|   | 2018                                 | 2017      |
|   | (In Thousands)                       |           |
| Operating activities  |                                      |           |
| Net income  | \$6,938                              | \$5,283   |
| Adjustments to reconcile net income to net cash provided by operating activities:   |                                      |           |
| Deferred income taxes, net  | 221                                  | (149 )    |
| Impairment of tax credit investments  | 442                                  | 225       |
| Provision for loan and lease losses   | 5,054                                | 4,228     |
| Depreciation, amortization and accretion, net                                       | 727                                  | 731       |
| Share-based compensation  | 506                                  | 544       |
| Increase in value of bank-owned life insurance policies                             | (589 )                               | (627 )    |
| Origination of loans for sale   | (43,519 )                            | (14,153 ) |
| Sale of loans originated for sale   | 41,280                               | 12,694    |
| Gain on sale of loans originated for sale   | (543 )                               | (921 )    |
| Excess tax benefit from share-based compensation                                    | (10 )                                | (7 )      |
| Returns on investments in limited partnerships                                      | —                                    | 92        |
| Net increase in accrued interest receivable and other assets                        | (704 )                               | (1,014 )  |
| Net increase in accrued interest payable and other liabilities                      | 1,177                                | 2,174     |
| Net cash provided by operating activities   | 10,980                               | 9,100     |
| Investing activities  |                                      |           |
| Proceeds from maturities, redemptions and paydowns of available-for-sale securities | 14,738                               | 19,541    |
| Proceeds from maturities, redemptions and paydowns of held-to-maturity securities   | 1,672                                | 1,814     |
| Proceeds from sale of available-for-sale securities                                 | —                                    | 5,063     |
| Purchases of available-for-sale securities  | (26,269 )                            | (15,930 ) |
| Purchases of held-to-maturity securities  | (4,867 )                             | (1,027 )  |
| Net increase in loans and leases  | (96,620 )                            | (10,803 ) |
| Investments in limited partnerships   | —                                    | (500 )    |
| Returns of investments in limited partnerships                                      | 316                                  | —         |
| Investment in historic development entities   | (905 )                               | —         |
| Investment in Federal Home Loan Bank stock  | (7,388 )                             | (7,454 )  |
| Proceeds from the sale of Federal Home Loan Bank stock                              | 3,763                                | 6,770     |
| Purchases of leasehold improvements and equipment, net                              | (611 )                               | (635 )    |
| Net cash used in investing activities   | (116,171)                            | (3,161 )  |
| Financing activities  |                                      |           |
| Net decrease in deposits  | (56,606 )                            | (64,241 ) |
| Repayment of Federal Home Loan Bank advances  | (490,500)                            | (260,916) |
| Proceeds from Federal Home Loan Bank advances                                       | 648,000                              | 309,415   |
| Proceeds from issuance of subordinated notes payable                                | —                                    | 9,090     |
| Repayment of subordinated notes payable   | —                                    | (7,877 )  |
| Net increase (decrease) in other borrowed funds                                     | 25                                   | (2,908 )  |
| Cash dividends paid   | (2,453 )                             | (2,267 )  |
| Purchase of treasury stock  | (11 )                                | (7 )      |
| Net cash provided by (used in) financing activities                                 | 98,455                               | (19,711 ) |
| Net decrease in cash and cash equivalents   | (6,736 )                             | (13,772 ) |



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|   |          |          |
|---|----------|----------|
| Cash and cash equivalents at the beginning of the period      | 52,539   | 77,517   |
| Cash and cash equivalents at the end of the period            | \$45,803 | \$63,745 |
| Supplementary cash flow information                           |          |          |
| Cash paid during the period for:                              |          |          |
| Interest paid on deposits and borrowings                      | \$9,212  | \$7,359  |
| Income taxes paid   | 646      | 339      |
| Non-cash investing and financing activities:                  |          |          |
| Transfer of loans from held-to-maturity to held-for-sale      | —        | 6,966    |
| Transfer from loans to foreclosed properties                  | 415      | —        |
| Transfer from premises and equipment to foreclosed properties | —        | 1,113    |

See accompany 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”), through our wholly owned subsidiary, First Business Bank (“FBB” or the “Bank”), have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). FBB operates as a commercial banking institution primarily in the Wisconsin and greater Kansas City markets. FBB also offers trust and investment services through First Business Trust & Investments (“FBTI”) and investment portfolio administrative services and asset/liability management services through First Business Consulting Services (“FBCS”), both divisions of FBB. The Bank provides a full range of financial services to businesses, business owners, executives, professionals and high net worth individuals. The Bank is subject to competition from other financial institutions and service providers and is 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”), ABKC Real Estate, LLC (“ABKC”), Rimrock Road Investment Fund, LLC (“Rimrock Road”), BOC Investment, LLC (“BOC”), Mitchell Street Apartments Investment, LLC (“Mitchell Street”) and FBB Tax Credit Investment LLC (“FBB Tax Credit”). FMIC is located in and was formed under the laws of the state of Nevada.

Basis of Presentation. The accompanying unaudited Consolidated Financial Statements were prepared in accordance with GAAP and 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, 2017. The unaudited Consolidated Financial Statements include the accounts of the Corporation and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. 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.

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 securities and interest rate swaps, level of the allowance for loan and lease losses, lease residuals, property under operating leases, goodwill, level of the Small Business Administration (“SBA”) recourse reserve and income taxes. The results of operations for the six month period ended June 30, 2018 are not necessarily indicative of results that may be expected for any other interim period or the entire fiscal year ending December 31, 2018. 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 unaudited 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, 2017.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606).” 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 to in exchange for those goods or services. The Corporation adopted ASU 2014-09 and all subsequent amendments to the ASU (collectively, “ASC 606”) in the first quarter of 2018 with no material impact on its results of operations, financial position and liquidity.

In January 2016, the FASB issued ASU No. 2016-01, “Financial Instruments (Subtopic 825-10).” The ASU amends certain aspects of recognition, measurement, presentation and disclosure of financial instruments. This amendment

supersedes the guidance to classify equity securities with readily determinable fair values into different categories, requires equity securities to be measured at fair value with changes in the fair value recognized through net income and simplifies the impairment assessment of equity investments without readily determinable fair values. The amendment requires public business entities that are required to disclose the fair value of financial instruments measured at amortized cost on the balance sheet to measure that fair value using the exit price notion. The amendment requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit

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risk when the entity has elected to measure the liability at fair value in accordance with the fair value option. The Corporation adopted the accounting standard during the first quarter of 2018 and modified its fair value disclosure of financial instruments to reflect an exit price notion. The adoption of the standard did not have a material impact on the Corporation's results of operations, financial position and liquidity.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." The ASU intends to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities and disclosing key information about leasing arrangements. The ASU will require lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) a lease liability, which is a lessees' obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The new lease guidance simplifies the accounting for sale and leaseback transactions primarily because lessees must recognize lease assets and lease liabilities. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. The ASU is effective for public companies for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, with early adoption permitted. The Corporation intends to adopt the accounting standard during the first quarter of 2019, as required, and is currently evaluating the impact on its results of operations, financial position and liquidity. The Corporation leases office space, loan production offices and specialty financing production offices under noncancelable operating leases which expire on various dates through 2028. The Corporation also leases office equipment. Future minimum lease payments for noncancelable operating leases as of June 30, 2018 was \$11.0 million.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments- Credit Losses (Topic 326)." The ASU replaces the incurred loss impairment methodology for recognizing credit losses with a methodology that reflects all expected credit losses. The ASU also requires consideration of a broader range of information to inform credit loss estimates, including such factors as past events, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures and any other financial asset not excluded from the scope that have the contractual right to receive cash. Entities will apply the amendments in the ASU through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. The ASU is effective for public companies for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted as of the fiscal years beginning after December 15, 2018. The Corporation intends to adopt the accounting standard during the first quarter of 2020, as required, and is currently evaluating the impact on its results of operations, financial position and liquidity. A cross-functional team has been established and a third-party software solution has been obtained to assist with the implementation of the standard. Management is in the process of gathering necessary data and reviewing potential methods to calculate the expected credit losses.

In June 2018, the FASB issued ASU No. 2018-07, "Compensation- Stock Compensation (Topic 718)." The ASU expands the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. The ASU is effective for public companies for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. 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 its results of operations, financial position and liquidity.

**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, or dividend equivalents, 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.

There were no anti-dilutive employee share-based awards for the three and six month periods ended June 30, 2018 and 2017.

|  | For the Three<br>Months Ended<br>June 30,<br>2018 |           | For the Six<br>Months Ended<br>June 30,<br>2017 |           |
|--|---|-----------|---|-----------|
|  | 2018  | 2017      | 2018  | 2017      |
|  | (Dollars in Thousands, Except Per Share Data)     |           |   |           |
| Basic earnings per common share  |   |           |   |           |
| Net income   | \$3,289   | \$ 1,886  | \$6,938   | \$ 5,283  |
| Less: earnings allocated to participating securities                                   | 48  | 25        | 102   | 70        |
| Basic earnings allocated to common stockholders  | \$3,241   | \$ 1,861  | \$6,836   | \$ 5,213  |
| Weighted-average common shares outstanding, excluding participating securities         | 8,631,189   | 8,601,379 | 8,631,668                                       | 8,601,002 |
| Basic earnings per common share  | \$0.38  | \$ 0.22   | \$0.79  | \$ 0.61   |
| Diluted earnings per common share  |   |           |   |           |
| Earnings allocated to common stockholders  | \$3,241   | \$ 1,861  | \$6,836   | \$ 5,213  |
| Weighted-average diluted common shares outstanding, excluding participating securities | 8,631,189   | 8,601,379 | 8,631,668                                       | 8,601,002 |
| Diluted earnings per common share  | \$0.38  | \$ 0.22   | \$0.79  | \$ 0.61   |

### 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, restricted stock, restricted stock units, dividend equivalent units and any other type of award permitted by the Plan. As of June 30, 2018, 214,867 shares were available for future grants under the Plan. 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 its treasury stock for shares delivered under the Plan.

#### Restricted Stock

Under the Plan, the Corporation may grant restricted stock, restricted stock units and other stock-based awards to plan participants, subject to forfeiture upon the occurrence of certain events until the dates specified in the participant's award agreement. While restricted stock is subject to forfeiture, restricted stock participants may exercise full voting rights and will receive all dividends and other distributions paid with respect to the restricted shares. Restricted stock units do not have voting rights and are provided dividend equivalents. The restricted stock granted under the Plan is 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 stock, the benefit of tax deductions in excess of recognized compensation expense is reflected as an income tax benefit in the unaudited Consolidated Statements of Income.

Restricted stock activity for the year ended December 31, 2017 and the six months ended June 30, 2018 was as follows:

| Number of<br>Restricted<br>Shares/Units | Weighted<br>Average<br>Grant-Date |
|---|-----------------------------------|
|---|-----------------------------------|

|   |           | Fair Value |
|---|-----------|------------|
| Nonvested balance as of December 31, 2016 | 116,245   | \$ 21.13   |
| Granted                                   | 71,130    | 21.67      |
| Vested                                    | (48,550 ) | 21.51      |
| Forfeited                                 | (8,384 )  | 21.65      |
| Nonvested balance as of December 31, 2017 | 130,441   | 21.43      |
| Granted                                   | 4,870     | 25.69      |
| Vested                                    | (1,868 )  | 23.25      |
| Forfeited                                 | (7,902 )  | 22.11      |
| Nonvested balance as of June 30, 2018     | 125,541   | \$ 21.52   |

As of June 30, 2018, the Corporation had \$1.9 million of deferred unvested compensation expense, which the Corporation expects to recognize over a weighted-average period of approximately 2.62 years.

Share-based compensation expense related to restricted stock included in the unaudited Consolidated Statements of Income was as follows:

|                                  | For the<br>Three<br>Months<br>Ended June<br>30,<br>2018 | 2017  | For the Six<br>Months<br>Ended June<br>30,<br>2018 | 2017  |
|----------------------------------|---|-------|--|-------|
| Share-based compensation expense | \$220   | \$268 | \$506  | \$544 |

(In Thousands)

#### Note 4 — Securities

The amortized cost and 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 June 30, 2018 |                        |                         | Fair Value |
|--|---------------------|------------------------|-------------------------|------------|
|  | Amortized Cost      | Gross Unrealized Gains | Gross Unrealized Losses |            |
|  | (In Thousands)      |                        |                         |            |
| Available-for-sale:  |                     |                        |                         |            |
| U.S. government agency obligations - government-sponsored enterprises  | \$4,992             | \$ —                   | \$(17 )                 | \$4,975    |
| Municipal obligations  | 7,137               | 2                      | (101 )                  | 7,038      |
| Collateralized mortgage obligations - government issued                | 21,961              | 83                     | (502 )                  | 21,542     |
| Collateralized mortgage obligations - government-sponsored enterprises | 102,141             | 13                     | (2,619 )                | 99,535     |
| Other securities   | 2,450               | —                      | (70 )                   | 2,380      |
|  | \$138,681           | \$ 98                  | \$(3,309 )              | \$135,470  |

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|  | As of December 31, 2017 |                              |                               |               |
|--|-------------------------|------------------------------|-------------------------------|---------------|
|  | Amortized<br>Cost       | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|  | (In Thousands)          |                              |                               |               |
| Available-for-sale:  |                         |                              |                               |               |
| U.S. government agency obligations - government-sponsored enterprises  | \$999                   | \$ 1                         | \$ —                          | \$1,000       |
| Municipal obligations  | 9,494                   | 2                            | (82)                          | ) 9,414       |
| Collateralized mortgage obligations - government issued                | 22,313                  | 149                          | (213)                         | ) 22,249      |
| Collateralized mortgage obligations - government-sponsored enterprises | 91,480                  | 24                           | (1,199)                       | ) 90,305      |
| Other securities   | 3,040                   | 3                            | (6)                           | ) 3,037       |
|  | \$127,326               | \$ 179                       | \$(1,500)                     | ) \$126,005   |

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

|  | As of June 30, 2018 |                              |                               |               |
|--|---------------------|------------------------------|-------------------------------|---------------|
|  | Amortized<br>Cost   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|  | (In Thousands)      |                              |                               |               |
| Held-to-maturity:  |                     |                              |                               |               |
| U.S. government agency obligations - government-sponsored enterprises  | \$1,499             | \$ —                         | \$ (5)                        | ) \$1,494     |
| Municipal obligations  | 21,406              | 50                           | (117)                         | ) 21,339      |
| Collateralized mortgage obligations - government issued                | 8,173               | —                            | (277)                         | ) 7,896       |
| Collateralized mortgage obligations - government-sponsored enterprises | 9,868               | —                            | (257)                         | ) 9,611       |
|  | \$40,946            | \$ 50                        | \$(656)                       | ) \$40,340    |

|  | As of December 31, 2017 |                              |                               |               |
|--|-------------------------|------------------------------|-------------------------------|---------------|
|  | Amortized<br>Cost       | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|  | (In Thousands)          |                              |                               |               |
| Held-to-maturity:  |                         |                              |                               |               |
| U.S. government agency obligations - government-sponsored enterprises  | \$1,499                 | \$ —                         | \$ (9)                        | ) \$1,490     |
| Municipal obligations  | 21,680                  | 176                          | (34)                          | ) 21,822      |
| Collateralized mortgage obligations - government issued                | 9,072                   | 1                            | (130)                         | ) 8,943       |
| Collateralized mortgage obligations - government-sponsored enterprises | 5,527                   | —                            | (86)                          | ) 5,441       |
|  | \$37,778                | \$ 177                       | \$(259)                       | ) \$37,696    |

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





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esent certificates of deposit of insured banks and savings institutions with an original maturity greater than three months. No sales of available-for-sale securities occurred during the six months ended June 30, 2018 and six sales of available-for-sale securities occurred during the six months ended June 30, 2017.

At June 30, 2018 and December 31, 2017, securities with a fair value of \$2.5 million and \$2.8 million, respectively, were pledged to secure interest rate swap contracts.

The amortized cost and fair value of securities by contractual maturity at June 30, 2018 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay certain obligations with or without call or prepayment penalties.

|                                    | Available-for-Sale |               | Held-to-Maturity  |               |
|------------------------------------|--------------------|---------------|-------------------|---------------|
|                                    | Amortized<br>Cost  | Fair<br>Value | Amortized<br>Cost | Fair<br>Value |
|                                    | (In Thousands)     |               |                   |               |
| Due in one year or less            | \$6,795            | \$6,786       | \$2,273           | \$2,267       |
| Due in one year through five years | 19,891             | 19,445        | 11,465            | 11,441        |
| Due in five through ten years      | 29,450             | 28,819        | 20,209            | 19,821        |
| Due in over ten years              | 82,545             | 80,420        | 6,999             | 6,811         |
|                                    | \$138,681          | \$135,470     | \$40,946          | \$40,340      |

The tables below show the Corporation's gross unrealized losses and fair value of available-for-sale investments aggregated by investment category and length of time that individual investments were in a continuous loss position at June 30, 2018 and December 31, 2017. At June 30, 2018, the Corporation held 166 available-for-sale securities that were in an unrealized loss position. Such securities have not experienced credit rating downgrades; however, they have primarily declined in value due to the current interest rate environment. At June 30, 2018, the Corporation held 51 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. The Corporation reviews its securities on a quarterly basis to monitor its exposure to other-than-temporary impairment. Consideration is given to such factors as the length of time and extent to which the security has been in an unrealized loss position, changes in security ratings and an evaluation of the present value of expected future cash flows, if necessary. Based on the Corporation's evaluation, it is expected that the Corporation will recover the entire amortized cost basis of each security. Accordingly, no other-than-temporary impairment was recorded in the unaudited Consolidated Statements of Income for the six months ended June 30, 2018 and 2017.

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A summary of unrealized loss information for securities available-for-sale, categorized by security type and length of time for which the security has been in a continuous unrealized loss position, follows:

|  | As of June 30, 2018 |                   |                     |                   |            |                   |
|--|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|  | Less than 12 Months |                   | 12 Months or Longer |                   | Total      |                   |
|  | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
|  | (In Thousands)      |                   |                     |                   |            |                   |
| Available-for-sale:  |                     |                   |                     |                   |            |                   |
| U.S. government agency obligations - government-sponsored enterprises  | \$4,975             | \$ 17             | \$—                 | \$ —              | \$4,975    | \$ 17             |
| Municipal obligations  | 3,681               | 41                | 2,588               | 60                | 6,269      | 101               |
| Collateralized mortgage obligations - government issued                | 10,917              | 232               | 6,353               | 270               | 17,270     | 502               |
| Collateralized mortgage obligations - government-sponsored enterprises | 68,892              | 1,552             | 25,464              | 1,067             | 94,356     | 2,619             |
| Other securities   | 2,137               | 68                | 243                 | 2                 | 2,380      | 70                |
|  | \$90,602            | \$ 1,910          | \$34,648            | \$ 1,399          | \$125,250  | \$ 3,309          |

|  | As of December 31, 2017 |                   |                     |                   |            |                   |
|--|-------------------------|-------------------|---------------------|-------------------|------------|-------------------|
|  | Less than 12 Months     |                   | 12 Months or Longer |                   | Total      |                   |
|  | Fair Value              | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
|  | (In Thousands)          |                   |                     |                   |            |                   |
| Available-for-sale:  |                         |                   |                     |                   |            |                   |
| Municipal obligations  | \$6,132                 | \$ 43             | \$2,755             | \$ 39             | \$8,887    | \$ 82             |
| Collateralized mortgage obligations - government issued                | 7,104                   | 40                | 6,715               | 173               | 13,819     | 213               |
| Collateralized mortgage obligations - government-sponsored enterprises | 59,256                  | 476               | 28,004              | 723               | 87,260     | 1,199             |
| Other securities   | 1,954                   | 6                 | —                   | —                 | 1,954      | \$ 6              |
|  | \$74,446                | \$ 565            | \$37,474            | \$ 935            | \$111,920  | \$ 1,500          |

The tables below show the Corporation's gross unrealized 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 June 30, 2018 and December 31, 2017. At June 30, 2018, the Corporation held 76 held-to-maturity securities that were in an unrealized loss position. Such securities have not experienced credit rating downgrades; however, they have primarily declined in value due to the current interest rate environment. There were 16 held-to-maturity securities that had been in a continuous loss position for twelve months or greater as of June 30, 2018. It is expected that the Corporation will recover the entire amortized cost basis of each held-to-maturity security based upon an evaluation of aforementioned factors. Accordingly, no other-than-temporary impairment was recorded in the unaudited Consolidated Statements of Income for the six months ended June 30, 2018 and 2017.

A summary of unrealized loss information for securities held-to-maturity, categorized by security type and length of time for which the security has been in a continuous unrealized loss position, follows:



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|  | As of June 30, 2018 |                   |                   |                   |                   |                   |
|--|---------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
|  | Less than 12        |                   | 12 Months or      |                   | Total             |                   |
|  | Months              |                   | Longer            |                   |                   |                   |
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value        | Unrealized Losses |
| (In Thousands)   |                     |                   |                   |                   |                   |                   |
| Held-to-maturity:  |                     |                   |                   |                   |                   |                   |
| U.S. government agency obligations - government-sponsored enterprises  | \$—                 | \$ —              | \$1,499           | \$ 5              | \$1,499           | \$ 5              |
| Municipal obligations  | 13,308              | 109               | 258               | 8                 | 13,566            | 117               |
| Collateralized mortgage obligations - government issued                | 4,036               | 131               | 4,137             | 146               | 8,173             | 277               |
| Collateralized mortgage obligations - government-sponsored enterprises | 4,857               | 74                | 5,011             | 183               | 9,868             | 257               |
|  | \$22,201            | \$ 314            | \$10,905          | \$ 342            | \$33,106          | \$ 656            |
| As of December 31, 2017  |                     |                   |                   |                   |                   |                   |
| Less than 12   |                     | 12 Months or      |                   | Total             |                   |                   |
| Months   |                     | Longer            |                   |                   |                   |                   |
| Fair Value   | Unrealized Losses   | Fair Value        | Unrealized Losses | Fair Value        | Unrealized Losses |                   |
| (In Thousands)   |                     |                   |                   |                   |                   |                   |
| Held-to-maturity:  |                     |                   |                   |                   |                   |                   |
| U.S. government agency obligations - government-sponsored enterprises  | \$—                 | \$ —              | \$1,499           | \$ 9              | \$1,499           | \$ 9              |
| Municipal obligations  | 3,723               | 27                | 259               | 7                 | 3,982             | 34                |
| Collateralized mortgage obligations - government issued                | 3,868               | 51                | 4,677             | 79                | 8,545             | 130               |
| Collateralized mortgage obligations - government-sponsored enterprises | —                   | —                 | 5,527             | 86                | 5,527             | 86                |
|  | \$7,591             | \$ 78             | \$11,962          | \$ 181            | \$19,553          | \$ 259            |

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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:

|   | June 30,<br>2018 | December 31,<br>2017 |
|---|------------------|----------------------|
|   | (In Thousands)   |                      |
| Commercial real estate:                     |                  |                      |
| Commercial real estate — owner occupied     | \$ 196,032       | \$ 200,387           |
| Commercial real estate — non-owner occupied | 485,962          | 470,236              |
| Land development                            | 45,033           | 40,154               |
| Construction                                | 188,036          | 125,157              |
| Multi-family                                | 137,388          | 136,978              |
| 1-4 family                                  | 35,569           | 44,976               |
| Total commercial real estate                | 1,088,020        | 1,017,888            |
| Commercial and industrial                   | 447,540          | 429,002              |
| Direct financing leases, net                | 32,001           | 30,787               |
| Consumer and other:                         |                  |                      |
| Home equity and second mortgages            | 7,962            | 7,262                |
| Other                                       | 21,075           | 18,099               |
| Total consumer and other                    | 29,037           | 25,361               |
| Total gross loans and leases receivable     | 1,596,598        | 1,503,038            |
| Less:                                       |                  |                      |
| Allowance for loan and lease losses         | 20,932           | 18,763               |
| Deferred loan fees                          | 1,645            | 1,443                |
| Loans and leases receivable, net            | \$ 1,574,021     | \$ 1,482,832         |

The total amount of the Corporation's ownership of SBA loans comprised of the following:

|   | June 30,<br>2018 | December 31,<br>2017 |
|---|------------------|----------------------|
|   | (In Thousands)   |                      |
| Retained, unguaranteed portions of sold SBA loans | \$ 26,030        | \$ 30,071            |
| Other SBA loans <sup>(1)</sup>                    | 23,341           | 22,254               |
| Total SBA loans                                   | \$ 49,371        | \$ 52,325            |

(1) Primarily consisted of SBA Express loans and impaired SBA loans that were repurchased from the secondary market, all of which were not saleable as of June 30, 2018 and December 31, 2017, respectively.

As of June 30, 2018 and December 31, 2017, \$9.0 million and \$11.1 million of SBA loans were considered impaired, respectively.

Loans transferred to third parties consist of the guaranteed portions of SBA loans which the Corporation sold in the secondary market, participation interests in other originated loans and residential real estate loans. The total principal amount of the guaranteed portions of SBA loans sold during the three months ended June 30, 2018 and 2017 was \$3.2 million and \$5.9 million, respectively. The total principal amount of the guaranteed portions of SBA loans sold during the six months ended June 30, 2018 and 2017 was \$6.3 million and \$9.2 million, respectively. 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 six months ended June 30, 2018 and 2017 have been derecognized in the unaudited Consolidated Financial Statements. The guaranteed portions 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. The total outstanding balance of sold SBA loans at June 30, 2018 and December 31, 2017 was \$89.5 million and \$100.3 million, respectively.



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The total principal amount of transferred participation interests in other originated commercial loans during the three months ended June 30, 2018 and 2017 was \$14.8 million and \$8.7 million, respectively. The total principal amount of transferred participation interests in other originated commercial loans during the six months ended June 30, 2018 and 2017 was \$34.4 million and \$20.7 million, respectively, all of which were treated as sales and derecognized under the applicable accounting guidance at the time of transfer. 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 outstanding balance of these transferred loans at June 30, 2018 and December 31, 2017 was \$112.7 million and \$106.4 million, respectively. As of June 30, 2018 and December 31, 2017, the total amount of the Corporation's partial ownership of these transferred loans on the unaudited Consolidated Balance Sheets was \$193.7 million and \$181.7 million, respectively. No loans in this participation portfolio were considered impaired as of June 30, 2018 and December 31, 2017. The Corporation does not share in the participant's portion of any potential charge-offs. The total amount of loan participations purchased on the unaudited Consolidated Balance Sheets as of June 30, 2018 and December 31, 2017 was \$610,000 and \$650,000, respectively.

The following tables illustrate ending balances of the Corporation's loan and lease portfolio, including impaired loans by class of receivable, and considering certain credit quality indicators:

|   | June 30, 2018          |           |           |           |              |
|---|------------------------|-----------|-----------|-----------|--------------|
|   | Category               |           |           |           |              |
|   | I                      | II        | III       | IV        | Total        |
|   | (Dollars in Thousands) |           |           |           |              |
| Commercial real estate:                     |                        |           |           |           |              |
| Commercial real estate — owner occupied     | \$ 160,650             | \$ 11,995 | \$ 13,341 | \$ 10,046 | \$ 196,032   |
| Commercial real estate — non-owner occupied | 464,794                | 20,072    | 1,065     | 31        | 485,962      |
| Land development                            | 41,690                 | 1,032     | —         | 2,311     | 45,033       |
| Construction                                | 185,439                | 501       | 217       | 1,879     | 188,036      |
| Multi-family                                | 137,388                | —         | —         | —         | 137,388      |
| 1-4 family                                  | 32,554                 | 1,533     | 721       | 761       | 35,569       |
| Total commercial real estate                | 1,022,515              | 35,133    | 15,344    | 15,028    | 1,088,020    |
| Commercial and industrial                   | 360,855                | 19,636    | 51,091    | 15,958    | 447,540      |
| Direct financing leases, net                | 30,459                 | 225       | 1,317     | —         | 32,001       |
| Consumer and other:                         |                        |           |           |           |              |
| Home equity and second mortgages            | 7,956                  | 5         | —         | 1         | 7,962        |
| Other                                       | 20,722                 | —         | —         | 353       | 21,075       |
| Total consumer and other                    | 28,678                 | 5         | —         | 354       | 29,037       |
| Total gross loans and leases receivable     | \$ 1,442,507           | \$ 54,999 | \$ 67,752 | \$ 31,340 | \$ 1,596,598 |
| Category as a % of total portfolio          | 90.36                  | % 3.44    | % 4.24    | % 1.96    | % 100.00     |

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|   | December 31, 2017      |           |           |           |              |
|---|------------------------|-----------|-----------|-----------|--------------|
|   | Category               |           |           |           |              |
|   | I                      | II        | III       | IV        | Total        |
|   | (Dollars in Thousands) |           |           |           |              |
| Commercial real estate:                     |                        |           |           |           |              |
| Commercial real estate — owner occupied     | \$ 166,018             | \$ 18,442 | \$ 8,850  | \$ 7,077  | \$ 200,387   |
| Commercial real estate — non-owner occupied | 441,246                | 27,854    | 1,102     | 34        | 470,236      |
| Land development                            | 36,470                 | 1,057     | —         | 2,627     | 40,154       |
| Construction                                | 121,528                | 757       | —         | 2,872     | 125,157      |
| Multi-family                                | 136,978                | —         | —         | —         | 136,978      |
| 1-4 family                                  | 34,598                 | 7,735     | 1,220     | 1,423     | 44,976       |
| Total commercial real estate                | 936,838                | 55,845    | 11,172    | 14,033    | 1,017,888    |
| Commercial and industrial                   | 341,875                | 25,344    | 49,453    | 12,330    | 429,002      |
| Direct financing leases, net                | 28,866                 | 342       | 1,579     | —         | 30,787       |
| Consumer and other:                         |                        |           |           |           |              |
| Home equity and second mortgages            | 7,250                  | 8         | —         | 4         | 7,262        |
| Other                                       | 17,745                 | —         | —         | 354       | 18,099       |
| Total consumer and other                    | 24,995                 | 8         | —         | 358       | 25,361       |
| Total gross loans and leases receivable     | \$ 1,332,574           | \$ 81,539 | \$ 62,204 | \$ 26,721 | \$ 1,503,038 |
| Category as a % of total portfolio          | 88.66                  | % 5.42    | % 4.14    | % 1.78    | % 100.00     |

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 borrowers' management team or the industry in which the borrower operates. 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 or 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 Bank's Loan Committee.

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 Bank. 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 contractual 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 subcommittees of the Bank's Loan Committee on a monthly basis and the Bank's Board of Directors at each of their regularly scheduled meetings.





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Category IV — Loans and leases in this category are considered to be impaired. Impaired loans and leases, with the exception of performing troubled debt restructurings, have been placed on non-accrual as management has determined that it is unlikely that the Bank will receive the contractual principal and interest in accordance with the original 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 subcommittees of the Bank's Loan Committee on a monthly basis and the Bank's Board of Directors at each of their regularly scheduled meetings.

Utilizing regulatory classification terminology, the Corporation identified \$42.5 million and \$32.7 million of loans and leases as Substandard as of June 30, 2018 and December 31, 2017, respectively. No loans and leases were identified as Doubtful as of June 30, 2018. The Corporation identified \$4.7 million of loans and leases as Doubtful as of December 31, 2017. Additionally, no loans were considered Special Mention or Loss as of either June 30, 2018 or December 31, 2017. The population of Substandard loans is a subset of Category III and Category IV loans. The delinquency aging of the loan and lease portfolio by class of receivable was as follows:

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|                                  | June 30, 2018             |                           |  |                   |             |                           |
|----------------------------------|---------------------------|---------------------------|--|-------------------|-------------|---------------------------|
|                                  | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | Greater<br>Than 90<br>Days Past<br>Due | Total Past<br>Due | Current     | Total Loans<br>and Leases |
|                                  | (Dollars in Thousands)    |                           |  |                   |             |                           |
| Accruing loans and leases        |                           |                           |  |                   |             |                           |
| Commercial real estate:          |                           |                           |  |                   |             |                           |
| Owner occupied                   | \$—                       | \$—                       | \$—                                    | \$—               | \$186,038   | \$186,038                 |
| Non-owner occupied               | —                         | —                         | —                                      | —                 | 485,931     | 485,931                   |
| Land development                 | —                         | —                         | —                                      | —                 | 42,722      | 42,722                    |
| Construction                     | —                         | —                         | —                                      | —                 | 186,157     | 186,157                   |
| Multi-family                     | —                         | —                         | —                                      | —                 | 137,388     | 137,388                   |
| 1-4 family                       | —                         | —                         | —                                      | —                 | 35,000      | 35,000                    |
| Commercial and industrial        | 1,995                     | —                         | —                                      | 1,995             | 429,591     | 431,586                   |
| Direct financing leases, net     | —                         | —                         | —                                      | —                 | 32,001      | 32,001                    |
| Consumer and other:              |                           |                           |  |                   |             |                           |
| Home equity and second mortgages | —                         | —                         | —                                      | —                 | 7,962       | 7,962                     |
| Other                            | —                         | —                         | —                                      | —                 | 20,722      | 20,722                    |
| Total                            | 1,995                     | —                         | —                                      | 1,995             | 1,563,512   | 1,565,507                 |
| Non-accruing loans and leases    |                           |                           |  |                   |             |                           |
| Commercial real estate:          |                           |                           |  |                   |             |                           |
| Owner occupied                   | —                         | —                         | 3,353                                  | 3,353             | 6,641       | 9,994                     |
| Non-owner occupied               | 31                        | —                         | —                                      | 31                | —           | 31                        |
| Land development                 | —                         | —                         | —                                      | —                 | 2,311       | 2,311                     |
| Construction                     | —                         | —                         | 1,879                                  | 1,879             | —           | 1,879                     |
| Multi-family                     | —                         | —                         | —                                      | —                 | —           | —                         |
| 1-4 family                       | —                         | —                         | 529                                    | 529               | 40          | 569                       |
| Commercial and industrial        | 1,557                     | 1,222                     | 9,378                                  | 12,157            | 3,797       | 15,954                    |
| Direct financing leases, net     | —                         | —                         | —                                      | —                 | —           | —                         |
| Consumer and other:              |                           |                           |  |                   |             |                           |
| Home equity and second mortgages | —                         | —                         | —                                      | —                 | —           | —                         |
| Other                            | —                         | —                         | 304                                    | 304               | 49          | 353                       |
| Total                            | 1,588                     | 1,222                     | 15,443                                 | 18,253            | 12,838      | 31,091                    |
| Total loans and leases           |                           |                           |  |                   |             |                           |
| Commercial real estate:          |                           |                           |  |                   |             |                           |
| Owner occupied                   | —                         | —                         | 3,353                                  | 3,353             | 192,679     | 196,032                   |
| Non-owner occupied               | 31                        | —                         | —                                      | 31                | 485,931     | 485,962                   |
| Land development                 | —                         | —                         | —                                      | —                 | 45,033      | 45,033                    |
| Construction                     | —                         | —                         | 1,879                                  | 1,879             | 186,157     | 188,036                   |
| Multi-family                     | —                         | —                         | —                                      | —                 | 137,388     | 137,388                   |
| 1-4 family                       | —                         | —                         | 529                                    | 529               | 35,040      | 35,569                    |
| Commercial and industrial        | 3,552                     | 1,222                     | 9,378                                  | 14,152            | 433,388     | 447,540                   |
| Direct financing leases, net     | —                         | —                         | —                                      | —                 | 32,001      | 32,001                    |
| Consumer and other:              |                           |                           |  |                   |             |                           |
| Home equity and second mortgages | —                         | —                         | —                                      | —                 | 7,962       | 7,962                     |
| Other                            | —                         | —                         | 304                                    | 304               | 20,771      | 21,075                    |
| Total                            | \$3,583                   | \$1,222                   | \$15,443                               | \$20,248          | \$1,576,350 | \$1,596,598               |
| Percent of portfolio             | 0.22 %                    | 0.08 %                    | 0.97 %                                 | 1.27 %            | 98.73 %     | 100.00 %                  |



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|                                  | December 31, 2017         |                              |  |                   |             |                           |
|----------------------------------|---------------------------|------------------------------|--|-------------------|-------------|---------------------------|
|                                  | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past<br>Due | Greater<br>Than 90<br>Days Past<br>Due | Total Past<br>Due | Current     | Total Loans<br>and Leases |
|                                  | (Dollars in Thousands)    |                              |  |                   |             |                           |
| Accruing loans and leases        |                           |                              |  |                   |             |                           |
| Commercial real estate:          |                           |                              |  |                   |             |                           |
| Owner occupied                   | \$—                       | \$—                          | \$—                                    | \$—               | \$193,366   | \$193,366                 |
| Non-owner occupied               | —                         | —                            | —                                      | —                 | 470,202     | 470,202                   |
| Land development                 | —                         | —                            | —                                      | —                 | 37,528      | 37,528                    |
| Construction                     | —                         | 196                          | —                                      | 196               | 122,089     | 122,285                   |
| Multi-family                     | —                         | —                            | —                                      | —                 | 136,978     | 136,978                   |
| 1-4 family                       | 496                       | —                            | —                                      | 496               | 43,319      | 43,815                    |
| Commercial and industrial        | 1,169                     | 197                          | —                                      | 1,366             | 415,315     | 416,681                   |
| Direct financing leases, net     | —                         | —                            | —                                      | —                 | 30,787      | 30,787                    |
| Consumer and other:              |                           |                              |  |                   |             |                           |
| Home equity and second mortgages | 106                       | —                            | —                                      | 106               | 7,156       | 7,262                     |
| Other                            | —                         | —                            | —                                      | —                 | 17,745      | 17,745                    |
| Total                            | 1,771                     | 393                          | —                                      | 2,164             | 1,474,485   | 1,476,649                 |
| Non-accruing loans and leases    |                           |                              |  |                   |             |                           |
| Commercial real estate:          |                           |                              |  |                   |             |                           |
| Owner occupied                   | 405                       | —                            | 4,836                                  | 5,241             | 1,780       | 7,021                     |
| Non-owner occupied               | —                         | —                            | —                                      | —                 | 34          | 34                        |
| Land development                 | —                         | —                            | —                                      | —                 | 2,626       | 2,626                     |
| Construction                     | —                         | —                            | 2,872                                  | 2,872             | —           | 2,872                     |
| Multi-family                     | —                         | —                            | —                                      | —                 | —           | —                         |
| 1-4 family                       | —                         | —                            | 948                                    | 948               | 213         | 1,161                     |
| Commercial and industrial        | 782                       | —                            | 7,349                                  | 8,131             | 4,190       | 12,321                    |
| Direct financing leases, net     | —                         | —                            | —                                      | —                 | —           | —                         |
| Consumer and other:              |                           |                              |  |                   |             |                           |
| Home equity and second mortgages | —                         | —                            | —                                      | —                 | —           | —                         |
| Other                            | —                         | —                            | 345                                    | 345               | 9           | 354                       |
| Total                            | 1,187                     | —                            | 16,350                                 | 17,537            | 8,852       | 26,389                    |
| Total loans and leases           |                           |                              |  |                   |             |                           |
| Commercial real estate:          |                           |                              |  |                   |             |                           |
| Owner occupied                   | 405                       | —                            | 4,836                                  | 5,241             | 195,146     | 200,387                   |
| Non-owner occupied               | —                         | —                            | —                                      | —                 | 470,236     | 470,236                   |
| Land development                 | —                         | —                            | —                                      | —                 | 40,154      | 40,154                    |
| Construction                     | —                         | 196                          | 2,872                                  | 3,068             | 122,089     | 125,157                   |
| Multi-family                     | —                         | —                            | —                                      | —                 | 136,978     | 136,978                   |
| 1-4 family                       | 496                       | —                            | 948                                    | 1,444             | 43,532      | 44,976                    |
| Commercial and industrial        | 1,951                     | 197                          | 7,349                                  | 9,497             | 419,505     | 429,002                   |
| Direct financing leases, net     | —                         | —                            | —                                      | —                 | 30,787      | 30,787                    |
| Consumer and other:              |                           |                              |  |                   |             |                           |
| Home equity and second mortgages | 106                       | —                            | —                                      | 106               | 7,156       | 7,262                     |
| Other                            | —                         | —                            | 345                                    | 345               | 17,754      | 18,099                    |
| Total                            | \$2,958                   | \$393                        | \$16,350                               | \$19,701          | \$1,483,337 | \$1,503,038               |
| Percent of portfolio             | 0.20                      | % 0.03                       | % 1.09                                 | % 1.32            | % 98.68     | % 100.00                  |



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The Corporation's total impaired assets consisted of the following:

|   | June 30, December 31,<br>2018 2017<br>(In Thousands) |           |               |                   |
|---|--|-----------|---------------|-------------------|
| Non-accrual loans and leases  |  |           |               |                   |
| Commercial real estate:   |  |           |               |                   |
| Commercial real estate — owner occupied   | \$9,994  | \$ 7,021  |               |                   |
| Commercial real estate — non-owner occupied   | 31   | 34        |               |                   |
| Land development  | 2,311  | 2,626     |               |                   |
| Construction  | 1,879  | 2,872     |               |                   |
| Multi-family  | —  | —         |               |                   |
| 1-4 family  | 569  | 1,161     |               |                   |
| Total non-accrual commercial real estate  | 14,784   | 13,714    |               |                   |
| Commercial and industrial   | 15,954   | 12,321    |               |                   |
| Direct financing leases, net  | —  | —         |               |                   |
| Consumer and other:   |  |           |               |                   |
| Home equity and second mortgages  | —  | —         |               |                   |
| Other   | 353  | 354       |               |                   |
| Total non-accrual consumer and other loans  | 353  | 354       |               |                   |
| Total non-accrual loans and leases  | 31,091   | 26,389    |               |                   |
| Foreclosed properties, net  | 1,484  | 1,069     |               |                   |
| Total non-performing assets   | 32,575   | 27,458    |               |                   |
| Performing troubled debt restructurings   | 249  | 332       |               |                   |
| Total impaired assets   | \$32,824   | \$ 27,790 |               |                   |
|   |  |           | June 30, 2018 | December 31, 2017 |
| Total non-accrual loans and leases to gross loans and leases                                |  |           | 1.95 %        | 1.76 %            |
| Total non-performing assets to total gross loans and leases plus foreclosed properties, net |  |           | 2.04          | 1.83              |
| Total non-performing assets to total assets   |  |           | 1.71          | 1.53              |
| Allowance for loan and lease losses to gross loans and leases                               |  |           | 1.31          | 1.25              |
| Allowance for loan and lease losses to non-accrual loans and leases                         |  |           | 67.32         | 71.10             |

As of June 30, 2018 and December 31, 2017, \$8.4 million and \$8.8 million of the non-accrual loans and leases were considered troubled debt restructurings, respectively. There were no unfunded commitments associated with troubled debt restructured loans and leases as of June 30, 2018.

All loans and leases modified as a troubled debt restructuring are measured 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.

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During the six months ended June 30, 2018, no loans were modified to a troubled debt restructuring. The following table provides the number of loans modified in a troubled debt restructuring during the six months ended June 30, 2017 and the pre- and post-modification recorded investment by class of receivable:

|                           | For the Six Months Ended June 30,<br>2017                |   |
|---------------------------|--|---|
|                           | Number of<br>Loans Modified<br>of Recorded<br>Investment | Post-Modification<br>Recorded<br>Investment |
|                           | (Dollars in Thousands)                                   |   |
| Commercial and industrial | 2 \$ 3,714   | \$ 3,714                                    |
| Consumer and other        | 1 17   | 17  |
| Total                     | 3 \$ 3,731   | \$ 3,731                                    |

During the six months ended June 30, 2017, the troubled debt restructurings included a combination of extension of terms and interest rate concessions.

There were no loans and leases modified in a troubled debt restructuring during the previous 12 months which subsequently defaulted during the six months ended June 30, 2018 and 2017.



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The following represents additional information regarding the Corporation's impaired loans and leases, including performing troubled debt restructurings, by class:

As of and for the Six Months Ended June 30, 2018

|                                      | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Impairment<br>Reserve | Average<br>Recorded<br>Investment <sup>(1)</sup> | Foregone<br>Interest<br>Income | Interest<br>Income<br>Recognized | Net<br>Foregone<br>Interest<br>Income |
|--------------------------------------|------------------------|--------------------------------|-----------------------|--|--------------------------------|----------------------------------|---------------------------------------|
| (In Thousands)                       |                        |                                |                       |  |                                |                                  |                                       |
| With no impairment reserve recorded: |                        |                                |                       |  |                                |                                  |                                       |
| Commercial real estate:              |                        |                                |                       |  |                                |                                  |                                       |
| Owner occupied                       | \$10,046               | \$11,345                       | \$ —                  | \$ 6,311   | \$ 270                         | \$ 162                           | \$ 108                                |
| Non-owner occupied                   | 31                     | 71                             | —                     | 35   | 1                              | —                                | 1                                     |
| Land development                     | 2,311                  | 6,608                          | —                     | 2,481  | 34                             | —                                | 34                                    |
| Construction                         | 1,879                  | 2,872                          | —                     | 2,432  | 106                            | —                                | 106                                   |
| Multi-family                         | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| 1-4 family                           | 761                    | 1,032                          | —                     | 1,066  | 30                             | 74                               | (44 )                                 |
| Commercial and industrial            | 3,533                  | 5,140                          | —                     | 3,031  | 188                            | 149                              | 39                                    |
| Direct financing leases, net         | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Consumer and other:                  |                        |                                |                       |  |                                |                                  |                                       |
| Home equity and second mortgages     | 1                      | 1                              | —                     | 2  | —                              | 29                               | (29 )                                 |
| Other                                | 304                    | 970                            | —                     | 313  | 28                             | —                                | 28                                    |
| Total                                | 18,866                 | 28,039                         | —                     | 15,671   | 657                            | 414                              | 243                                   |
| With impairment reserve recorded:    |                        |                                |                       |  |                                |                                  |                                       |
| Commercial real estate:              |                        |                                |                       |  |                                |                                  |                                       |
| Owner occupied                       | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Non-owner occupied                   | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Land development                     | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Construction                         | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Multi-family                         | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| 1-4 family                           | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Commercial and industrial            | 12,425                 | 14,735                         | 4,658                 | 8,699  | 831                            | —                                | 831                                   |
| Direct financing leases, net         | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Consumer and other:                  |                        |                                |                       |  |                                |                                  |                                       |
| Home equity and second mortgages     | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Other                                | 49                     | 49                             | 49                    | 8  | —                              | —                                | —                                     |
| Total                                | 12,474                 | 14,784                         | 4,707                 | 8,707  | 831                            | —                                | 831                                   |
| Total:                               |                        |                                |                       |  |                                |                                  |                                       |
| Commercial real estate:              |                        |                                |                       |  |                                |                                  |                                       |
| Owner occupied                       | 10,046                 | 11,345                         | —                     | 6,311  | 270                            | 162                              | 108                                   |
| Non-owner occupied                   | 31                     | 71                             | —                     | 35   | 1                              | —                                | 1                                     |
| Land development                     | 2,311                  | 6,608                          | —                     | 2,481  | 34                             | —                                | 34                                    |
| Construction                         | 1,879                  | 2,872                          | —                     | 2,432  | 106                            | —                                | 106                                   |
| Multi-family                         | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| 1-4 family                           | 761                    | 1,032                          | —                     | 1,066  | 30                             | 74                               | (44 )                                 |
| Commercial and industrial            | 15,958                 | 19,875                         | 4,658                 | 11,730   | 1,019                          | 149                              | 870                                   |
| Direct financing leases, net         | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Consumer and other:                  |                        |                                |                       |  |                                |                                  |                                       |
| Home equity and second mortgages     | 1                      | 1                              | —                     | 2  | —                              | 29                               | (29 )                                 |
| Other                                | 353                    | 1,019                          | 49                    | 321  | 28                             | —                                | 28                                    |

|             |          |          |          |           |          |        |          |
|-------------|----------|----------|----------|-----------|----------|--------|----------|
| Grand total | \$31,340 | \$42,823 | \$ 4,707 | \$ 24,378 | \$ 1,488 | \$ 414 | \$ 1,074 |
|-------------|----------|----------|----------|-----------|----------|--------|----------|

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

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As of and for the Year Ended December 31, 2017

|                                      | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Impairment<br>Reserve | Average<br>Recorded<br>Investment <sup>(1)</sup> | Foregone<br>Interest<br>Income | Interest<br>Income<br>Recognized | Net<br>Foregone<br>Interest<br>Income |
|--------------------------------------|------------------------|--------------------------------|-----------------------|--|--------------------------------|----------------------------------|---------------------------------------|
| (In Thousands)                       |                        |                                |                       |  |                                |                                  |                                       |
| With no impairment reserve recorded: |                        |                                |                       |  |                                |                                  |                                       |
| Commercial real estate:              |                        |                                |                       |  |                                |                                  |                                       |
| Owner occupied                       | \$7,077                | \$7,077                        | \$ —                  | \$ 5,549   | \$ 613                         | \$ —                             | \$ 613                                |
| Non-owner occupied                   | 34                     | 75                             | —                     | 1,830  | 97                             | 226                              | (129 )                                |
| Land development                     | 2,627                  | 5,297                          | —                     | 3,092  | 84                             | —                                | 84                                    |
| Construction                         | —                      | —                              | —                     | 2,000  | 134                            | 214                              | (80 )                                 |
| Multi-family                         | —                      | —                              | —                     | 1  | —                              | —                                | —                                     |
| 1-4 family                           | 1,423                  | 1,706                          | —                     | 2,146  | 53                             | 7                                | 46                                    |
| Commercial and industrial            | 5,465                  | 6,502                          | —                     | 3,634  | 858                            | 7                                | 851                                   |
| Direct financing leases, net         | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Consumer and other:                  |                        |                                |                       |  |                                |                                  |                                       |
| Home equity and second mortgages     | 4                      | 3                              | —                     | 7  | —                              | —                                | —                                     |
| Other                                | 345                    | 1,011                          | —                     | 365  | 59                             | —                                | 59                                    |
| Total                                | 16,975                 | 21,671                         | —                     | 18,624   | 1,898                          | 454                              | 1,444                                 |
| With impairment reserve recorded:    |                        |                                |                       |  |                                |                                  |                                       |
| Commercial real estate:              |                        |                                |                       |  |                                |                                  |                                       |
| Owner occupied                       | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Non-owner occupied                   | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Land development                     | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Construction                         | 2,872                  | 2,872                          | 415                   | 2,252  | 158                            | —                                | 158                                   |
| Multi-family                         | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| 1-4 family                           | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Commercial and industrial            | 6,865                  | 8,813                          | 4,067                 | 12,288   | 639                            | —                                | 639                                   |
| Direct financing leases, net         | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Consumer and other:                  |                        |                                |                       |  |                                |                                  |                                       |
| Home equity and second mortgages     | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Other                                | 9                      | 9                              | 9                     | —  | —                              | —                                | —                                     |
| Total                                | 9,746                  | 11,694                         | 4,491                 | 14,540   | 797                            | —                                | 797                                   |
| Total:                               |                        |                                |                       |  |                                |                                  |                                       |
| Commercial real estate:              |                        |                                |                       |  |                                |                                  |                                       |
| Owner occupied                       | 7,077                  | 7,077                          | —                     | 5,549  | 613                            | —                                | 613                                   |
| Non-owner occupied                   | 34                     | 75                             | —                     | 1,830  | 97                             | 226                              | (129 )                                |
| Land development                     | 2,627                  | 5,297                          | —                     | 3,092  | 84                             | —                                | 84                                    |
| Construction                         | 2,872                  | 2,872                          | 415                   | 4,252  | 292                            | 214                              | 78                                    |
| Multi-family                         | —                      | —                              | —                     | 1  | —                              | —                                | —                                     |
| 1-4 family                           | 1,423                  | 1,706                          | —                     | 2,146  | 53                             | 7                                | 46                                    |
| Commercial and industrial            | 12,330                 | 15,315                         | 4,067                 | 15,922   | 1,497                          | 7                                | 1,490                                 |
| Direct financing leases, net         | —                      | —                              | —                     | —  | —                              | —                                | —                                     |
| Consumer and other:                  |                        |                                |                       |  |                                |                                  |                                       |
| Home equity and second mortgages     | 4                      | 3                              | —                     | 7  | —                              | —                                | —                                     |
| Other                                | 354                    | 1,020                          | 9                     | 365  | 59                             | —                                | 59                                    |
| Grand total                          | \$26,721               | \$33,365                       | \$ 4,491              | \$ 33,164  | \$ 2,695                       | \$ 454                           | \$ 2,241                              |

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



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The difference between the recorded investment of loans and leases and the unpaid principal balance of \$11.5 million and \$6.6 million as of June 30, 2018 and December 31, 2017, respectively, represents partial charge-offs of loans and leases resulting from losses due to the appraised 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 \$249,000 and \$332,000 of loans as of June 30, 2018 and December 31, 2017, respectively, that were performing troubled debt restructurings, and although 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 such loan's principal. Foregone interest represents the interest that was contractually due on the loan but not received or recorded. To the extent the amount of principal on a non-accrual loan 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 categorizes the portfolio into segments with similar risk characteristics. 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 Three Months Ended June 30, 2018 |                           |                    |          |
|-------------------------------------|--|---------------------------|--------------------|----------|
|                                     | Commercial Real Estate                             | Commercial and Industrial | Consumer and Other | Total    |
|                                     | (In Thousands)                                     |                           |                    |          |
| Beginning balance                   | \$9,990  | \$ 8,151                  | \$ 497             | \$18,638 |
| Charge-offs                         | (121 )   | (168 )                    | (17 )              | (306 )   |
| Recoveries                          | 2  | 17                        | 2                  | 21       |
| Net charge-offs                     | (119 )   | (151 )                    | (15 )              | (285 )   |
| Provision for loan and lease losses | 1,276  | 1,237                     | 66                 | 2,579    |
| Ending balance                      | \$11,147   | \$ 9,237                  | \$ 548             | \$20,932 |
|                                     | As of and for the Three Months Ended June 30, 2017 |                           |                    |          |
|                                     | Commercial Real Estate                             | Commercial and Industrial | Consumer and Other | Total    |
|                                     | (In Thousands)                                     |                           |                    |          |
| Beginning balance                   | \$12,817   | \$ 7,943                  | \$ 906             | \$21,666 |
| Charge-offs                         | (51 )  | (3,706 )                  | —                  | (3,757 ) |
| Recoveries                          | 46   | 66                        | —                  | 112      |
| Net charge-offs                     | (5 )   | (3,640 )                  | —                  | (3,645 ) |
| Provision for loan and lease losses | (809 )   | 4,787                     | (322 )             | 3,656    |
| Ending balance                      | \$12,003   | \$ 9,090                  | \$ 584             | \$21,677 |

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|                                     | As of and for the Six Months Ended June 30, 2018 |                           |                    |          |
|-------------------------------------|--|---------------------------|--------------------|----------|
|                                     | Commercial Real Estate                           | Commercial and Industrial | Consumer and Other | Total    |
|                                     | (In Thousands)                                   |                           |                    |          |
| Beginning balance                   | \$10,131   | \$ 8,225                  | \$ 407             | \$18,763 |
| Charge-offs                         | (2,296 )   | (657 )                    | (37 )              | (2,990 ) |
| Recoveries                          | 15   | 19                        | 71                 | 105      |
| Net charge-offs                     | (2,281 )   | (638 )                    | 34                 | (2,885 ) |
| Provision for loan and lease losses | 3,297  | 1,650                     | 107                | 5,054    |
| Ending balance                      | \$11,147   | \$ 9,237                  | \$ 548             | \$20,932 |

|                                     | As of and for the Six Months Ended June 30, 2017 |                           |                    |          |
|-------------------------------------|--|---------------------------|--------------------|----------|
|                                     | Commercial Real Estate                           | Commercial and Industrial | Consumer and Other | Total    |
|                                     | (In Thousands)                                   |                           |                    |          |
| Beginning balance                   | \$12,384   | \$ 7,970                  | \$ 558             | \$20,912 |
| Charge-offs                         | (118 )   | (3,761 )                  | (87 )              | (3,966 ) |
| Recoveries                          | 150  | 312                       | 41                 | 503      |
| Net charge-offs                     | 32   | (3,449 )                  | (46 )              | (3,463 ) |
| Provision for loan and lease losses | (413 )   | 4,569                     | 72                 | 4,228    |
| Ending balance                      | \$12,003   | \$ 9,090                  | \$ 584             | \$21,677 |

The following tables provide information regarding the allowance for loan and lease losses and balances by type of allowance methodology.

|   | As of June 30, 2018    |                           |                    |             |
|---|------------------------|---------------------------|--------------------|-------------|
|   | Commercial Real Estate | Commercial and Industrial | Consumer and Other | Total       |
|   | (In Thousands)         |                           |                    |             |
| Allowance for loan and lease losses:            |                        |                           |                    |             |
| Collectively evaluated for impairment           | \$11,147               | \$ 4,579                  | \$ 499             | \$16,225    |
| Individually evaluated for impairment           | —                      | 4,658                     | 49                 | 4,707       |
| Loans acquired with deteriorated credit quality | —                      | —                         | —                  | —           |
| Total   | \$11,147               | \$ 9,237                  | \$ 548             | \$20,932    |
| Loans and lease receivables:                    |                        |                           |                    |             |
| Collectively evaluated for impairment           | \$1,072,992            | \$ 463,583                | \$ 28,683          | \$1,565,258 |
| Individually evaluated for impairment           | 14,697                 | 15,953                    | 354                | 31,004      |
| Loans acquired with deteriorated credit quality | 331                    | 5                         | —                  | 336         |
| Total   | \$1,088,020            | \$ 479,541                | \$ 29,037          | \$1,596,598 |

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|   | As of December 31, 2017   |                                 |                       |             |
|---|---------------------------|---------------------------------|-----------------------|-------------|
|   | Commercial<br>Real Estate | Commercial<br>and<br>Industrial | Consumer<br>and Other | Total       |
|   | (In Thousands)            |                                 |                       |             |
| Allowance for loan and lease losses:            |                           |                                 |                       |             |
| Collectively evaluated for impairment           | \$9,716                   | \$ 4,158                        | \$ 398                | \$14,272    |
| Individually evaluated for impairment           | 415                       | 4,067                           | 9                     | 4,491       |
| Loans acquired with deteriorated credit quality | —                         | —                               | —                     | —           |
| Total   | \$10,131                  | \$ 8,225                        | \$ 407                | \$18,763    |
| Loans and lease receivables:                    |                           |                                 |                       |             |
| Collectively evaluated for impairment           | \$1,003,855               | \$ 447,459                      | \$ 25,003             | \$1,476,317 |
| Individually evaluated for impairment           | 13,506                    | 12,324                          | 358                   | 26,188      |
| Loans acquired with deteriorated credit quality | 527                       | 6                               | —                     | 533         |
| Total   | \$1,017,888               | \$ 459,789                      | \$ 25,361             | \$1,503,038 |

## Note 6 — Other Assets

The Corporation is a limited partner in several limited partnership investments. The Corporation is not the general partner, does not have controlling ownership and is not the primary beneficiary in any of these limited partnerships and the limited partnerships have not been consolidated. These investments are accounted for using the equity method of accounting and are evaluated for impairment at the end of each reporting period.

A summary of accrued interest receivable and other assets is as follows:

|  | June 30, December 31, |           |
|--|-----------------------|-----------|
|  | 2018                  | 2017      |
|  | (In Thousands)        |           |
| Accrued interest receivable                        | \$5,568               | \$ 5,019  |
| Net deferred tax asset                             | 2,273                 | 2,584     |
| Investment in historic development entities        | 1,849                 | 1,161     |
| Investment in a community development entity       | 6,336                 | 6,591     |
| Investment in limited partnerships                 | 4,082                 | 4,261     |
| Investment in Trust II                             | 315                   | 315       |
| Fair value of interest rate swaps                  | 1,612                 | 942       |
| Prepaid expenses                                   | 2,982                 | 3,091     |
| Other assets                                       | 6,125                 | 5,884     |
| Total accrued interest receivable and other assets | \$31,142              | \$ 29,848 |

## Note 7 — Deposits

The composition of deposits is shown below. Average balances represent year-to-date averages.

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|   | June 30, 2018          |                 |              | December 31, 2017 |                 |              |
|---|------------------------|-----------------|--------------|-------------------|-----------------|--------------|
|   | Balance                | Average Balance | Average Rate | Balance           | Average Balance | Average Rate |
|   | (Dollars in Thousands) |                 |              |                   |                 |              |
| Non-interest-bearing transaction accounts | \$255,521              | \$234,487       | — %          | \$277,445         | \$230,907       | — %          |
| Interest-bearing transaction accounts     | 272,057                | 285,216         | 0.73         | 217,625           | 226,540         | 0.59         |
| Money market accounts                     | 450,654                | 494,779         | 0.78         | 515,077           | 583,241         | 0.47         |
| Certificates of deposit                   | 78,062                 | 76,424          | 1.25         | 76,199            | 56,667          | 1.00         |
| Wholesale deposits                        | 281,431                | 289,614         | 1.80         | 307,985           | 361,712         | 1.70         |
| Total deposits                            | \$1,337,725            | \$1,380,520     | 0.87         | \$1,394,331       | \$1,459,067     | 0.74         |

## Note 8 — FHLB Advances, Other Borrowings and Junior Subordinated Notes

The composition of borrowed funds at is shown below. Average balances represent year-to-date averages.

|                                 | June 30, 2018          |                          |                       | December 31, 2017 |                          |                       |
|---------------------------------|------------------------|--------------------------|-----------------------|-------------------|--------------------------|-----------------------|
|                                 | Balance                | Weighted Average Balance | Weighted Average Rate | Balance           | Weighted Average Balance | Weighted Average Rate |
|                                 | (Dollars in Thousands) |                          |                       |                   |                          |                       |
| Federal funds purchased         | \$—                    | \$240                    | 2.41 %                | \$—               | \$66                     | 1.22 %                |
| FHLB advances                   | 341,000                | 270,445                  | 1.95                  | 183,500           | 105,276                  | 1.40                  |
| Line of credit                  | —                      | 7                        | 4.43                  | 10                | 328                      | 3.64                  |
| Other borrowings <sup>(1)</sup> | 675                    | 675                      | 8.09                  | 675               | 1,241                    | 14.50                 |
| Subordinated notes payable      | 23,741                 | 23,725                   | 6.66                  | 23,713            | 23,161                   | 6.93                  |
| Junior subordinated notes       | 10,026                 | 10,022                   | 11.01                 | 10,019            | 10,011                   | 11.11                 |
|                                 | \$375,442              | \$305,114                | 2.63                  | \$217,917         | \$140,083                | 3.14                  |
| Short-term borrowings           | \$164,500              |                          |                       | \$37,010          |                          |                       |
| Long-term borrowings            | 210,942                |                          |                       | 180,907           |                          |                       |
|                                 | \$375,442              |                          |                       | \$217,917         |                          |                       |

(1) Weighted average rate of other borrowings reflects the cost of prepaying a secured borrowing during the second quarter of 2017.

As of June 30, 2018 and December 31, 2017, 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, 2018, the Corporation pays a commitment fee on this line of credit. During both the six months ended June 30, 2018 and 2017, the Corporation incurred interest expense due to this fee of \$7,000.

## Note 9 — Commitments and Contingencies

In the normal course of business, various legal proceedings involving the Corporation are pending. Management, based upon advice from legal counsel, does not anticipate any significant losses as a result of these actions. 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 and cash flows.

The Corporation sells the guaranteed portions of SBA loans, as well as participation interests in other originated loans, to third parties. The Corporation has a continuing involvement in each of the transferred lending arrangements by way of relationship





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management and servicing the loans, as well as being subject to normal and customary requirements of the SBA loan program and standard representations and warranties related to sold amounts. In the event of a loss resulting from default and a determination by the SBA that there is a deficiency in the manner in which the loan was originated, funded or serviced by the Corporation, the SBA may require the Corporation to repurchase the loan, deny its liability under the guaranty, reduce the amount of the guaranty, or, if it has already paid under the guaranty, seek recovery of the principal loss related to the deficiency from the Corporation. The Corporation must comply with applicable SBA regulations in order to maintain the guaranty. In addition, the Corporation retains the option to repurchase the sold guaranteed portion of an SBA loan if the loan defaults.

Management has assessed estimated losses inherent in the outstanding guaranteed portions of SBA loans sold in accordance with ASC 450, Contingencies, and determined a recourse reserve based on the probability of future losses for these loans to be \$2.4 million at June 30, 2018, which is reported in accrued interest payable and other liabilities on the unaudited Consolidated Balance Sheets.

The summary of the activity in the SBA recourse reserve is as follows:

|  | As of and for the<br>Six Months<br>Ended<br>June 30, June 30,<br>2018 2017<br>(In Thousands) |         |
|--|--|---------|
| Balance at the beginning of the period | \$2,849  | \$1,750 |
| SBA recourse (benefit) provision       | (196 )   | 780     |
| Charge-offs, net                       | (238 )   | (795 )  |
| Balance at the end of the period       | \$2,415  | \$1,735 |

#### Note 10 — 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:

|  | June 30, 2018  |          |    |          |
|--|----------------|----------|----|----------|
|  | Fair Value     |          |    |          |
|  | Measurements   |          |    |          |
|  | Using          |          |    |          |
|  | Level          | Level    |    | Total    |
|  | 1              | 2        | 3  |          |
|  | (In Thousands) |          |    |          |
| Assets:  |                |          |    |          |
| Securities available-for-sale:   |                |          |    |          |
| U.S. government agency obligations - government-sponsored enterprises  | \$             | -\$4,975 | \$ | -\$4,975 |
| Municipal obligations  | —              | 7,038    | —  | 7,038    |
| Collateralized mortgage obligations - government issued                | —              | 21,542   | —  | 21,542   |
| Collateralized mortgage obligations - government-sponsored enterprises | —              | 99,535   | —  | 99,535   |
| Other securities   | —              | 2,380    | —  | 2,380    |
| Interest rate swaps  | —              | 1,612    | —  | 1,612    |
| Liabilities:   |                |          |    |          |
| Interest rate swaps  | —              | 704      | —  | 704      |
| December 31, 2017  |                |          |    |          |
| Fair Value   |                |          |    |          |
| Measurements   |                |          |    |          |
| Using  |                |          |    |          |
|  | Level          | Level    |    | Total    |
|  | 1              | 2        | 3  |          |
|  | (In Thousands) |          |    |          |
| Assets:  |                |          |    |          |
| Securities available-for-sale:   |                |          |    |          |
| U.S. government agency obligations - government-sponsored enterprises  | \$             | -\$1,000 | \$ | -\$1,000 |
| Municipal obligations  | —              | 9,414    | —  | 9,414    |
| Asset backed securities  | —              | —        | —  | —        |
| Collateralized mortgage obligations - government issued                | —              | 22,249   | —  | 22,249   |
| Collateralized mortgage obligations - government-sponsored enterprises | —              | 90,305   | —  | 90,305   |
| Other securities   | —              | 3,037    | —  | 3,037    |
| Interest rate swaps  | —              | 942      | —  | 942      |
| Liabilities:   |                |          |    |          |
| Interest rate swaps  | —              | 1,064    | —  | 1,064    |

For assets and liabilities measured at fair value on a recurring basis, there were no transfers between the levels during the three and six months ended June 30, 2018 or the year ended December 31, 2017 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:

|                       | June 30, 2018  |         |          |       |
|-----------------------|----------------|---------|----------|-------|
|                       | Fair Value     |         |          |       |
|                       | Measurements   |         |          |       |
|                       | Using          |         |          |       |
|                       | Level          | Level   | Level    | Total |
|                       | 1              | 2       | 3        |       |
|                       | (In Thousands) |         |          |       |
| Impaired loans        | \$-10,719      | \$5,833 | \$16,552 |       |
| Foreclosed properties | -1,484         | —       | 1,484    |       |

|                       | December 31, 2017 |         |          |       |
|-----------------------|-------------------|---------|----------|-------|
|                       | Fair Value        |         |          |       |
|                       | Measurements      |         |          |       |
|                       | Using             |         |          |       |
|                       | Level             | Level   | Level    | Total |
|                       | 1                 | 2       | 3        |       |
|                       | (In Thousands)    |         |          |       |
| Impaired loans        | \$-10,063         | \$5,084 | \$15,147 |       |
| Foreclosed properties | -1,069            | —       | 1,069    |       |

Impaired loans were written down to the fair value of their underlying collateral less costs to sell of \$16.6 million and \$15.1 million at June 30, 2018 and December 31, 2017, respectively, through the establishment of specific reserves or by recording charge-offs when the carrying value exceeded the fair value of the underlying collateral of impaired loans. 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, typically when discounts are 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 5% - 75% as of the measurement date of June 30, 2018. The weighted average of those unobservable inputs was 17%. The majority of the impaired loans in the Level 3 category are considered collateral dependent loans or are supported by a SBA guaranty.

Foreclosed properties, upon initial recognition, are remeasured 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.

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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:

|  | June 30, 2018      |            |          |          |           |
|--|--------------------|------------|----------|----------|-----------|
|  | Carrying<br>Amount | Fair Value |          |          |           |
|  | Total              | Level 1    | Level 2  | Level 3  |           |
| (In Thousands)                                       |                    |            |          |          |           |
| Financial assets:                                    |                    |            |          |          |           |
| Cash and cash equivalents                            | \$45,803           | \$45,802   | \$41,103 | \$ 4,699 | \$ —      |
| Securities available-for-sale                        | 135,470            | 135,470    | —        | 135,470  | —         |
| Securities held-to-maturity                          | 40,946             | 40,340     | —        | 40,340   | —         |
| Loans held for sale                                  | 4,976              | 5,474      | —        | 5,474    | —         |
| Loans and lease receivables, net                     | 1,574,021          | 1,570,464  | —        | 10,719   | 1,559,745 |
| Federal Home Loan Bank stock                         | 9,295              | N/A        | N/A      | N/A      | N/A       |
| Accrued interest receivable                          | 5,568              | 5,568      | 5,568    | —        | —         |
| Interest rate swaps                                  | 1,612              | 1,612      | —        | 1,612    | —         |
| Financial liabilities:                               |                    |            |          |          |           |
| Deposits   | 1,337,725          | 1,333,899  | 978,232  | 355,663  | —         |
| Federal Home Loan Bank advances and other borrowings | 365,416            | 360,520    | —        | 360,520  | —         |
| Junior subordinated notes                            | 10,026             | 9,154      | —        | —        | 9,154     |
| Accrued interest payable                             | 2,940              | 2,940      | 2,940    | —        | —         |
| Interest rate swaps                                  | 704                | 704        | —        | 704      | —         |
| Off-balance-sheet items:                             |                    |            |          |          |           |
| Standby letters of credit                            | 43                 | 43         | —        | —        | 43        |

N/A = The fair value is not applicable due to restrictions placed on transferability

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|  | December 31, 2017  |            |           |          |           |
|--|--------------------|------------|-----------|----------|-----------|
|  | Carrying<br>Amount | Fair Value |           |          |           |
|  |                    | Total      | Level 1   | Level 2  | Level 3   |
|  | (In Thousands)     |            |           |          |           |
| Financial assets:                                    |                    |            |           |          |           |
| Cash and cash equivalents                            | \$52,539           | \$52,539   | \$ 35,114 | \$17,425 | \$ —      |
| Securities available-for-sale                        | 126,005            | 126,005    | —         | 126,005  | —         |
| Securities held-to-maturity                          | 37,778             | 37,696     | —         | 37,696   | —         |
| Loans held for sale                                  | 2,194              | 2,413      | —         | 2,413    | —         |
| Loans and lease receivables, net                     | 1,482,832          | 1,482,664  | —         | 10,063   | 1,472,601 |
| Federal Home Loan Bank stock                         | 5,670              | N/A        | N/A       | N/A      | N/A       |
| Accrued interest receivable                          | 5,019              | 5,019      | 5,019     | —        | —         |
| Interest rate swaps                                  | 942                | 942        | —         | 942      | —         |
| Financial liabilities:                               |                    |            |           |          |           |
| Deposits   | 1,394,331          | 1,391,801  | 1,010,147 | 381,654  | —         |
| Federal Home Loan Bank advances and other borrowings | 207,898            | 206,441    | —         | 206,441  | —         |
| Junior subordinated notes                            | 10,019             | 8,836      | —         | —        | 8,836     |
| Accrued interest payable                             | 2,095              | 2,095      | 2,095     | —        | —         |
| Interest rate swaps                                  | 1,064              | 1,064      | —         | 1,064    | —         |
| Off-balance-sheet items:                             |                    |            |           |          |           |
| Standby letters of credit                            | 75                 | 75         | —         | —        | 75        |

N/A = The fair value is not applicable due to restrictions placed on transferability

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 unaudited 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.

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 by 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 the guaranteed portions of SBA loans, are carried at the lower of cost or estimated fair value. The estimated fair value is based on what secondary markets are currently offering for portfolios with similar characteristics.

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

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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 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 11 — 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 considered hedging instruments 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 considered the impact of netting and any applicable credit enhancements such as collateral postings, thresholds and guarantees.

At June 30, 2018, the aggregate amortizing notional value of interest rate swaps with various commercial borrowers was \$93.2 million. The Corporation receives fixed rates and pays floating rates based upon LIBOR on the swaps with commercial borrowers. These interest rate swaps mature between September 2018 and July 2034. 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 unaudited Consolidated Balance Sheet as a derivative asset of \$687,000, included in accrued interest receivable and other assets, and as a derivative liability of \$704,000, included in accrued interest payable and other liabilities. As of June 30, 2018, no interest rate swaps were in default.

At June 30, 2018, the aggregate amortizing notional value of interest rate swaps with dealer counterparties was also \$93.2 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 September 2018 through July 2034. Dealer counterparty swaps are subject to master netting agreements among the contracts within our Bank and are reported on the unaudited Consolidated Balance Sheet as a net derivative asset of \$17,000, included in accrued interest receivable and other assets. The gross amount of dealer counterparty swaps, without regard to the enforceable master netting agreement, was a gross derivative liability of \$687,000 and a gross derivative asset of \$704,000. No right of offset existed with dealer counterparty swaps as of June 30, 2018.

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 three and six months ended June 30, 2018 and 2017 had an insignificant impact on the unaudited Consolidated Statements of Income.

The Corporation also enters into interest rate swaps to manage interest rate risk and reduce the cost of match-funding certain long-term fixed rate loans. These derivative contracts involve the receipt of floating rate interest from a counterparty in exchange for the Corporation making fixed-rate payments over the life of the agreement, without the exchange of the underlying notional value. The instruments are designated as cash flow hedges as the receipt of floating rate interest from the counterparty is used to manage interest rate risk associated with forecasted issuances of short-term FHLB advances. The change in the fair value of these hedging instruments is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged transactions affects earnings.

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As of June 30, 2018, the aggregate notional value of interest rate swaps designated as cash flow hedges was \$30.0 million. These interest rate swaps matures between June 2027 and December 2027. A pre-tax unrealized gain of \$358,000 and \$1.0 million was recognized in other comprehensive income for the three and six months ended June 30, 2018, respectively, and there was no ineffective portion of these hedges.

The table below provides information about the balance sheet location and fair value of the Corporation's derivative instruments:

|   | Interest Rate Swap Contracts                          |        | Fair Value  | Balance Sheet Location | Fair Value |
|---|---|--------|---|------------------------|------------|
|   | Balance Sheet Location                                |        |   |                        |            |
|   | (In Thousands)  |        |   |                        |            |
| Derivatives not designated as hedging instruments |   |        |   |                        |            |
| June 30, 2018                                     | Accrued interest receivable and other assets          | \$ 704 | Accrued interest payable and other liabilities        | \$ 704                 |            |
| December 31, 2017                                 | Accrued interest receivable and other assets          | \$ 942 | Accrued interest payable and other liabilities        | \$ 942                 |            |
| Derivatives designated as hedging instruments     |   |        |   |                        |            |
| June 30, 2018                                     | Accrued interest receivable and other assets          | \$ 908 | Accumulated other comprehensive income <sup>(1)</sup> | \$ 908                 |            |
| December 31, 2017                                 | Accumulated other comprehensive income <sup>(1)</sup> | \$ 122 | Accrued interest payable and other liabilities        | \$ 122                 |            |

<sup>(1)</sup> The fair value of derivatives designated as hedging instruments included in accumulated other comprehensive income represent pre-tax amounts, which are reported net of tax on the unaudited Consolidated Balance Sheets.

## Note 12 — Regulatory Capital

The Corporation and the Bank are subject to various regulatory capital requirements administered by Federal and the State of Wisconsin 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 Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory practices. The Corporation's and the Bank's 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, 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 Bank. The Corporation's and the Bank's 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 financial institutions to strongly consider eliminating, deferring or significantly reducing dividends if: (i) net income available to common stockholders 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 and 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

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(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 Bank is 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 Bank 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 Bank 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 Bank 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 adjusted total assets. These risk-based capital requirements presently address credit risk related to both recorded and off-balance-sheet commitments and obligations.

In July 2013, the FRB and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's 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 increased 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 in assets to retain, through a one-time election, the past treatment for accumulated other comprehensive income, which did 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, was also established above the regulatory minimum capital requirements. This capital conservation buffer is being phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increases each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019.

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As of June 30, 2018, the Corporation's capital levels exceeded the regulatory minimums and Bank's capital levels remained characterized as well capitalized under the regulatory framework. The following table summarizes both the Corporation's and Bank's capital ratios and the ratios required by their federal regulators:

|                              | Actual    |         | Minimum Required for Capital Adequacy Purposes |        | For Capital Adequacy Purposes Plus Capital Conservation Buffer |         | Minimum Required to Be Well Capitalized Under Prompt Corrective Action Requirements |         |
|------------------------------|-----------|---------|--|--------|--|---------|---|---------|
|                              | Amount    | Ratio   | Amount   | Ratio  | Amount   | Ratio   | Amount  | Ratio   |
| (Dollars in Thousands)       |           |         |  |        |  |         |   |         |
| As of June 30, 2018          |           |         |  |        |  |         |   |         |
| Total capital                |           |         |  |        |  |         |   |         |
| (to risk-weighted assets)    |           |         |  |        |  |         |   |         |
| Consolidated                 | \$221,068 | 11.87 % | \$149,042                                      | 8.00 % | \$183,974  | 9.875 % | N/A   | N/A     |
| First Business Bank          | 213,343   | 11.50   | 148,355  | 8.00   | 183,125  | 9.875   | \$185,444   | 10.00 % |
| Tier 1 capital               |           |         |  |        |  |         |   |         |
| (to risk-weighted assets)    |           |         |  |        |  |         |   |         |
| Consolidated                 | \$174,038 | 9.34 %  | \$111,781                                      | 6.00 % | \$146,713  | 7.875 % | N/A   | N/A     |
| First Business Bank          | 190,160   | 10.25   | 111,266  | 6.00   | 146,037  | 7.875   | \$148,355   | 8.00 %  |
| Common equity tier 1 capital |           |         |  |        |  |         |   |         |
| (to risk-weighted assets)    |           |         |  |        |  |         |   |         |
| Consolidated                 | \$164,012 | 8.80 %  | \$83,836                                       | 4.50 % | \$118,768  | 6.375 % | N/A   | N/A     |
| First Business Bank          | 190,160   | 10.25   | 83,450   | 4.50   | 118,220  | 6.375   | \$120,538   | 6.50 %  |
| Tier 1 leverage capital      |           |         |  |        |  |         |   |         |
| (to adjusted assets)         |           |         |  |        |  |         |   |         |
| Consolidated                 | \$174,038 | 9.25 %  | \$75,262                                       | 4.00 % | \$75,262   | 4.00 %  | N/A   | N/A     |
| First Business Bank          | 190,160   | 10.15   | 74,938   | 4.00   | 74,938   | 4.00    | \$93,672  | 5.00 %  |

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|                              | Actual    |         | Minimum Required for Capital Adequacy Purposes |        | For Capital Adequacy Purposes Plus Capital Conservation Buffer |         | Minimum Required to Be Well Capitalized Under Prompt Corrective Action Requirements |         |
|------------------------------|-----------|---------|--|--------|--|---------|---|---------|
|                              | Amount    | Ratio   | Amount   | Ratio  | Amount   | Ratio   | Amount  | Ratio   |
| (Dollars in Thousands)       |           |         |  |        |  |         |   |         |
| As of December 31, 2017      |           |         |  |        |  |         |   |         |
| Total capital                |           |         |  |        |  |         |   |         |
| (to risk-weighted assets)    |           |         |  |        |  |         |   |         |
| Consolidated                 | \$214,501 | 11.98 % | \$143,219                                      | 8.00 % | \$165,597  | 9.250 % | N/A   | N/A     |
| First Business Bank          | 207,986   | 11.66   | 142,736  | 8.00   | 165,038  | 9.250   | \$178,420   | 10.00 % |
| Tier 1 capital               |           |         |  |        |  |         |   |         |
| (to risk-weighted assets)    |           |         |  |        |  |         |   |         |
| Consolidated                 | \$169,176 | 9.45 %  | \$107,414                                      | 6.00 % | \$129,792  | 7.250 % | N/A   | N/A     |
| First Business Bank          | 186,374   | 10.45   | 107,052  | 6.00   | 129,354  | 7.250   | \$142,736   | 8.00 %  |
| Common equity tier 1 capital |           |         |  |        |  |         |   |         |
| (to risk-weighted assets)    |           |         |  |        |  |         |   |         |
| Consolidated                 | \$159,157 | 8.89 %  | \$80,561                                       | 4.50 % | \$102,939  | 5.750 % | N/A   | N/A     |
| First Business Bank          | 186,374   | 10.45   | 80,289   | 4.50   | 102,591  | 5.750   | \$115,973   | 6.50 %  |
| Tier 1 leverage capital      |           |         |  |        |  |         |   |         |
| (to adjusted assets)         |           |         |  |        |  |         |   |         |
| Consolidated                 | \$169,176 | 9.54 %  | \$70,920                                       | 4.00 % | \$70,920   | 4.00 %  | N/A   | N/A     |
| First Business Bank          | 186,374   | 10.56   | 70,617   | 4.00   | 70,617   | 4.00    | \$88,272  | 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 subsidiary. "FBB" or the "Bank" refers to our subsidiary, First Business Bank.

Forward-Looking Statements

This report may include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995, which reflect our current views with respect to future events and financial performance. Forward-looking statements are not based on historical information, but rather are related to future operations, strategies, financial results or other developments. Forward-looking statements are based on management's expectations as well as certain assumptions and estimates made by, and information available to, management at the time the statements are made. Such statements are subject to risks and uncertainties, including among other things:

- Competitive pressures among depository and other financial institutions nationally and in our markets.
- Adverse changes in the economy or business conditions, either nationally or in our markets.
- Increases in defaults by borrowers and other delinquencies.
- Our ability to manage growth effectively, including the successful expansion of our client support, administrative infrastructure and internal management systems.
- Fluctuations in interest rates and market prices.
- The consequences of continued bank acquisitions and mergers in our markets, resulting in fewer but much larger and financially stronger competitors.
- Changes in legislative or regulatory requirements applicable to us and our subsidiary.
- Changes in tax requirements, including tax rate changes, new tax laws and revised tax law interpretations.
- Fraud, including client and system failure or breaches of our network security, including our internet banking activities.
- Failure to comply with the applicable SBA regulations in order to maintain the eligibility of the guaranteed portion of SBA loans.

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 stockholders and potential investors. See Part I, Item 1A — Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2017 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 is 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.



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## 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 subsidiary, FBB. All of our operations are conducted through the Bank and its subsidiaries. We operate as a business bank focusing on delivering a full line of commercial banking products and services tailored to meet the specific needs of small- to medium-sized businesses, business owners, executives, professionals and high net worth individuals. Our products and services include commercial lending, SBA lending and servicing, asset-based lending, equipment financing, factoring, trust and investment services, investment portfolio administrative services, asset/liability management 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 is predicated on deep client relationships fostered by local expertise, combined with the efficiency of centralized administrative functions such as information technology, loan and deposit operations, finance and accounting, credit administration, compliance and human resources. Our focused model allows experienced staff to provide the level of financial expertise needed to develop and maintain long-term relationships with our clients.

## Operational Summary

Results for the three and six months ended June 30, 2018 include:

Total assets increased to \$1.900 billion as of June 30, 2018 compared to \$1.794 billion as of December 31, 2017. Net income for the three months ended June 30, 2018 was \$3.3 million compared to net income of \$1.9 million for the three months ended June 30, 2017. Net income for the six months ended June 30, 2018 was \$6.9 million compared to net income of \$5.3 million for the six months ended June 30, 2017.

Diluted earnings per common share for the three months ended June 30, 2018 were \$0.38 compared to diluted earnings per common share of \$0.22 for the three months ended June 30, 2017. Diluted earnings per common share for the six months ended June 30, 2018 were \$0.79 compared to diluted earnings per common share of \$0.61 for the six months ended June 30, 2017.

Annualized return on average assets ("ROAA") and annualized return on average equity ("ROAE") were 0.70% and 7.59%, respectively, for the three month period ended June 30, 2018, compared to 0.42% and 4.50%, respectively, for the same time period in 2017. ROAA and ROAE were 0.74% and 8.22%, respectively, for the six month period ended June 30, 2018 compared to 0.59% and 6.38%, respectively, for the same period in 2017.

Net interest income increased 9.4% to \$16.9 million for the three months ended June 30, 2018 compared to \$15.5 million for the three months ended June 30, 2017. For the six months ended June 30, 2018, net interest income increased 9.1% to \$33.1 million compared to \$30.4 million for the six months ended June 30, 2017.

Trust and investment services fee income increased 20.6% to \$2.0 million for the three months ended June 30, 2018 compared to \$1.6 million for the three months ended June 30, 2017. For the six months ended June 30, 2018, trust and investment services fee income increased 18.5% to \$3.9 million compared to \$3.3 million for the six months ended June 30, 2017.

Top line revenue, the sum of net interest income and non-interest income, increased 3.4% to \$20.9 million for the three months ended June 30, 2018 compared to \$20.2 million for the three months ended June 30, 2017. For the six months ended June 30, 2018, top line revenue increased 6.7% to \$41.8 million compared to \$39.2 million for the six months ended June 30, 2017.

Net interest margin increased 13 basis points to 3.77% for the three months ended June 30, 2018 compared to 3.64% for the three months ended June 30, 2017. Net interest margin increased 13 basis points to 3.71% for the six months ended June 30, 2018 compared to 3.58% for the six months ended June 30, 2017.

Efficiency ratio was 67.07% for the three months ended June 30, 2018, compared to 65.39% for the three months ended June 30, 2017. For the six months ended June 30, 2018 our efficiency ratio was 67.27% compared to 68.03% for the same time period in 2017.

Provision for loan and lease losses was \$2.6 million for the three months ended June 30, 2018 compared to \$3.7 million for the same period in the prior year. Provision for loan and lease losses was \$5.1 million for the six months

ended June 30, 2018 compared to \$4.2 million for the same time period in 2017.

SBA recourse provision was \$99,000 for the three months ended June 30, 2018, compared to \$774,000 for the three months ended June 30, 2017. For the six months ended June 30, 2018, SBA recourse provision was a net benefit of \$196,000 compared to an expense of \$780,000 for the six months ended June 30, 2017.

Net charge-offs of \$285,000 represented an annualized 0.07% of average loans and leases for the three months ended June 30, 2018 compared to annualized net charge-offs of 0.99% for the three months ended June 30, 2017. Net charge-offs of \$2.9 million represented an annualized 0.37% of average loans and leases for the six months ended June 30, 2018 compared to annualized net charge-offs of 0.47% for the six months ended June 30, 2017.

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Gross loans and leases receivable increased \$93.4 million, or 12.4% annualized, to \$1.595 billion at June 30, 2018 from \$1.502 billion at December 31, 2017.

Allowance for loan and lease losses as a percentage of gross loans and leases was 1.31% at June 30, 2018 compared to 1.25% at December 31, 2017.

Non-performing assets as a percentage of total assets was 1.71% at June 30, 2018 compared to 1.53% at December 31, 2017.

Non-accrual loans and leases increased by \$4.7 million, or 17.8%, to \$31.1 million at June 30, 2018 from \$26.4 million at December 31, 2017.

## Results of Operations

## Top Line Revenue

Top line revenue is comprised of net interest income and non-interest income. For the three and six months ended June 30, 2018, top line revenue increased 3.4% and 6.7%, respectively, compared to the same period in the prior year primarily due to higher loan yields combined with loan growth, as well as an increase in trust and investment fee income. This increase was partially offset by higher rates paid on interest-bearing liabilities amid a rising rate environment and a decline in gains on the sale of SBA loans, loan fees and other non-interest income.

The components of top line revenue were as follows:

|                        | For the Three Months Ended June 30, |          |        | For the Six Months Ended June 30, |          |        |
|------------------------|-------------------------------------|----------|--------|-----------------------------------|----------|--------|
|                        | 2018                                | 2017     | Change | 2018                              | 2017     | Change |
|                        | (Dollars in Thousands)              |          |        |                                   |          |        |
| Net interest income    | \$16,931                            | \$15,479 | 9.4 %  | \$33,132                          | \$30,367 | 9.1 %  |
| Non-interest income    | 3,982                               | 4,738    | (16.0) | 8,648                             | 8,801    | (1.7)  |
| Total top line revenue | \$20,913                            | \$20,217 | 3.4    | \$41,780                          | \$39,168 | 6.7    |

## Annualized Return on Average Assets and Annualized Return on Average Equity

ROAA for the three months ended June 30, 2018 increased to 0.70% compared to 0.42% for the three months ended June 30, 2017. ROAA for the six months ended June 30, 2018 increased to 0.74% compared to 0.59% for the six months ended June 30, 2017. The increase in ROAA for both periods was primarily due to an increase in net interest income, trust and investment fee income and a reduction to the corporate federal income tax rate from 35% to 21% effective January 1, 2018. This improvement in profitability was partially offset by an increase in compensation expense and moderate decreases in certain non-interest income items, including gains on the sale of SBA loans and other non-interest income. 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 that can ultimately influence return on equity measures.

ROAE for the three months ended June 30, 2018 was 7.59% compared to 4.50% for the three months ended June 30, 2017. ROAE for the six months ended June 30, 2018 was 8.22% compared to 6.38% for the six months ended June 30, 2017. The reasons for the increase in ROAE are consistent with the explanations discussed above with respect to ROAA. We view ROAE to be an important measure of profitability and we continue to focus on improving the return to our stockholders by enhancing the overall profitability of our client relationships, controlling expenses and seeking to minimize credit costs.

## Efficiency Ratio

Efficiency ratio is a non-GAAP measure representing non-interest expense excluding the effects of the SBA recourse provision, impairment of tax credit investments, losses or gains on foreclosed properties, amortization of other intangible assets and other discrete items, if any, divided by operating revenue, which is equal to net interest income plus non-interest income less realized gains or losses on securities, if any.

The efficiency ratio was 67.07% and 67.27% for the three and six months ended June 30, 2018, respectively, compared to 65.39% and 68.03% for the three and six months ended June 30, 2017, respectively. We continue to progress towards enhancing the Corporation's long-term efficiency ratio through both proactive expense management

and revenue growth efforts. These efforts include the recently completed charter consolidation and core conversion, an expected

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normalization of loan workout costs, as well as long-term revenue initiatives. These initiatives include efforts to increase SBA lending production and to increase commercial banking market share, particularly in our less mature markets, by continuing to invest in production talent. Management will continue to take proactive measures to drive positive operating leverage with the objective of moving the efficiency ratio back within the Corporation's long-term operating goal of 58-62%.

We believe the efficiency ratio allows investors and analysts to better assess the Corporation's operating expenses in relation to its operating revenue by removing the volatility that is associated with certain non-recurring or discrete items. The efficiency ratio also allows management to benchmark performance of our model to our peers without the influence of the loan loss provision and tax considerations, which will ultimately influence other traditional financial measurements, including ROAA and ROAE. The information provided below reconciles the efficiency ratio to its most comparable GAAP measure.

Please refer to both the Non-Interest Income and Non-Interest Expense sections below for discussion on the primary drivers of the year-over-year improvement in the efficiency ratio.

|   | For the Three Months Ended June 30, |           |              |             | For the Six Months Ended June 30, |           |              |             |
|---|-------------------------------------|-----------|--------------|-------------|-----------------------------------|-----------|--------------|-------------|
|   | 2018                                | 2017      | \$<br>Change | %<br>Change | 2018                              | 2017      | \$<br>Change | %<br>Change |
|   | (Dollars in Thousands)              |           |              |             |                                   |           |              |             |
| Total non-interest expense              | \$ 14,467                           | \$ 14,221 | \$ 246       | 1.7 %       | \$ 28,374                         | \$ 27,781 | \$ 593       | 2.1 %       |
| Less:                                   |                                     |           |              |             |                                   |           |              |             |
| Amortization of other intangible assets | 12                                  | 14        | (2 )         | (14.3 )     | 24                                | 28        | (4 )         | (14.3 )     |
| SBA recourse provision (benefit)        | 99                                  | 774       | (675 )       | (87.2 )     | (196 )                            | 780       | (976 )       | (125.1)     |
| Impairment of tax credit investments    | 329                                 | 112       | 217          | 193.8       | 442                               | 225       | 217          | 96.4        |
| Deconversion fees                       | —                                   | 101       | (101 )       | (100.0)     | —                                 | 101       | (101 )       | (100.0)     |
| Total operating expense                 | \$ 14,027                           | \$ 13,220 | \$ 807       | 6.1         | \$ 28,104                         | \$ 26,647 | \$ 1,457     | 5.5         |
| Net interest income                     | \$ 16,931                           | \$ 15,479 | \$ 1,452     | 9.4         | \$ 33,132                         | \$ 30,367 | 2,765        | 9.1         |
| Total non-interest income               | 3,982                               | 4,738     | (756 )       | (16.0 )     | 8,648                             | 8,801     | (153 )       | (1.7 )      |
| Less:                                   |                                     |           |              |             |                                   |           |              |             |
| Gain on sale of securities              | —                                   | 1         | (1 )         | (100.0)     | —                                 | 1         | (1 )         | (100.0)     |
| Total operating revenue                 | \$ 20,913                           | \$ 20,216 | \$ 697       | 3.4         | \$ 41,780                         | \$ 39,167 | \$ 2,613     | 6.7         |
| Efficiency ratio                        | 67.07 %                             | 65.39 %   |              |             | 67.27 %                           | 68.03 %   |              |             |

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## Net Interest Income

Net interest income levels depend on the amount of and yield on interest-earning assets as compared to the amount of and rate 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 six months ended June 30, 2018 compared to the same periods in 2017. 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<br>Three Months Ended June<br>30,<br>2018 Compared to 2017 |         |         | Increase (Decrease) for the<br>Six Months Ended June 30,<br>2018 Compared to 2017 |         |         |
|--|--|---------|---------|---|---------|---------|
|  | Rate   | Volume  | Net     | Rate  | Volume  | Net     |
|  | (In Thousands)   |         |         |   |         |         |
| Interest-earning assets  |  |         |         |   |         |         |
| Commercial real estate and other mortgage loans <sup>(1)</sup> | \$1,306  | \$1,338 | \$2,644 | \$2,180   | \$2,486 | \$4,666 |
| Commercial and industrial loans <sup>(1)</sup>                 | 570  | (304 )  | 266     | 853   | (479 )  | 374     |
| Direct financing leases <sup>(1)</sup>                         | (19 )  | 26      | 7       | (36 )   | 24      | (12 )   |
| Consumer and other loans <sup>(1)</sup>                        | 28   | 14      | 42      | 44  | 26      | 70      |
| Total loans and leases receivable                              | 1,885  | 1,074   | 2,959   | 3,041   | 2,057   | 5,098   |
| Mortgage-related securities                                    | 174  | (14 )   | 160     | 324   | (95 )   | 229     |
| Other investment securities                                    | 17   | (15 )   | 2       | 34  | (24 )   | 10      |
| FHLB and FRB Stock   | 12   | 30      | 42      | 10  | 57      | 67      |
| Short-term investments   | 93   | (13 )   | 80      | 108   | 5       | 113     |
| Total net change in income on interest-earning assets          | 2,181  | 1,062   | 3,243   | 3,517   | 2,000   | 5,517   |
| Interest-bearing liabilities                                   |  |         |         |   |         |         |
| Transaction accounts   | 281  | 59      | 340     | 300   | 216     | 516     |
| Money market accounts  | 556  | (148 )  | 408     | 881   | (282 )  | 599     |
| Certificates of deposit  | 56   | 50      | 106     | 92  | 121     | 213     |
| Wholesale deposits   | 132  | (435 )  | (303 )  | 249   | (870 )  | (621 )  |
| Total deposits   | 1,025  | (474 )  | 551     | 1,522   | (815 )  | 707     |
| FHLB advances  | 244  | 1,114   | 1,358   | 449   | 1,760   | 2,209   |
| Other borrowings   | (127 )   | 9       | (118 )  | (143 )  | (21 )   | (164 )  |
| Junior subordinated notes                                      | —  | —       | —       | (1 )  | 1       | —       |
| Total net change in expense on interest-bearing liabilities    | 1,142  | 649     | 1,791   | 1,827   | 925     | 2,752   |
| Net change in net interest income                              | \$1,039  | \$413   | \$1,452 | \$1,690   | \$1,075 | \$2,765 |

(1) Includes non-accrual loans and leases and loans held for sale.

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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 and six months ended June 30, 2018 and 2017. The average balances are derived from average daily balances.

|   | For the Three Months Ended June 30, |           |                                   |                 |           |                                   |      |  |
|---|-------------------------------------|-----------|-----------------------------------|-----------------|-----------|-----------------------------------|------|--|
|   | 2018                                |           | 2017                              |                 | 2018      |                                   | 2017 |  |
|   | Average Balance                     | Interest  | Average Yield/Rate <sup>(4)</sup> | Average Balance | Interest  | Average Yield/Rate <sup>(4)</sup> |      |  |
|   | (Dollars in Thousands)              |           |                                   |                 |           |                                   |      |  |
| <b>Interest-earning assets</b>  |                                     |           |                                   |                 |           |                                   |      |  |
| Commercial real estate and other mortgage loans <sup>(1)</sup>          | \$ 1,073,326                        | \$ 13,264 | 4.94 %                            | \$ 959,176      | \$ 10,620 | 4.43 %                            |      |  |
| Commercial and industrial loans <sup>(1)</sup>                          | 434,657                             | 7,347     | 6.76                              | 453,578         | 7,081     | 6.24                              |      |  |
| Direct financing leases <sup>(1)</sup>                                  | 31,284                              | 313       | 4.00                              | 28,728          | 306       | 4.26                              |      |  |
| Consumer and other loans <sup>(1)</sup>                                 | 29,914                              | 319       | 4.27                              | 28,580          | 277       | 3.88                              |      |  |
| Total loans and leases receivable <sup>(1)</sup>                        | 1,569,181                           | 21,243    | 5.42                              | 1,470,062       | 18,284    | 4.98                              |      |  |
| Mortgage-related securities <sup>(2)</sup>                              | 136,982                             | 775       | 2.26                              | 140,086         | 615       | 1.76                              |      |  |
| Other investment securities <sup>(3)</sup>                              | 34,391                              | 163       | 1.90                              | 37,765          | 161       | 1.70                              |      |  |
| FHLB and FRB stock  | 8,392                               | 66        | 3.15                              | 4,229           | 24        | 2.26                              |      |  |
| Short-term investments  | 45,473                              | 221       | 1.94                              | 49,584          | 141       | 1.14                              |      |  |
| Total interest-earning assets   | 1,794,419                           | 22,468    | 5.01                              | 1,701,726       | 19,225    | 4.52                              |      |  |
| Non-interest-earning assets   | 94,923                              |           |                                   | 81,798          |           |                                   |      |  |
| Total assets  | \$ 1,889,342                        |           |                                   | \$ 1,783,524    |           |                                   |      |  |
| <b>Interest-bearing liabilities</b>                                     |                                     |           |                                   |                 |           |                                   |      |  |
| Transaction accounts  | \$ 272,840                          | 628       | 0.92                              | \$ 231,720      | 288       | 0.50                              |      |  |
| Money market accounts   | 474,943                             | 1,067     | 0.90                              | 588,787         | 659       | 0.45                              |      |  |
| Certificates of deposit   | 71,994                              | 239       | 1.33                              | 54,530          | 133       | 0.98                              |      |  |
| Wholesale deposits  | 278,496                             | 1,275     | 1.83                              | 375,530         | 1,578     | 1.68                              |      |  |
| Total interest-bearing deposits   | 1,098,273                           | 3,209     | 1.17                              | 1,250,567       | 2,658     | 0.85                              |      |  |
| FHLB advances   | 322,791                             | 1,637     | 2.03                              | 87,386          | 279       | 1.28                              |      |  |
| Other borrowings  | 24,889                              | 414       | 6.65                              | 24,494          | 532       | 8.69                              |      |  |
| Junior subordinated notes   | 10,023                              | 277       | 11.05                             | 10,009          | 277       | 11.08                             |      |  |
| Total interest-bearing liabilities                                      | 1,455,976                           | 5,537     | 1.52                              | 1,372,456       | 3,746     | 1.09                              |      |  |
| Non-interest-bearing demand deposit accounts                            | 240,352                             |           |                                   | 229,051         |           |                                   |      |  |
| Other non-interest-bearing liabilities                                  | 19,752                              |           |                                   | 14,531          |           |                                   |      |  |
| Total liabilities   | 1,716,080                           |           |                                   | 1,616,038       |           |                                   |      |  |
| Stockholders' equity  | 173,262                             |           |                                   | 167,486         |           |                                   |      |  |
| Total liabilities and stockholders' equity                              | \$ 1,889,342                        |           |                                   | \$ 1,783,524    |           |                                   |      |  |
| Net interest income   |                                     | \$ 16,931 |                                   |                 | \$ 15,479 |                                   |      |  |
| Interest rate spread  |                                     |           | 3.49 %                            |                 |           | 3.43 %                            |      |  |
| Net interest-earning assets   | \$ 338,443                          |           |                                   | \$ 329,270      |           |                                   |      |  |
| Net interest margin   |                                     |           | 3.77 %                            |                 |           | 3.64 %                            |      |  |
| Average interest-earning assets to average interest-bearing liabilities | 123.25                              | %         |                                   | 123.99          | %         |                                   |      |  |
| Return on average assets <sup>(4)</sup>                                 | 0.70                                |           |                                   | 0.42            |           |                                   |      |  |
| Return on average equity <sup>(4)</sup>                                 | 7.59                                |           |                                   | 4.50            |           |                                   |      |  |
| Average equity to average assets  | 9.17                                |           |                                   | 9.39            |           |                                   |      |  |
| Non-interest expense to average assets <sup>(4)</sup>                   | 3.06                                |           |                                   | 3.19            |           |                                   |      |  |

(1)

The average balances of loans and leases include non-accrual loans and leases and loans held for sale. Interest income related to non-accrual loans and leases is recognized when collected. Interest income includes net loan fees collected in lieu of interest.

(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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|   | For the Six Months Ended June 30, |           |                                      |                    |           |                                      |
|---|-----------------------------------|-----------|--------------------------------------|--------------------|-----------|--------------------------------------|
|   | 2018                              |           | 2017                                 |                    |           |                                      |
|   | Average<br>Balance                | Interest  | Average<br>Yield/Rate <sup>(4)</sup> | Average<br>Balance | Interest  | Average<br>Yield/Rate <sup>(4)</sup> |
|   | (Dollars in Thousands)            |           |                                      |                    |           |                                      |
| Interest-earning assets   |                                   |           |                                      |                    |           |                                      |
| Commercial real estate and other mortgage loans <sup>(1)</sup>          | \$ 1,060,112                      | \$ 25,605 | 4.83 %                               | \$ 952,679         | \$ 20,939 | 4.40 %                               |
| Commercial and industrial loans <sup>(1)</sup>                          | 437,061                           | 14,049    | 6.43                                 | 452,570            | 13,675    | 6.04                                 |
| Direct financing leases <sup>(1)</sup>                                  | 30,582                            | 617       | 4.04                                 | 29,422             | 629       | 4.28                                 |
| Consumer and other loans <sup>(1)</sup>                                 | 29,639                            | 633       | 4.27                                 | 28,392             | 563       | 3.97                                 |
| Total loans and leases receivable <sup>(1)</sup>                        | 1,557,394                         | 40,904    | 5.25                                 | 1,463,063          | 35,806    | 4.89                                 |
| Mortgage-related securities <sup>(2)</sup>                              | 132,546                           | 1,462     | 2.21                                 | 142,929            | 1,233     | 1.73                                 |
| Other investment securities <sup>(3)</sup>                              | 35,386                            | 332       | 1.88                                 | 38,157             | 322       | 1.69                                 |
| FHLB and FRB stock  | 7,559                             | 114       | 3.02                                 | 3,693              | 47        | 2.57                                 |
| Short-term investments  | 51,349                            | 377       | 1.47                                 | 50,356             | 264       | 1.05                                 |
| Total interest-earning assets   | 1,784,234                         | 43,189    | 4.84                                 | 1,698,198          | 37,672    | 4.44                                 |
| Non-interest-earning assets   | 91,853                            |           |                                      | 81,031             |           |                                      |
| Total assets  | \$ 1,876,087                      |           |                                      | \$ 1,779,229       |           |                                      |
| Interest-bearing liabilities  |                                   |           |                                      |                    |           |                                      |
| Transaction accounts  | \$ 285,216                        | 1,036     | 0.73                                 | \$ 212,118         | 520       | 0.49                                 |
| Money market accounts   | 494,779                           | 1,918     | 0.78                                 | 607,882            | 1,319     | 0.43                                 |
| Certificates of deposit   | 76,424                            | 478       | 1.25                                 | 54,959             | 265       | 0.96                                 |
| Wholesale deposits  | 289,614                           | 2,606     | 1.80                                 | 388,031            | 3,227     | 1.66                                 |
| Total interest-bearing deposits   | 1,146,033                         | 6,038     | 1.05                                 | 1,262,990          | 5,331     | 0.84                                 |
| FHLB advances   | 270,445                           | 2,641     | 1.95                                 | 74,118             | 432       | 1.17                                 |
| Other borrowings  | 24,647                            | 826       | 6.70                                 | 25,204             | 990       | 7.86                                 |
| Junior subordinated notes   | 10,022                            | 552       | 11.02                                | 10,007             | 552       | 11.03                                |
| Total interest-bearing liabilities                                      | 1,451,147                         | 10,057    | 1.39                                 | 1,372,319          | 7,305     | 1.06                                 |
| Non-interest-bearing demand deposit accounts                            | 234,487                           |           |                                      | 228,536            |           |                                      |
| Other non-interest-bearing liabilities                                  | 21,643                            |           |                                      | 12,886             |           |                                      |
| Total liabilities   | 1,707,277                         |           |                                      | 1,613,741          |           |                                      |
| Stockholders' equity  | 168,810                           |           |                                      | 165,488            |           |                                      |
| Total liabilities and stockholders' equity                              | \$ 1,876,087                      |           |                                      | \$ 1,779,229       |           |                                      |
| Net interest income   |                                   | \$ 33,132 |                                      |                    | \$ 30,367 |                                      |
| Interest rate spread  |                                   |           | 3.45 %                               |                    |           | 3.37 %                               |
| Net interest-earning assets   | \$ 333,087                        |           |                                      | \$ 325,879         |           |                                      |
| Net interest margin   |                                   |           | 3.71 %                               |                    |           | 3.58 %                               |
| Average interest-earning assets to average interest-bearing liabilities | 122.95 %                          |           |                                      | 123.75 %           |           |                                      |
| Return on average assets <sup>(4)</sup>                                 | 0.74                              |           |                                      | 0.59               |           |                                      |
| Return on average equity <sup>(4)</sup>                                 | 8.22                              |           |                                      | 6.38               |           |                                      |
| Average equity to average assets  | 9.00                              |           |                                      | 9.30               |           |                                      |
| Non-interest expense to average assets                                  | 3.02                              |           |                                      | 3.12               |           |                                      |

The average balances of loans and leases include non-accrual loans and leases and loans held for sale. Interest (1) income related to non-accrual loans and leases is recognized when collected. Interest income includes net loan fees collected in lieu of interest.

- (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 and Six Months Ended June 30, 2018 and 2017

Net interest income increased \$1.5 million, or 9.4%, and \$2.8 million, or 9.1% during the three and six months ended June 30, 2018, respectively, compared to the same periods in 2017. The increase in net interest income was attributable to both positive interest-earning asset volume and rate variances. Interest-earning asset growth was primarily driven by a \$99.1 million, or 6.7%, increase in average loans and leases from the second quarter of 2017. Both periods of comparisons also benefited from increases to short-term market rates throughout 2017 and 2018, which management defines as the daily average effective federal funds rate for purposes of estimating interest-earning and interest-bearing betas. The change in the yield on the respective interest-earning asset or the rate paid on interest-bearing liability compared to the change in short-term market rates is commonly referred to as a beta. The daily average effective federal funds rate increased 79 basis points and 77 basis points for the three and six months ended June 30, 2018, respectively, compared to the same period in 2017.

The yield on average interest-earning assets for the three months ended June 30, 2018 increased to 5.01% from 4.52% for the three months ended June 30, 2017. The yield on average interest-earning assets for the six months ended June 30, 2018 increased to 4.84% from 4.44% for the six months ended June 30, 2017. The increase in both periods of comparison was primarily due to increased rates on variable-rate loans following raises to the targeted federal funds rate. The average interest-earnings assets beta for the three and six months ended June 30, 2018 was 62% and 52%, respectively, compared to the same period in 2017. Similarly, the yield on average loans and leases receivable for the three months ended June 30, 2018 increased to 5.42% from 4.98% for the three months ended June 30, 2017. The yield on average loans and leases receivable for the six months ended June 30, 2018 increased to 5.25% from 4.89% for the six months ended June 30, 2017. The average loans and leases receivable beta for the three and six months ended June 30, 2018 was 56% and 47%, respectively, compared to the same period in 2017.

The weighted average rate paid on interest-bearing deposits for the three months ended June 30, 2018 increased to 1.17% from 0.85% for the three months ended June 30, 2017. The weighted average rate paid on interest-bearing deposits for the six months ended June 30, 2018 increased to 1.05% from 0.84% for the six months ended June 30, 2017. The average interest-bearing deposits beta for the three and six months ended June 30, 2018 was 41% and 27%, respectively, compared to the same period in 2017. The rising rate environment has resulted in increases in deposit pricing as necessary to serve the Corporation's client relationships. Management believes an increase in average total interest-bearing deposit costs will continue as the Corporation looks to effectively manage deposit relationships amid intense competition and continued expectation of a rising rate environment.

The overall weighted average rate paid on interest-bearing liabilities was 1.52% and 1.39% for the three and six months ended June 30, 2018, respectively, compared to 1.09% and 1.06% for the three and six months ended June 30, 2017, respectively. The primary reason for the increase in rate paid was an increase in rates across all in-market deposit types combined with higher wholesale funding rates resulting from a rising rate environment. The average interest-bearing liabilities beta for the three and six months ended June 30, 2018 was 54% and 43%, respectively, compared to the same period in 2017. Consistent with the Corporation's longstanding funding strategy to manage risk and use the most efficient and cost effective source of wholesale funds, fixed rate FHLB advances were used at various maturity terms to continue replacing wholesale deposits, as well as to fund strong loan growth during the first half of 2018. Average FHLB advances for the three months ended June 30, 2018 increased \$235.4 million to \$322.8 million at a weighted average rate paid of 2.03%. Average FHLB advances for the six months ended June 30, 2018 increased \$196.3 million to \$270.4 million at a weighted average rate paid of 1.95%. The weighted average original maturity of our FHLB term advances was 2.7 years at June 30, 2018 compared to 3.6 years at June 30, 2017.

We believe we effectively manage the Corporation's liability structure in both term and rate to deliver a net interest margin at or above our target of 3.50%. Further, we expect future success in attracting in-market deposit relationships in our Wisconsin and Kansas City markets which we believe will contribute to our ability to maintain an appropriate cost of funds. Average in-market client deposits - comprised of all transaction accounts, money market accounts and non-wholesale deposits - were \$1.060 billion and \$1.091 billion for the three and six months ended June 30, 2018, respectively, compared to \$1.104 billion and \$1.103 billion for the three and six months ended June 30, 2017, respectively.

Net interest margin increased 13 basis points to 3.77% for the three months ended June 30, 2018, compared to 3.64% for the three months ended June 30, 2017. Similarly, net interest margin increased 13 basis points to 3.71% for the six months ended June 30, 2018, compared to 3.58% for the six months ended June 30, 2017. Pricing discipline amid a rising rate environment has contributed to the increased net interest margin. Over both periods of comparison, the increase in the yield on average interest-earning assets has outpaced the corresponding increase in the rate paid on interest-bearing liabilities.

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Management believes the successful efforts to manage funding costs and profitably expand loan balances will allow the Corporation to continue to maintain a net interest margin of 3.50% or better. However, the collection of loan fees in lieu of interest is an expected source of volatility to quarterly net interest income and net interest margin, given the nature of the Corporation's asset-based lending business. Net interest margin may also experience volatility due to events such as the collection of interest on loans previously in non-accrual status or the accumulation of significant short-term deposit inflows.

**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 in the period and the amount of reserves established for impaired loans that present collateral shortfall positions. Refer to the section entitled Allowance for Loan and Lease Losses, below, for further information regarding our allowance for loan and lease loss methodology.

We recorded provision expense of \$2.6 million and \$5.1 million for the three and six months ended June 30, 2018, compared to \$3.7 million and \$4.2 million for the same time periods in 2017. Provision for the six months ended June 30, 2018 was primarily driven by losses associated with six impaired loan relationships, all of which were originated as part of our legacy SBA loan portfolio. The current year provision also reflected an increase to the general reserve commensurate with loan growth.

The addition of specific reserves on impaired loans represents new specific reserves established when collateral shortfalls are present, while conversely the release of specific reserves represents the reduction of previously established reserves that are no longer required. Changes in the allowance for loan and lease losses due to subjective factor changes reflect management's evaluation of the level of risk within the portfolio based upon several factors for each portfolio segment. Charge-offs in excess of previously established specific reserves require an additional provision for loan and lease losses to maintain the allowance for loan and lease losses at a level deemed appropriate by management. Change in the inherent risk of the portfolio is primarily influenced by the overall growth in gross loans and leases and an analysis of loans previously charged off, as well as movement of existing loans and leases 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 the section entitled Asset Quality, below, for further information regarding the overall credit quality of our loan and lease portfolio.

**Comparison of Non-Interest Income for the Three and Six Months Ended June 30, 2018 and 2017****Non-Interest Income**

Non-interest income primarily consists of fees earned for trust and investment services, gains on sale of SBA loans, service charges on deposits, loan fee income and commercial loan swap fee income. For the three months ended June 30, 2018 non-interest income decreased by \$756,000, or 16.0%, to \$4.0 million from \$4.7 million for the same period in 2017. Non-interest income decreased by \$153,000, or 1.7%, to \$8.6 million from \$8.8 million for the six months ended June 30, 2018 as compared to the same period in 2017.

Management continues to focus on revenue growth from multiple non-interest income sources in order to maintain a diversified revenue stream through greater contribution from fee-based revenues. Total non-interest income accounted for 19.0% and 20.7% of our total revenues for the three and six months ended June 30, 2018, compared to 23.4% and 22.5% for the three and six months ended June 30, 2017. Management believes the expected gradual expansion of our rebuilt SBA lending program will drive our fee income ratio towards our current strategic target of 25%.

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The components of non-interest income were as follows for the three and six months ended June 30, 2018 and 2017:

|   | For the Three Months Ended June 30, |         |           |         | For the Six Months Ended June 30, |         |           |         |
|---|-------------------------------------|---------|-----------|---------|-----------------------------------|---------|-----------|---------|
|   | 2018                                | 2017    | \$        | %       | 2018                              | 2017    | \$        | %       |
|   |                                     |         | Change    | Change  |                                   |         | Change    | Change  |
|   | (Dollars in Thousands)              |         |           |         |                                   |         |           |         |
| Trust and investment services fee income                      | \$1,987                             | \$1,648 | \$ 339    | 20.6 %  | 3,884                             | 3,277   | \$ 607    | 18.5 %  |
| Gain on sale of SBA loans                                     | 274                                 | 535     | (261 )    | (48.8 ) | 543                               | 895     | (352 )    | (39.3 ) |
| Service charges on deposits                                   | 720                                 | 766     | (46 )     | (6.0 )  | 1,504                             | 1,531   | (27 )     | (1.8 )  |
| Loan fees   | 389                                 | 675     | (286 )    | (42.4 ) | 917                               | 1,133   | (216 )    | (19.1 ) |
| Increase in cash surrender value of bank-owned life insurance | 297                                 | 316     | (19 )     | (6.0 )  | 589                               | 627     | (38 )     | (6.1 )  |
| Commercial loan swap fees                                     | 70                                  | 250     | (180 )    | (72.0 ) | 703                               | 449     | 254       | 56.6    |
| Other non-interest income                                     | 245                                 | 548     | (303 )    | (55.3 ) | 508                               | 889     | (381 )    | (42.9 ) |
| Total non-interest income                                     | \$3,982                             | \$4,738 | \$ (756 ) | (16.0 ) | \$8,648                           | \$8,801 | \$ (153 ) | (1.7 )  |
| Fee income ratio <sup>(1)</sup>                               | 19.0 %                              | 23.4 %  |           |         | 20.7 %                            | 22.5 %  |           |         |

(1) Fee income ratio is non-interest income divided by top line revenue (defined as net interest income plus non-interest income).

Trust and investment services fee income increased \$339,000, or 20.6%, and \$607,000, or 18.5%, to a record \$2.0 million and \$3.9 million for the three and six months ended June 30, 2018, respectively, compared to \$1.6 million and \$3.3 million for the three and six months ended June 30, 2017. This increase was driven by growth in assets under management and administration attributable to both new client relationships and increased equity market values throughout 2017. At June 30, 2018, there were a record \$1.465 billion of trust assets under management compared to \$1.164 billion at June 30, 2017. Assets under administration were \$180.3 million at June 30, 2018 compared to \$173.9 million at June 30, 2017.

Gains on sale of SBA loans for the three and six months ended June 30, 2018 totaled \$274,000 and \$543,000, respectively, a decrease of \$261,000, or 48.8%, and \$352,000, or 39.3%, from the same periods in 2017. We believe we now have a solid SBA infrastructure and production team in place. The SBA pipeline of approved loans continues to grow, however, gains on the sale of SBA loans may be a source of volatility based on the uncertain timing of loan closings and fundings from a platform in the early stages of growth.

Loan fees decreased \$286,000, or 42.4%, and \$216,000, or 19.1%, to \$389,000 and \$917,000 for the three and six months ended June 30, 2018, respectively, compared to \$675,000 and \$1.1 million for the three and six months ended June 30, 2017, respectively. The decrease in both periods of comparison is principally due to elevated miscellaneous asset-based lending fees in 2017 related to loan prepayments and a reduction in asset-based lending audit fee income. Commercial loan swap fee income was \$70,000 and \$703,000 for the three and six months ended June 30, 2018, respectively, compared to \$250,000 and \$449,000 for the three and six months ended June 30, 2017, respectively. We believe due to the market's assumption of a rising interest rate environment we could see additional demand for these types of opportunities throughout the remainder of 2018.

Other non-interest income decreased for both the three and six months ended June 30, 2018 primarily due to a \$212,000 allocation of net income from an equity investment received during the second quarter of 2017.

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## Comparison of Non-Interest Expense for the Three and Six Months Ended June 30, 2018 and 2017

## Non-Interest Expense

The components of non-interest expense were as follows for the three and six months ended June 30, 2018 and 2017:

|   | For the Three Months Ended June 30, |          |              |             | For the Six Months Ended June 30, |          |              |             |
|---|-------------------------------------|----------|--------------|-------------|-----------------------------------|----------|--------------|-------------|
|   | 2018                                | 2017     | \$<br>Change | %<br>Change | 2018                              | 2017     | \$<br>Change | %<br>Change |
|   | (Dollars in Thousands)              |          |              |             |                                   |          |              |             |
| Compensation                                    | \$9,116                             | \$8,382  | \$ 734       | 8.8 %       | \$18,187                          | \$17,065 | \$1,122      | 6.6 %       |
| Occupancy                                       | 544                                 | 519      | 25           | 4.8         | 1,073                             | 994      | 79           | 7.9         |
| Professional fees                               | 928                                 | 1,041    | (113 )       | (10.9 )     | 1,963                             | 2,051    | (88 )        | (4.3 )      |
| Data processing                                 | 626                                 | 635      | (9 )         | (1.4 )      | 1,236                             | 1,219    | 17           | 1.4         |
| Marketing                                       | 591                                 | 582      | 9            | 1.5         | 925                               | 952      | (27 )        | (2.8 )      |
| Equipment                                       | 343                                 | 300      | 43           | 14.3        | 686                               | 583      | 103          | 17.7        |
| Computer software                               | 679                                 | 639      | 40           | 6.3         | 1,420                             | 1,322    | 98           | 7.4         |
| FDIC insurance                                  | 369                                 | 381      | (12 )        | (3.1 )      | 668                               | 761      | (93 )        | (12.2 )     |
| Collateral liquidation costs                    | 222                                 | 77       | 145          | 188.3       | 223                               | 185      | 38           | 20.5        |
| Impairment on tax credit investments            | 329                                 | 112      | 217          | 193.8       | 442                               | 225      | 217          | 96.4        |
| SBA recourse provision (benefit)                | 99                                  | 774      | (675 )       | (87.2 )     | (196 )                            | 780      | (976 )       | (125.1)     |
| Other non-interest expense                      | 621                                 | 779      | (158 )       | (20.3 )     | 1,747                             | 1,644    | 103          | 6.3         |
| Total non-interest expense                      | \$14,467                            | \$14,221 | \$ 246       | 1.7         | \$28,374                          | \$27,781 | \$593        | 2.1         |
| Total operating expense <sup>(1)</sup>          | \$14,027                            | \$13,220 |              |             | \$28,104                          | \$26,647 |              |             |
| Compensation expense to total operating expense | 64.99 %                             | 63.40 %  |              |             | 64.71 %                           | 64.04 %  |              |             |
| Full-time equivalent employees                  | 265                                 | 250      |              |             | 265                               | 250      |              |             |

(1) Total operating expense represents total non-interest expense, adjusted to exclude the impact of discrete items as previously defined in the non-GAAP efficiency ratio calculation, above.

Non-interest expense for the three months ended June 30, 2018 increased by \$246,000, or 1.7%, to \$14.5 million compared to \$14.2 million for the same period in 2017. During the second quarter of 2018, in accordance with the applicable accounting guidance, the Corporation recognized \$217,000 in nonrecurring tax credit investment impairment expense, which corresponded with a net tax benefit of \$245,000 recognized during the quarter. Excluding the impairment impact of the tax credit investment, second quarter 2018 non-interest expense increased \$29,000. This moderate increase was primarily due to increases in compensation and collateral liquidation costs, partially offset by a decrease in SBA recourse provision.

Compensation expense increased by \$734,000, or 8.8%, to \$9.1 million for the three months ended June 30, 2018 from \$8.4 million for the three months ended June 30, 2017. The overall increase reflected growth related to annual merit increases, as well as the addition of several new producers across multiple business lines, including commercial lending, SBA lending, equipment finance and wealth management. We expect to continue to opportunistically invest in talent to support our strategic growth efforts, both in the form of additional production and operational staff.

Collateral liquidation costs for the three months ended June 30, 2018 increased \$145,000 to \$222,000 compared to \$77,000 for the same period in 2017. The increase primarily reflected the Corporation's workout expenses related to two non-accrual loans.

SBA recourse provision decreased \$675,000 to \$99,000 for the three months ended June 30, 2018, compared to \$774,000 for the three months ended June 30, 2017. The decrease was primarily due to continued amortization of the legacy SBA portfolio. As of June 30, 2018, the total outstanding balance of SBA loans sold prior to 2017 was \$68.5 million, of which \$10.9 million were impaired, down from outstanding balances of \$84.3 million and \$101.6 million

as of December 31, 2017 and December 31, 2016, respectively.

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Non-interest expense for the six months ended June 30, 2018 increased by \$593,000, or 2.1%, to \$28.4 million compared to \$27.8 million for the same period in 2017. Excluding the aforementioned tax credit investment impairment, non-interest expense increased \$376,000. The increase in non-interest expense was primarily due to an increase in compensation expense, partially offset by a decrease in SBA recourse provision. The drivers of these variances are consistent with the explanations discussed above for the three months ended June 30, 2018.

Expense management and strategic investments are critical components of our growth strategy and our culture, from our limited branch network and unique funding model, to our investments in talent and technology. We are diligently managing our operating costs to align with revenue expectations while continuing to make investments that enhance our business and our ability to serve current and prospective clients.

### Income Taxes

Income tax expense was \$1.4 million for the six months ended June 30, 2018, with an effective tax rate of 16.9%, compared to income tax expense of \$1.9 million for the six months ended June 30, 2017, with an effective tax rate of 26.2%. The lower income tax expense and effective rate primarily reflect the reduction to the corporate federal income tax rate from 35% to 21%, effective January 1, 2018. The Corporation also recognized a state historic tax credit during the second quarter of 2018, which reduced income tax expense by \$245,000.

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. 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

Total assets increased by \$105.7 million, or 5.9%, to \$1.900 billion as of June 30, 2018 compared to \$1.794 billion at December 31, 2017. The increase in total assets was primarily driven by growth in our loan and lease portfolio.

#### Short-Term Investments

Short-term investments decreased by \$11.1 million, or 31.3%, to \$24.4 million at June 30, 2018 from \$35.5 million at December 31, 2017. Our short-term investments primarily consist of interest-bearing deposits held at the FRB and commercial paper. We value the safety and soundness provided by the FRB and therefore incorporate short-term investments in our on-balance-sheet liquidity program. As of June 30, 2018, our total investment in commercial paper was \$4.7 million as compared to \$17.4 million at December 31, 2017. We approach our decisions to purchase commercial paper with similar rigor and underwriting standards as applied to our loan and lease portfolio. The original maturities of the commercial paper are usually 60 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 and lease growth when opportunities are presented and the level of our securities portfolio. Please refer to the section entitled Liquidity and Capital Resources for further discussion.

#### Securities

Total securities, including available-for-sale and held-to-maturity, increased by \$12.6 million, or 7.7%, to \$176.4 million at June 30, 2018 compared to \$163.8 million at December 31, 2017. During the six months ended June 30, 2018, we recognized unrealized losses of \$1.9 million before income taxes through other comprehensive income. As of June 30, 2018 and December 31, 2017, our overall securities portfolio, including available-for-sale securities and held-to-maturity securities, had an estimated weighted average expected maturity of 3.85 and 3.74 years, respectively. Generally, our investment philosophy remains as stated in our most recent Annual Report on Form 10-K.

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, data integrity validation primarily through comparison of current price to an expectation-based analysis of movement in

prices based upon

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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 June 30, 2018.

No securities were sold during the six months ended June 30, 2018.

#### Loans and Leases Receivable

Loans and leases receivable, net of allowance for loan and lease losses, increased by \$91.2 million, or 6.1%, to \$1.574 billion at June 30, 2018 from \$1.483 billion at December 31, 2017. As of June 30, 2018, construction loans were the largest contributor to loan growth increasing \$62.9 million to \$188.0 million from \$125.2 million at December 31, 2017. There continues to be a concentration in commercial real estate (“CRE”) loans, however, in general our composition of total loans and leases has remained relatively consistent due to balanced growth across our product offerings. CRE loans represented 68.1% and 67.7% of our total loans as of June 30, 2018 and December 31, 2017, respectively. As of June 30, 2018, approximately 18% of the CRE loans were owner-occupied CRE. We consider owner-occupied CRE more characteristic of the Corporation’s commercial and industrial (“C&I”) portfolio as, in general, the client’s primary source of repayment is the cash flow from the operating entity occupying the commercial real estate property.

Our C&I portfolio increased \$18.5 million, or 4.3%, to \$447.5 million at June 30, 2018 from \$429.0 million at December 31, 2017 primarily driven by asset-based loan growth of \$19.8 million. We will continue to emphasize actively pursuing C&I loans across the Corporation as this segment of our loan and lease portfolio provides an attractive yield commensurate with an appropriate level of credit risk and creates opportunities for in-market deposit, treasury management and trust and investment relationships which generate additional fee revenue.

While we continue to experience significant competition as banks operating in our primary geographic areas attempt to deploy liquidity, we remain committed to our underwriting standards and will not deviate from those standards for the sole purpose of growing our loan and lease portfolio. We continue to expect our new loan and lease activity to be adequate to replace normal amortization and to continue to grow at a modest pace in future quarters. 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.

Non-accrual loans increased \$4.7 million, or 17.8%, to \$31.1 million at June 30, 2018, compared to \$26.4 million at December 31, 2017. The Corporation’s non-accrual loans as a percentage of total gross loans and leases measured 1.95% and 1.76% at June 30, 2018 and December 31, 2017, respectively. Likewise, the ratio of non-performing assets to total assets increased to 1.71% at June 30, 2018, compared to 1.53% at December 31, 2017. Please refer to the section entitled Asset Quality, below, for additional information.

#### Deposits

As of June 30, 2018, deposits decreased by \$56.6 million, or 4.1% to \$1.338 billion from \$1.394 billion at December 31, 2017. The decrease in deposits was primarily due to typical seasonality of our money market and non-interest bearing transaction accounts, in addition to the continued purposeful reduction in the level of wholesale deposits, which decreased by \$26.6 million, or 8.6%, to \$281.4 million at June 30, 2018 from \$308.0 million at December 31, 2017. These decreases were partially offset by an increase in the level of interest-bearing transaction accounts, which increased by \$54.4 million, or 25.0%, to \$272.1 million at June 30, 2018 from \$217.6 million at December 31, 2017 primarily related to successful efforts in attracting in-market deposits from municipality relationships throughout our markets. Deposit ending balances associated with in-market relationships will fluctuate based upon maturity of time deposits, client demands for the use of their cash and our ability to service and maintain existing and new client relationships.

Our strategic efforts continue to be focused on adding in-market deposit relationships. We measure the success of in-market deposit gathering efforts based on the number and average balances of our deposit accounts as compared to ending balances due to the volatility of some of our larger relationships. The Bank’s average in-market deposits, consisting of all transaction accounts, money market accounts and non-wholesale deposits, were approximately \$1.091 billion, or 66.1% of total bank funding for the six months ended June 30, 2018. Total bank funding is defined as total deposits plus FHLB advances. This compares to in-market deposits of \$1.103 billion, or 70.5% of total funding for the same period in 2017. As average in-market deposit balances remained relatively stable between the periods of comparison, the decrease in the funding ratio was due to increased FHLB advances to support strong

current year loan growth.

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## FHLB Advances and Other Borrowings

As of June 30, 2018, FHLB advances and other borrowings increased by \$157.5 million, or 75.8%, to \$365.4 million from \$207.9 million at December 31, 2017.

Consistent with our funding philosophy to manage risk and use the most efficient and cost effective source of wholesale funds, we expect the balance of FHLB advances to increase in future periods as we continue to reduce our brokered certificate of deposit portfolio to help reduce the increase in our FDIC insurance assessment rate resulting from the FDIC's revised methodology made effective July 1, 2016. Our operating range of bank wholesale funds to total bank funding is 30%-40%. Wholesale funds include brokered certificates of deposit, deposits gathered from internet listing services and FHLB advances. As of June 30, 2018, the ratio of end of period bank wholesale funds to end of period total bank funds was 37.1%. Refer to the section entitled Liquidity and Capital Resources, below, for further information regarding our use and monitoring of wholesale funds.

## Asset Quality

## Impaired Assets

Total impaired assets consisted of the following at June 30, 2018 and December 31, 2017, respectively:

|   | June 30,<br>2018       | December 31,<br>2017 |       |   |
|---|------------------------|----------------------|-------|---|
|   | (Dollars in Thousands) |                      |       |   |
| Non-accrual loans and leases  |                        |                      |       |   |
| Commercial real estate:   |                        |                      |       |   |
| Commercial real estate - owner occupied   | \$9,994                | \$ 7,021             |       |   |
| Commercial real estate - non-owner occupied   | 31                     | 34                   |       |   |
| Land development  | 2,311                  | 2,626                |       |   |
| Construction  | 1,879                  | 2,872                |       |   |
| Multi-family  | —                      | —                    |       |   |
| 1-4 family  | 569                    | 1,161                |       |   |
| Total non-accrual commercial real estate  | 14,784                 | 13,714               |       |   |
| Commercial and industrial   | 15,954                 | 12,321               |       |   |
| Direct financing leases, net  | —                      | —                    |       |   |
| Consumer and other:   |                        |                      |       |   |
| Home equity and second mortgages  | —                      | —                    |       |   |
| Other   | 353                    | 354                  |       |   |
| Total non-accrual consumer and other loans  | 353                    | 354                  |       |   |
| Total non-accrual loans and leases  | 31,091                 | 26,389               |       |   |
| Foreclosed properties, net  | 1,484                  | 1,069                |       |   |
| Total non-performing assets   | 32,575                 | 27,458               |       |   |
| Performing troubled debt restructurings   | 249                    | 332                  |       |   |
| Total impaired assets   | \$32,824               | \$ 27,790            |       |   |
| Total non-accrual loans and leases to gross loans and leases                          | 1.95                   | %                    | 1.76  | % |
| Total non-performing assets to gross loans and leases plus foreclosed properties, net | 2.04                   |                      | 1.83  |   |
| Total non-performing assets to total assets   | 1.71                   |                      | 1.53  |   |
| Allowance for loan and lease losses to gross loans and leases                         | 1.31                   |                      | 1.25  |   |
| Allowance for loan and lease losses to non-accrual loans and leases                   | 67.32                  |                      | 71.10 |   |

As of June 30, 2018 and December 31, 2017, \$8.4 million and \$8.8 million of non-accrual loans and leases were considered troubled debt restructurings, respectively.

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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. Non-performing assets increased \$5.1 million, or 18.6%, to \$32.6 million at June 30, 2018 from \$27.5 million at December 31, 2017. The increase reflected a \$9.1 million asset-based loan that was moved to impaired status during the second quarter, which due to its collateral position did not require a specific reserve or charge-off at June 30, 2018. Non-performing assets also increased approximately \$2.7 million from two legacy SBA loan relationships that migrated to impaired during the second quarter. These second quarter increases were partially offset by a \$5.9 million decrease in non-performing assets during the first quarter of 2018, which reflected the full payoff of a \$2.8 million asset-based loan and net charge-offs related to three legacy SBA loan relationships that were previously identified as impaired.

We also monitor early stage delinquencies to assist in the identification of potential future problems. As of June 30, 2018, 98.7% of the loan and lease portfolio was in a current payment status, unchanged from December 31, 2017. We also monitor our asset quality through our established credit quality indicator categories. As we continue to actively monitor the credit quality of our loan and lease portfolios, 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 work proactively with our impaired loan borrowers to find solutions to difficult situations that are in the best interests of the Bank.

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

|  | As of and for the<br>Six Months<br>Ended June 30, |          | As of and<br>for the<br>Year<br>Ended<br>December<br>31,<br>2017 |
|--|---|----------|--|
|  | 2018  | 2017     |  |
|  | (In Thousands)                                    |          |  |
| Impaired loans and leases with no impairment reserves required             | \$18,866  | \$19,658 | \$16,975   |
| Impaired loans and leases with impairment reserves required                | 12,474  | 18,206   | 9,746  |
| Total impaired loans and leases  | 31,340  | 37,864   | 26,721   |
| Less: Impairment reserve (included in allowance for loan and lease losses) | 4,707   | 7,586    | 4,491  |
| Net impaired loans and leases  | \$26,633  | \$30,278 | \$22,230   |
| Average impaired loans and leases  | \$24,378  | \$33,345 | \$33,164   |
| Foregone interest income attributable to impaired loans and leases         | \$1,488   | \$1,362  | \$2,695  |
| Less: Interest income recognized on impaired loans and leases              | 414   | —        | 454  |
| Net foregone interest income on impaired loans and leases                  | \$1,074   | \$1,362  | \$2,241  |

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, 2017 | \$1,069 |
| Loans transferred to foreclosed properties    | 415     |
| Foreclosed properties as of June 30, 2018     | \$1,484 |

#### Allowance for Loan and Lease Losses

The allowance for loan and lease losses increased \$2.2 million from \$18.8 million as of December 31, 2017 to \$20.9 million as of June 30, 2018. The allowance for loan and lease losses as a percentage of gross loans and leases also increased from 1.25% as of December 31, 2017 to 1.31% as of June 30, 2018. 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.



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During the three months ended June 30, 2018, we recorded net charge-offs on impaired loans and leases of approximately \$285,000, or 0.07% of average loans and leases annualized, comprised of \$306,000 of charge-offs and \$21,000 of recoveries. During the three months ended June 30, 2017, we recorded net charge-offs on impaired loans and leases of approximately \$3.6 million, or 0.99% of average loans and leases annualized, comprised of \$3.8 million of charge-offs and \$112,000 of recoveries.

During the six months ended June 30, 2018, we recorded net charge-offs on impaired loans and leases of approximately \$2.9 million, or 0.37% of average loans and leases annualized, comprised of \$3.0 million of charge-offs and \$105,000 of recoveries. During the six months ended June 30, 2017, we recorded net charge-offs on impaired loans and leases of approximately \$3.5 million, or 0.47% of average loans and leases annualized, comprised of \$4.0 million of charge-offs and \$503,000 of recoveries.

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. Based upon the application of our methodology for estimating the appropriate level of allowance for loan and lease loss reserves, 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 \$20.9 million, or 1.31% of total loans and leases, was appropriate as of June 30, 2018. Given ongoing complexities with current workout situations, 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 the 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.

As of June 30, 2018 and December 31, 2017, our allowance for loan and lease losses to total non-accrual loans and leases was 67.32% and 71.10%, respectively. Non-accrual 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-accrual 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 that we will not recover the entire amount of our principal. This practice may lead to a lower allowance for loan and lease losses to non-accrual loans and leases ratio as compared to our peers or industry expectations. Our allowance for loan and lease losses 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 rise as we continue to grow our loan and lease portfolio. Conversely, if we identify additional impaired loans or leases 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 was appropriate for the probable incurred losses inherent in our loan and lease portfolio as of June 30, 2018.



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

|   | As of and for the<br>Three Months Ended<br>June 30, |          | As of and for the Six<br>Months Ended June |          |   |
|---|---|----------|--|----------|---|
|   | 2018  | 2017     | 2018                                       | 2017     |   |
|   | (Dollars in Thousands)                              |          |  |          |   |
| Allowance at beginning of period                                    | \$18,638  | \$21,666 | \$18,763                                   | \$20,912 |   |
| Charge-offs:  |   |          |  |          |   |
| Commercial real estate:   |   |          |  |          |   |
| Commercial real estate — owner occupied                             | —   | —        | (1,299 )                                   | (9 )     |   |
| Commercial real estate — non-owner occupied                         | —   | (22 )    | —  | (80 )    |   |
| Construction and land development                                   | (121 )  | —        | (992 )                                     | —        |   |
| Multi-family  | —   | —        | —  | —        |   |
| 1-4 family  | —   | (29 )    | (5 )                                       | (29 )    |   |
| Commercial and industrial   | (168 )  | (3,706 ) | (657 )                                     | (3,761 ) |   |
| Direct financing leases   | —   | —        | —  | —        |   |
| Consumer and other:   |   |          |  |          |   |
| Home equity and second mortgages                                    | —   | —        | —  | —        |   |
| Other   | (17 )   | —        | (37 )                                      | (87 )    |   |
| Total charge-offs   | (306 )  | (3,757 ) | (2,990 )                                   | (3,966 ) |   |
| Recoveries:   |   |          |  |          |   |
| Commercial real estate:   |   |          |  |          |   |
| Commercial real estate — owner occupied                             | 1   | 41       | 2  | 42       |   |
| Commercial real estate — non-owner occupied                         | 1   | 1        | 1  | 1        |   |
| Construction and land development                                   | —   | 1        | —  | 102      |   |
| Multi-family  | —   | —        | —  | —        |   |
| 1-4 family  | —   | 3        | 12   | 5        |   |
| Commercial and industrial   | 17  | 66       | 18   | 312      |   |
| Direct financing leases   | —   | —        | 1  | —        |   |
| Consumer and other:   |   |          |  |          |   |
| Home equity and second mortgages                                    | 2   | —        | 71   | 1        |   |
| Other   | —   | —        | —  | 40       |   |
| Total recoveries  | 21  | 112      | 105  | 503      |   |
| Net charge-offs   | (285 )  | (3,645 ) | (2,885 )                                   | (3,463 ) |   |
| Provision for loan and lease losses                                 | 2,579   | 3,656    | 5,054                                      | 4,228    |   |
| Allowance at end of period  | \$20,932  | \$21,677 | \$20,932                                   | \$21,677 |   |
| Annualized net charge-offs as a % of average gross loans and leases | 0.07  | % 0.99   | % 0.37                                     | % 0.47   | % |

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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 Bank. While the Bank is subject to certain generally applicable regulatory limitations regarding its 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 June 30, 2018 were the interest payments due on subordinated and junior subordinated notes. On July 25, 2018, the Bank's Board of Directors declared a dividend in the amount of \$2.5 million bringing year-to-date dividend declarations to \$7.5 million. The capital ratios of the Corporation and its subsidiary continue to meet all applicable regulatory capital adequacy requirements. The Corporation's and the Bank's 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 Bank maintains liquidity by obtaining funds from several sources. The Bank's 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.

On-balance-sheet liquidity is 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 June 30, 2018 and December 31, 2017, our immediate on-balance-sheet liquidity was \$271.5 million and \$401.1 million, respectively. At June 30, 2018 and December 31, 2017, the Bank had \$19.3 million and \$17.7 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 bank wholesale funding or invest in securities to maintain adequate liquidity at an improved margin. The decline in on-balance-sheet liquidity is primarily attributable to the increased use of FHLB advances.

We had \$622.4 million of outstanding wholesale funds at June 30, 2018, compared to \$491.5 million of wholesale funds as of December 31, 2017, which represented 37.1% and 31.1%, respectively, of ending balance total bank funding. Wholesale funds include brokered certificates of deposit, deposits gathered from internet listing services and FHLB advances. Total bank funding is defined as total deposits plus FHLB advances. We are committed to raising in-market deposits while maintaining our overall target mix of wholesale funds and in-market deposits. Wholesale funds continue to be an efficient and cost effective source of funding for the Bank and allows it 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 and borrowings 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 funds 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 funds in an orderly manner, we will use short-term FHLB advances to meet our temporary funding needs. The short-term FHLB 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 funds 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 funds 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) and FHLB advances with contractual maturity terms and no call provisions. The Bank limits the percentage

of wholesale funds to total bank funds in accordance with liquidity policies approved by its Board of Directors. The Corporation's overall operating range of wholesale funds to total bank funds is 30%-40%. The Bank was in compliance with policy limits as of June 30, 2018 and December 31, 2017.

The Bank was able to access the wholesale deposit market as needed at rates and terms comparable to market standards during the six month period ended June 30, 2018. In the event there is a disruption in the availability of wholesale deposits at maturity, the Bank has 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

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with the FRB and borrowings from the FHLB or Federal Reserve Discount Window utilizing currently unencumbered securities and acceptable loans as collateral. As of June 30, 2018, the available liquidity was in excess of the stated policy minimum. We believe the Bank will also have access to the unused federal funds lines, cash flows from borrower repayments and cash flows from security maturities. The Bank also has the ability to raise local market deposits by offering attractive rates to generate the level required to fulfill their liquidity needs.

The Bank is required by federal regulation to maintain sufficient liquidity to ensure safe and sound operations. We believe the Bank has 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 six months ended June 30, 2018, operating activities resulted in a net cash inflow of \$11.0 million, which included net income of \$6.9 million. Net cash used in investing activities for the six months ended June 30, 2018 was approximately \$116.2 million which consisted of cash outflows to fund net loan growth and reinvestment of cash flows within purchases of additional securities, partially 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 six months ended June 30, 2018 was \$98.5 million primarily due to a net increase in FHLB advances, partially offset by a decrease in deposits. Please refer to the Consolidated Statements of Cash Flows included in PART I. Item 1. for further details regarding significant sources of cash flow for the Corporation.

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

As of June 30, 2018, there were no material 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, 2017. 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

Our primary market risk is interest rate risk, which arises from exposure of our financial position to changes in interest rates. It is our strategy to reduce the impact of interest rate risk on net interest margin by maintaining a favorable match between the maturities and repricing dates of interest-earning assets and interest-bearing liabilities. This strategy is monitored by the Bank's Asset/Liability Management Committee, in accordance with policies approved by the Bank's Board. This committee meets regularly to review the sensitivity of the 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 parallel, instantaneous and sustained change in interest rates. Key assumptions include:

- the behavior of interest rates and pricing spreads;
- the changes in product balances; and
- the behavior of loan and deposit clients in different rate environments.

This analysis incorporates several assumptions, the most material of which relate to the re-pricing characteristics and balance fluctuations of deposits with indeterminate or non-contractual maturities, and is measured as a percentage change in net interest income for the next 12 months due to instantaneous movements in benchmark interest rates from a baseline scenario. Estimated changes are dependent upon material assumptions such as those previously discussed.

The earnings simulation analysis does not incorporate any management actions that may be used to mitigate negative consequences of actual interest rate movement. For that reason and others, they do not reflect the likely actual results but serve as conservative estimates of interest rate risk. The simulation analysis is not comparable to actual results or directly predictive of future values of other measures provided.

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. Our success in attracting in-market deposits adds to the interest rate liability sensitivity of the organization.

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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. Wholesale certificates of deposit and FHLB advances are a significant source of our funding and we use a variety of maturities to augment our management of interest rate exposure. 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 these assumptions to be reasonable, although the actual amortization and repayment of assets and liabilities may vary substantially. Our economic sensitivity to changes in interest rates at June 30, 2018 has not changed materially since December 31, 2017.

### 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 June 30, 2018.

#### 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 June 30, 2018 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 Annual Report on Form 10-K for the year ended December 31, 2017.

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

(a) None.

(b) Not applicable.

(c) None.

### 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 June 30, 2018, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets as of June 30, 2018 and December 31, 2017, (ii) Consolidated Statements of Income for the three and six months ended June 30, 2018 and 2017, (iii) Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2018 and 2017, (iv) Consolidated Statements of Changes in Stockholders' Equity for the six months ended June 30, 2018 and 2017, (v) Consolidated Statements of Cash Flows for the six months ended June 30, 2018 and 2017, 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.

July 27, 2018 /s/ Corey A. Chambas  
Corey A. Chambas  
Chief Executive Officer

July 27, 2018 /s/ Edward G. Sloane, Jr.  
Edward G. Sloane, Jr.  
Chief Financial Officer  
(principal financial officer)